SMALL BUSINESS TAX REFORM

JOINT HEARINGS

BEFORE THE

SELECT COMMITTEE ON SMALL BUSINESS

AND THE

SUBCOMMITTEE ON FINANCIAL MARKETS

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

FIRST SESSION

ON

STUDY OF THE BUSINESS TAX STRUCTURE AS IT AFFECTS SMALL BUSINESS

JUNE 17, 18, AND 19, 1975

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CONTENTS

Statement of Senators— Page

Bentsen, Hon. Lloyd, a U.S. Senator from the State of Texas........ 2, 339
Clark, Hon. Dick, a U.S. Senator from the State of Iowa............ 166
Dole, Hon. Robert, a U.S. Senator from the State of Kansas......... 4
McIntyre, Hon. Thomas J., a U.S. Senator from the State of New Hampshire........ 167
Nelson, Hon. Gaylord, a U.S. Senator from the State of Wisconsin........ 3, 188, 339

Appearance of—

Bixler, Roland M., president, J-B-T Instruments, Inc., chairman, Task Force on Small Business Tax Policy, National Association of Manufacturers........ 480
Dunkelberg, Dr. William C., consultant, National Federation of Independent Business........ 188
Eisner, Robert, William R. Kenan professor and chairman, Department of Economics, Northwestern University, Evanston, Ill........ 5
Fielding, Bruce G., certified public accountant, secretary, board of directors, National Federation of Independent Business........ 168
Hanschen, Richard J., partner, New Business Resources—Venture Capital Partnership, Dallas, Tex........ 443
Harwell, James H., executive director, Texas Industrial Commission. 65
Holt, Charles C., director, Inflation and Unemployment Research, the Urban Institute, Washington, D.C........ 48
Lewis, John, executive vice president, National Small Business Association........ 152
Liebenson, Herbert, vice president for government affairs, National Small Business Association........ 152
Massa, Cliff, director of taxation, National Association of Manufacturers........ 482
Mauer, Bruno J., president, Independent Business Association of Wisconsin........ 275
McKevitt, James D. Michael, Washington counsel, National Federation of Independent Business........ 168
Mendenhall, John, CPA and attorney, a member of the law firm of Williams, Connolly and Califano of Washington, D.C........ 152
Morgenthaler, David T., Morgenthaler Associates, a director of the National Capital Venture Association........ 430
Murray, Ralph W., vice president, Smaller Manufacturers Council.. 274
Noone, Charles M., general counsel, National Association of Small Business Investment Companies........ 370
Pendergast, Edward H., past president, Smaller Business Association of New England........ 238
Richard, Edward H., president, Magnetics International, Inc., and chairman, Council of Smaller Enterprises, Cleveland, Ohio........ 340
Rohde, Gilbert C., president, Wisconsin Farmers Union........ 468
Shils, Dr. Edward B., chairman, Department of Management and the Wharton Entrepreneurial Center, The Whorton School, University of Pennsylvania........ 215
Stults, Walter B., executive vice president, National Association of Small Business Investment Companies........ 370
Ward, Oliver O., president, Smaller Business Association of New England........ 231
Zucker, Dr. William, administrative director, Wharton Entrepreneurial Center, The Wharton School, University of Pennsylvania.. 215

Statements of—

	Page
Rubel, Stanley M., president, Capital Publishing Corp., and executive director, National Venture Capital Association	449
Schnitzer, Dr. Martin C., professor of business administration, and Dr. Monroe Murphy Bird, professor of marketing, Virginia Polytechnic Institute and State University	105

EXHIBITS

Article, "Ideas and Trends—A Hard Look at Corporate Taxes," by Robert Eisner, from Business Week, December 14, 1974	10
Article, "Business Investment Preferences," by Robert Eisner, reprinted from the George Washington Law Review, Vol. 42, No. 3, March 1974, pages 486-500	12
Article, "Tax Policy and Investment: An Analysis of Survey Responses," by Robert Eisner and Patrick J. Lawler, reprinted from the American Economic Review, Vol. LXV, No. 1, March 1975, pages 206-212	28
Article, "Tax Incentives for Investment," by Robert Eisner, from the National Tax Journal, Vol. XXVI, No. 3, September 1973, pages 397-401	36
Article, "Policy Proposals—Men and Machines and Taxes," by Robert Eisner, from Social Policy, September/October 1973, pages 44-45	42
Economic impact analysis summary sheet of the Texas Industrial Commission, September 1, 1973 to August 31, 1974	72
Official policy statement of the Texas Industrial Commission, adopted December 17, 1974	96
Letter dated July 14, 1975, to Senator Jacob K. Javits, Member, Senate Select Committee on Small Business, from Robert Eisner, William R. Kenan Professor, Northwestern University, with accompanying statement	121
Supplementary statement by Charles C. Holt entitled "Research Assistance to Small Business"	134
Statement, "Unemployment, Inflation, and Structural Reform," by Charles C. Holt, director, Inflation and Unemployment Research, The Urban Institute, before the Economic Growth Subcommittee, Joint Economic Committee, U.S. Congress, June 3, 1975	140
Chart, annual rates of profit on stockholders' equity by asset size—before taxes, 1952-1974, prepared by the National Small Business Association (facing page)	164
Table, the average company income statement covering a 6-year period	177
Table, the average company balance sheet	178
Table, the average company income statement seventh year	179
Table, the average company balance sheet	180
Press release dated June 18, 1975, from the National Federation of Independent Business	183
Background statement on the tax reform position of the National Federation of Independent Business presented by Bruce G. Fielding, CPA, NFIB Director	185
National Federation of Independent Business 1975 tax reform proposals	206
Excerpt from the Internal Revenue Code, Section 11, before amendment by the Tax Reduction Act of 1975	252
Table, history of income tax on corporations, 1936-1974	254
Table, number of firms by size of receipts and business form, 1970	255
Table, business receipts by size and business form, 1970	256
Table, Smaller Business Association of New England effects of various approaches to reduction in corporate tax rates, February 24, 1975	257
Statements on Domestic International Sales Corporations, Subchapter S, and Depreciation, by the Smaller Manufacturers Council	265
Article, "Columbia Cuts Industries' Gas During Winter," by Richard F. Fontana, from the Pittsburgh Post-Gazette, May 17, 1975	273
Booklet, "What new jobs mean to a community," prepared by Economic Analysis and Study, Chamber of Commerce of the United States, 1973	281
Booklet, "Tax Reform for Small Business—1975," a Washington presentation of small business associations (Smaller Business Association of New England, Independent Business Association of Wisconsin, Smaller Manufacturers Council, and Council of Smaller Enterprises), 1975	302

	Page
Article, "A Capital Idea," by E. Douglas Kenna, president, National Association of Manufactuers, from Conference Board, May 19, 1975	326
Article, "Peter and Paul," from Newsweek magazine, June 9, 1975, page 26	336
Article, "Feature—Evaluating SBIC Performance," from the SBIC Digest, May 1975, pages 13–18	392
Section-by-section analysis of the SBIC tax bill and actual language of National Association of Small Business Investment Companies proposals	398
Editorial, "Competition Makes a Boom," from Business Week, April 20, 1974, page 124	438
Proposal of the National Capital Venture Association entitled "Incentive Stock Option Proposal," with accompanying memorandum of detailed explanation	439
Membership roster of the National Venture Capital Association	464
Report, "Tax Impact Project Report," prepared by the Fiscal and Economic Policy Department, National Association of Manufacturers, June 16, 1975	488

APPENDIXES

I.	Notice of hearings on small business tax reform by Senator Gaylord Nelson, Chairman, Select Committee on Small Business, U.S. Senate, from the Congressional Record, June 12, 1975, pages S10459–S10460	537
II.	Statement of the National Milk Producers Federation with respect to tax and financial problems of small business, June 19, 1975	540
III.	Letter dated June 20, 1975, to William E. Woods, Washington representative and associate general counsel, National Association of Retail Druggists, from Senator Gaylord Nelson, Chairman, Select Committee on Small Business, U.S. Senate, with accompanying comments of the NARD	546
IV.	Charts, capital invested per employee, from The Conference Board's Road Maps of Industry, No. 1749, November 1, 1974	548
V.	Letter dated June 25, 1975, to Senator Gaylord Nelson, Chairman, Select Committee on Small Business, U.S. Senate, from Senator Bob Dole, Member, Committee on Finance, U.S. Senate	550
VI.	Study, "Social and Economic Consequences of the Merger Movement in Wisconsin," by Jon G. Udell, Graduate School of Business, University of Wisconsin	551
VII.	Letter dated May 22, 1975, to Senator Sam Nunn, Member, Select Committee on Small Business, U.S. Senate, from James G. Killough, attorney, McClain, Mellen, Bowling & Hickman	639
VIII.	Letter dated June 18, 1975, to Herbert L. Spira, associate general counsel, Senate Select Committee on Small Business, from Herbert Liebenson, staff vice president, governmental affairs, National Small Business Association, with accompanying NSBA supplemental statement	644
IX.	Letter dated July 11, 1975, to Herbert L. Spira, associate general counsel, Senate Select Committee on Small Business, from David M. Weiman, legislative assistant, National Farmers Union, with accompanying articles	652
X.	Article, "New Enterprise Generation," by Richard S. Morse, from the National Bureau of Standards Special Publication 388, Proceedings of the Conference on the Public Needs and the Role of the Inventor, June 11–14, 1973, Monterey, Calif. (issued May 1974)	663
XI.	Article, "The credit crunch moves down on the farm—a bad harvest this year could make it difficult for farmers to pay their debts," from Business Week, June 2, 1975, pages 38–39	670
XII.	Booklet, "Farm Real Estate Market Developments," published by the Economic Research Service, U.S. Department of Agriculture, Publication No. CD–79, July 1974, excerpts	672
XIII.	Letter dated July 17, 1975, to Senator Gaylord Nelson, Chairman, Senate Select Committee on Small Business, from James B. Swenson, Office of Federal Services, Price Waterhouse & Co., with accompanying statement	692

XIV. Letter dated July 23, 1975, to Senator Gaylord Nelson, Chairman, Select Committee on Small Business, U.S. Senate, from Nathaniel H. Rogg, executive vice president, National Association of Home Builders .... Page 701

HEARING DATES

June 17, 1975:
Morning session 1
June 18, 1975:
Morning session 165
June 19, 1975:
Morning session 339

SMALL BUSINESS TAX REFORM

TUESDAY JUNE 17, 1975

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
AND THE SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The committees met, pursuant to notice, at 9:40 a.m., in room 2221, Dirksen Senate Office Building, Senators Gaylord Nelson (chairman of the Select Committee on Small Business), and Lloyd Bentsen (chairman of the Subcommittee on Financial Markets of the Committee on Finance) presiding.

Present: Senators Nelson, Bentsen, Byrd, Clark, Javits, Brock, Dole, and Packwood.

Also present: William B. Cherkasky, staff director and Herbert L. Spira, tax counsel, Select Committee on Small Business; Richard R. Rivers and Michael Rowny, professional staff, Senate Finance Committee; David Allen, Office of Senator Bentsen; and Phillip Kawior, Office of Senator Brock.

Senator BENTSEN [presiding]. The hearing will come to order. I am very pleased to be here cochairing this with my distinguished colleague, the Senator from Wisconsin, Senator Nelson.

This morning the Senate Financial Markets Subcommittee and the Senate Small Business Committee, open the first in a series of joint hearings on the tax and financial problems currently facing our Nation's small businessmen.

I include the family farmers and the ranchers in this category.

Americans too often forget the indispensable role of small business in promoting healthy competition in our economy, creating jobs for a growing work force and developing innovative ideas and products. Small business, in many ways, is the essence of our country's promise. It has always been relatively easy for an American to go into business for himself; to become his own boss.

This has not only been good for the millions of individual Americans who have set up their own businesses, but it has been good for our economy and the country at large. This great diversity of ownership has spurred competition, helping keep prices down, helping to assure a wide variety of goods and services and helping bring strength and resilience to our free enterprise system.

In recent years, though, it has become more and more difficult for Americans to go into business for themselves, and for those already operating small businesses to keep their doors open or to resist urgings to sell out to the giant concerns.

Gentlemen, that is why you are here. I have a complete opening statement that I am going to insert in the record.
[The prepared statement of Senator Bentsen follows:]

STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM THE STATE OF TEXAS

This morning the Senate Financial Markets Subcommittee and the Senate Small Business Committee open the first in a series of joint hearings on the tax and financial problems currently facing our Nation's small business.

I include family farmers and ranchers in this category.

Americans too often forget the indispensable role of small business in promoting healthy competition in our economy, creating jobs for a growing work force and developing innovative ideas and products. Small business, in many ways, is the essence of our country's promise. It has always been relatively easy for an American to go into business for himself; to become his own boss.

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In recent years, though, it has become more and more difficult for Americans to go into business for themselves, and for those already operating small businesses to keep their doors open or to resist urgings to sell out to the giant concerns.

Inflation, recession and energy shortages are especially harmful to smaller enterprises. Tax laws and related paper work burdens impose a disproportionate burden on small business. Too often Government ignores the interests of the small businessman when it establishes tax policies or energy policies or other economic policies affecting this vital segment of our economy.

In recent years it has become particularly difficult for small businesses to raise the capital they need to expand or modernize or simply get off the ground.

Family farmers and ranchers, too, face a severe credit crunch. Since 1969 farm debt has increased 80 percent. In 1974, while net farm income dropped 37 percent, farm indebtedness increased about 25 percent. So it is important to review the financial needs of agricultural as well as commercial businesses.

The current economic climate and the difficulties it imposes on Americans seeking to open their own businesses, works to the detriment of each of us.

It deprives us of the benefits of new and better ideas. It stifles competition. It denies employment to millions of Americans who would be employed by small business. In short, it makes it increasingly difficult to spur the economic growth needed to end this recession and restore economic health.

The initiative of small inventors and enterprises led to the development of the photo-copying industry, of insulin, and cellophane, and air conditioning, and the cyclotron and other products and processes too numerous to list.

We can't afford to stifle this progress.

During these hearings we will be looking at the major problems facing small business—and once we identify the problems we will try to come up with some solutions.

We will be looking at possible tax reforms and how we can best encourage the development of small business through the tax system. As things stand now, tax laws and incentives are so complex that often only large corporations with specially trained lawyers can take advantage of them. For the small business, these laws mean only an added paperwork burden of forms and filings, documents and deadlines.

What we're talking about here, is a return to the climate of opportunity that has promoted broad-based economic growth in America since our beginning. Economic growth that is stable and vibrant. Economic growth that is not inflationary.

Economic growth that will keep prices down as it works to put eight and one half million unemployed Americans back to work.

I am convinced this can be done. I know it *must* be done. And during these small business hearings we will be working to see that it *is* done.

Senator BENTSEN. Mr. Chairman, would you care to make a comment.

Senator NELSON. Thank you, Senator Bentsen.

I also have an opening statement; but in order not to impose upon the witnesses' time, I will submit the statement for the record.

[The prepared statement of Senator Nelson follows:]

STATEMENT OF HON. GAYLORD NELSON, A U.S. SENATOR FROM THE STATE OF WISCONSIN

This morning's session begins three days of joint hearings of the Select Committee on Small Business and the Subcommittee on Financial Markets of the Senate Finance Committee, under the chairmanship of Senator Bentsen.

We hope to develop sound and balanced recommendations on small business tax provisions for inclusion in the omnibus tax reform legislation, upon which hearings will begin in the House Ways and Means Committee at the end of this month.

Over the past 20 years, since the Internal Revenue Code was last revised in 1954, the nation's tax laws have grown enormously in complexity. For example, the compact version of the Code is now 1½ inches thick and weighs almost 2½ pounds.

For any small, local, family, or independent business—and especially for the thousands of new businesses which are born each year—this tax statute, together with its related regulations, instructions, guidelines and forms, is a baffling and frustrating maze. Attempting to understand and comply with Federal, State, and local tax obligations constitutes a major drain on the time and productive energies of the nation's small enterprise.

As a result of this growing mountain of material—and of special provisions which large corporations can take full advantage of while small business cannot—the treatment of smaller business has become increasingly inequitable.

Although the statutory corporate tax rate is 48%, one out of every five big companies pay less than 43% and the largest 100 corporations consistently pay between 25 and 30%. In contrast, medium-sized companies which are trying to expand into effective competitors must often pay the full statutory 48%, and sometimes even more than half their income in taxes.

This sort of taxation discourages the formation and development of new businesses which have traditionally been America's best source of innovation, employment and economic growth. In other words, the tax laws are stifling economic expansion in the United States, which is especially noxious now that we are suffering the worst recession since the 1930's and unemployment of over 9%.

No one wanted it to be this way; it just happened. But our nation can no longer afford such inefficiency, and we must correct the situation for the sake of fair play as well as for the revival of our economy.

Of the nearly 13 million U.S. enterprises, small business accounts for:

About 97% of all businesses, by number;

52 to 53% of all private employment;

43% of all the business output in the country; and

About one-third of the entire gross national product.

Beyond those statistics, these enterprises carry with them not only the dreams of their owners, but the hopes of our country for better goods, services, and ideas at lower prices. We look to enterprising businesspeople to renew the reservoir of American ingenuity, to give our citizens productive and dignified employment, and to sharpen America's advantages in world competition.

However, over the years, the pressures on Congress have not really permitted an in-depth exploration of how the tax system affects the smaller and medium-sized independent business firm. Our Committee began to dig into the issues in February of this year, in connection with the emergency Tax Reduction Act of 1975.

The facts which we developed at that time assisted Congress in putting into that law the first rate reduction for smaller corporations in a decade and the first tax reduction for medium-sized corporations in 25 years. However, these provisions remain in effect for only one or two years.

As Congress now begins what may be the most searching overhaul of the Tax Code since 1954, we will be working to assure that the needs of smaller business for simplicity, clarity, and equitable treatment can be given appropriate consideration.

We feel a special responsibility in undertaking this study because there are nine members of the Senate Finance Committee involved—one-half of the membership of that vital committee. Six are also members of the Select Committee on Small Business. We have already agreed that three further days of public hearings will be held September 23 to 25 to implement this inquiry.

Our witnesses share this heavy burden, and we appreciate their willingness to turn their thoughts and efforts into this area of importance for the nation.

Our first subject will be the impact of business taxes upon employment and upon small businesses in generating employment.

Senator NELSON. Our hope out of these hearings is to develop a sound and balanced series of recommendations on small business tax provisions that we will be able to propose for inclusion in the omnibus tax reform legislation, upon which hearings will begin in the House Ways and Means Committee at the end of this month.

The committee is very pleased to have you gentlemen here this morning to present your testimony.

At about 5 minutes to 10 I must go to the Foreign Relations Committee to present some testimony on pending legislation there. This series of hearings will be jointly conducted by the Subcommittee on Financial Markets of the Finance Committee and the Select Committee on Small Business.

Before introducing the witnesses for this morning I would like to insert into the hearing record at this point a statement by Senator Robert Dole on the matter before us.

[The statement of Senator Dole follows:]

STATEMENT OF HON. ROBERT DOLE, A U.S. SENATOR FROM THE STATE OF KANSAS

Mr. Chairman, I am pleased that the Select Committee on Small Business and the Subcommittee on Financial Markets of the Committee on Finance have convened these joint hearings on the fiscal problems of small business in America. And I am especially pleased that the hearings include an inquiry into the special problems of an often forgotten sector of "small business"—the family farm and ranch.

For too long, the Congress has ignored the unique financial problems of the small business sector of our economy, focusing attention on larger enterprises instead. And by so doing, we have neglected over 11 million businesses, accounting for over 90 percent of all manufacturing, farming, wholesaling, retailing, and professional services in the United States.

Of particular interest to me as a farm State Senator is the severe financial situation created for family farming and ranching operations by the unreasonably low estate tax exemption—an outmoded provision of the Internal Revenue Code which threatens the very existence of the family farm in America. I have introduced legislation (S. 678 and S. 679) designed to correct this most unfair provision of our tax laws, and I am hopeful that we will move swiftly to enact realistic estate tax laws which will assure the continued existence of the family farm.

Fortunately, Congress has demonstrated some willingness to deal with the problems of small business during this session. Already, in the tax reduction Act, we increased the corporate surtax exemption to $50,000, lowered the tax bracket to 20% on the first $25,000 of corporate income, increased to $100,000 the amount of used property eligible for the investment tax credit, and increased the amount of the investment credit itself to 10 percent. These actions should be of particular benefit to small business. But, as presently constituted, they are temporary revisions, most of which expire at the end of the current year.

And therein lies a more fundamental problem for small business. For the small or medium sized farmer, rancher, or businessman does not have the time or money to keep to date with constantly changing laws. Thus, in planning his future capital needs, the small businessman is faced with an increasingly complex, ever-changing tax structure around which he must make a wise investment and operating decisions. The need for relatively simple, constant federal tax laws is, therefore, a major concern of small business.

Mr. Chairman, it is time for Congress to begin addressing itself to the problems and needs of that sector of our economy upon which fully half of the American people depend for support. Hopefully, today's joint hearings, along with the February hearings by the Select Committee on small business, signals a determination on the part of Congress to begin a thorough evaluation of the needs and problems of small businessmen and women.

Senator NELSON. Will you gentlemen proceed?

Would you gentlemen please identify yourselves so that the reporter will have an accurate record properly attributing your comments to the proper witnesses?

Mr. EISNER. Yes; I am Robert Eisner.

Mr. HOLT. I am Charles Holt.

Mr. HARWELL. I am Jim Harwell.

Senator NELSON. Mr. Eisner, you are chairman of the department of economics of Northwestern University?

Mr. EISNER. That is right, sir.

Senator NELSON. Mr. Holt, you are director of unemployment research at the Urban Institute?

Mr. HOLT. That is correct.

Senator NELSON. And James Harwell is executive director of Texas Industrial Commission.

Mr. HARWELL. Right, sir.

Senator NELSON. Gentlemen, we are very pleased to have you here this morning.

You may present your testimony however you desire—read it or submit it for the record and speak extemporaneously, however best suits your purposes.

If any one of you wishes to comment on any testimony of the other witnesses, please feel perfectly free to do so. I trust you will have no objections to interruptions for questions by Senator Bentsen or myself, or any other committee members who may be here.

Please go ahead.

STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR AND CHAIRMAN, DEPARTMENT OF ECONOMICS, NORTHWESTERN UNIVERSITY, EVANSTON, ILL.

Mr. EISNER. I am very happy to be here.

I will submit my statement for the record and make my remarks extemporaneously.

[The prepared statement and attachments of Mr. Eisner follow:]

STATEMENT BY ROBERT EISNER, WILLIAM R. KENAN PROFESSOR AND CHAIRMAN OF THE DEPARTMENT OF ECONOMICS, NORTHWESTERN UNIVERSITY, EVANSTON, ILL.

I am happy to have this opportunity to offer some introductory remarks on the indicated subject of "Employment, Taxes and Small Business." I shall add for the record a number of articles that I have written on related issues. I shall confine myself here largely to the enunciation of a few general but basic principles and a suggestion of their particular applicability to small business.

The principles relate to the essential nature of a free and competitive economy and the proper role of government intervention and the tax structure. Where proposals aimed at aiding small business are inconsistent with these principles, they suffer appropriate hazards in soliciting the support of an enlightened Congress or, worse, if they are adopted, they are likely to do more harm than good to the economy as a whole.

Basically, of course, we are faced by the usual stricture that there is no such thing as a free lunch; someone is paying for it. This must immediately be qualified by the judgment that if the lunch is already available, the act of eating it conveys no additional cost. That qualification is of major importance when the economy is in a recession as deep as the current one, with perhaps 15 to 20 percent of our resources idle. Using involuntarily idled resources of men or machinery does not impose a real cost in the sense of denying us other opportunities.

With over 9 percent unemployed, with industrial capacity unutilized in staggering proportions, almost any tax relief, "tax expenditures," or other direct government expenditures tend to create additional demand and increase production. That is hardly an argument for wasteful expenditures but even the classic canard of paying some workers to dig holes in the ground and others to fill them in again has the advantage of giving both groups income with which they can freely buy goods and services of some use. And then the producers of these goods and services can in turn spend the income they receive on other goods and services and the well known multiplier effect can give us a substantial expansion. Nevertheless, it would be better to accomplish the same results without the wasted effort of digging and then filling in holes in the ground. And in terms of long run tax policy, we should strive to use government to improve and not injure efforts to achieve optimal allocation of resources and maximum efficiency in production, consistent with a climate that enhances individual freedom of choice.

All this tells us that, as a first approximation, we should ask all businesses and individuals to pay for the government services that they receive. Beyond that we should try to correct for imperfect or inadequate functioning of markets. This may relate to imperfections which give undue advantage to one type of business or individual rather than another or to what economists refer to as "externalities," that is advantages or disadvantages, as a consequence of economic transactions, which are enjoyed by those who do not participate directly in those transactions. Thus an enterprise endeavoring to produce under competitive conditions may find it most economical to operate in a fashion that pollutes the environment, causing costs which are not taken into account by either producers of the product or its purchasers. Conversely, an employer giving a youth a decent job which leads to a constructive career may be saving society at large considerable costs in idleness, unrest and crime which would not be taken account of in the individual calculus of profit maximization.

Other than these two justifications for government intervention, market imperfections or externalities, there is a third possible justification, that we like to improve, by some socially accepted standard, on the distribution of income which would occur without the government intervention. Put bluntly, we wish to take from some and give to others. This does not increase the total pie but redistributes it in a way which we may consider to be more fair. An economist has no basis in principle for rejecting income redistribution, and many of us in terms of our own political views and senses of equity, favor such redistribution in one case or another. But if it is redistribution we are advocating, we should make clear it is just that and not try to confuse the public with arguments that such redistribution is good for "the Country," economic growth, prosperity or some other presumed national interest.

Getting down to the particular, diverting resources to increase investment, unless the resources were idle in the first place, means less consumption now. It may mean more consumption in the future than the sacrifice now, but that will be true only if the investment is sufficiently productive to offer surplus over and above its original cost. Diverting resources to business investment in plant and equipment means less for consumption or other business investment (such as inventories or research and development expenditures or job training), or less for investment in residential construction, or less for household investment in durable goods, or less for investment by non-profit institutions or government. Diverting resources to small business means less for large business. Where small business is less efficient than large business, diverting resources from large business to small business without influencing efficiency will reduce total output.

Warnings of this type from dismal economists cannot be ignored without peril to out national prosperity and perhaps ultimately to our national solvency. "Do-gooders," whether on behalf of presumably worthy charities or any particular economic interest, including that of small business, can do a great deal of harm if in the process of helping their special cause they shrink the total pie. There are certain areas where, in accordance with the basic principles enunciated above, government intervention in behalf of small business, via the tax structure or otherwise, may well be in order. I shall suggest some of these. In other instances, perhaps more important, existing government intervention is injuring small business inappropriately and unjustifiably from the standpoint of the economy as a whole. Such intervention should be eliminated. But in many instances proposed remedies, however well meaning, are bad for the economy, of questionable equity and possibly even productive of a negative backwash which would more than cancel out their presumed direct advantages to small business.

The major category of tax concessions to which I must object, tax concessions widely advocated by most business spokesmen and apparently many spokesmen for small business, relate to so-called incentives for capital expenditures. These include most directly the now increased (at least temporarily) equipment tax credit (frequently misnamed: "investment tax credit" or even "job development credit"), rapid or accelerated depreciation allowances which increase tax depreciation beyond economic depreciation or the true rate of decrease of capital values, and so-called liberalization of capital gains taxation. These various concessions, "tax preferences," or "tax expenditures" already in effect cost the Treasury well in excess of $30 billion per year. Their proposed extensions will increase this loss by many billions more. The resultant gains to the economy are largely, if not entirely, illusory and in any case far less than could be achieved by other measures with much lower alternative cost.

The equipment tax credit is a prototype of unjustified intervention in the economic system and distortion of economic processes. Ostensibly introduced to encourage investment, it actually relates only to business investment and to one portion of business investment at that, investment in eligible equipment. To the extent that it is successful in drawing real and financial resources into business expenditures on eligible equipment, it thus discourages other business investment, residential construction, and investment by households and government. It tends also to be pro-cyclical rather than counter-cyclical in its effects, offering more benefits to business in times of boom when equipment expenditures are high anyway and less benefit in times of recession when equipment expenditures are low and probably, indeed, less likely to be stimulated by relatively moderate tax advantages. It is also of doubtful efficacy. My own estimates and those of a number of other econometricians and economic analysts suggest that the tax loss to the Treasury from the equipment tax credit is considerably in excess of the amount of whatever additional investment it brings about.

From the standpoint of economic growth, the notion that tax gimmicks of this kind are desirable stimuli to economic growth by raising the rate of investment involves several unfortunate confusions. First, and too often ignored, there is a real question whether government has any business, at least in a society which with full employment can be as prosperous as ours can be, in stimulating economic growth, that is more tomorrow at the expense of having less today, than the people would choose by their free saving and investment decisions in the market. But second, beyond that, a notion that investment brings on growth is based on the view that the net marginal productivity of investment is positive or, in less technical terms, that a dollar of investment now will add more than a dollar to production in the future. This will generally be true in a free economy without government tax subsidies. For businesses would hardly knowingly undertake capital expenditures which would not return in the future at least as much as their original cost. Once special tax advantages enter into the entrepreneurial calculation, we can have no confidence that that requirement is met. A business may well find it justifiable to spend $100 million on equipment that adds to future production only $95 million as long as a 10 percent government tax credit adds $10 million to make up the missing $5 million and put the company $5 million ahead. But spending on capital equipment that cannot pay for itself without government handouts is the path not of economic growth but of economic decay. And if the capital expenditures were profitable to begin with, they should have been undertaken in a properly functioning free competitive economy without the government tax subsidy.

What may appropriately be of most particular concern to small business is that the equipment tax credit and other business investment tax preferences are of disproportionate advantage to large business, with small business figuratively picking up the crumbs from the table. A major reason for this is simply that it is big business that tends to be most capital intensive and uses not only the largest amounts but the largest proportions of equipment in the productive process. Hence tax benefits for the purchase of business equipment are a much more substantial boon to large business than to small business, both absolutely and relatively. The consequence is not only that small business gets less relative benefit. There may also be a backwash in this instance which leaves small business altogether worse off. Aside from the fact that an alternative to reducing business taxes in a manner that gives peculiarly large benefits to big business might be a reduction in taxes of another form which would be of more benefit to small business, there are certain real and monetary effects of a tax credit and other investment tax subsidies which indirectly injure small business. First, to the extent that

large business does take advantage of the tax credit to invest more it puts added pressure on the supply of machinery, thus raising machinery prices which all business, including small business, must pay. Secondly, added business investment by large concerns may further tighten credit markets, raising interest rates and making credit more difficult to obtain by small business. The net gain to small business from these incentives would thus clearly be less than the apparent gross gain which seems so attractive, and may more possibly be negative.

There is in fact a third manner in which the equipment tax credit and accelerated depreciation allowances are likely to be of less relative benefit to small than to large business. This relates to the rather obvious fact that the tax credits and increased tax depreciation deductions are essentially benefits to firms that are already making profits. With limited provision for loss offset, small firms and new firms which are showing little or nothing in the way of taxable profits hardly benefit from tax advantages which would reduce their profits tax liabilities.

The objections to direct business investment tax subsidies suggest other kinds of tax relief which might be more in order for the economy in general and small business in particular. First, to the extent that relief in direct business taxation is called for, it cannot take the path of special favors for this or that kind of expenditure or behavior unless there is a clear and compelling social reason for such relief. For high rates of business taxation in general along with deductions for both appropriate and inappropriate expenses tend to bias the economy in favor of deductible expenditures. It is a well known and essentially accurate axiom of business behavior that Uncle Sam is a partner in not only close to half of business profits, but roughly half of business costs. Many decisions as to business behavior, whether the support of conventions in happy vacation spots or three-martini business lunches or many more prosaic costs might well be different if the U.S. Treasury were not meeting half of the bill. The way to correct the questionable allocation of resources implicit in these expenditures is not to add further deductions but rather to reduce the overall tax rate. I have recently proposed the elimination of the corporate income tax, with attribution of corporate earnings to individual stockholders in proportion to their equity. By thus taxing corporate earnings directly once at individual income tax rates, regardless of whether they are distributed or not, we would improve capital markets by encouraging distribution of earnings along with our discouragement of tax deductible expenditures by business. But this is of course a considerable proposal on which I do not mean to dwell now. It might be kept in mind, however, while we are considering such adjustments to the current tax law as raising the figure at which the corporate tax surcharge becomes effective, thus possibly significantly reducing the *rate* of business taxation on small corporations while having relatively little effect on large ones. Such a measure might be deemed reasonable merely in terms of compensating for the erosion by inflation of this tax benefit to small corporations.

There is another tax reduction which I proposed in another context that might be of special benefit to small business and even have some peculiar justification in terms of small business. This would involve what might be considered a real job development credit, a direct reduction in taxes on employment. Without attributing evil motives to all those who have used the term, I must express my personal feeling that application of the "job development" term to a business equipment tax credit was one of the more dastardly actions of an Administration that had elevated to high purpose the deception of the public in the interest of international and domestic policy. For to all of the arguments advanced against the equipment tax credit we may add another to those concerned with increasing employment. A tax credit for purchase of machinery can have only an indirect effect of stimulating employment by stimulating the economy, an effect which endows it with no advantages over any other tax cut or stimulus to the economy. But a credit for the purchase of equipment has a direct effect of making it more profitable for firms to substitute machinery for labor. That can hardly increase employment. Where the tax advantage induces firms to acquire equipment which without the tax subsidy could not pay for itself, it is essentially bringing about the substitution of less productive machinery for more productive labor!

If we wish to encourage directly the employment of labor, the obvious approach is to reduce the taxes on that employment, which have now risen to 11.7 percent on the great bulk of wage earners' income. I have proposed that for the young, let us say, those under 21 years of age, this tax be reduced, eliminated, suspended or defrayed out of general Treasury revenues. Such action would encourage what is probably the most important and productive investment that we can undertake, investment in human capital. An increasing body of economic research in the last decade or so has strengthened a view which many of us may have long had, that

the major and perhaps the dominant compound in economic progress is a well-trained, well-motivated, growing and creative labor force, from lowest paid workers up to top management. Workers learn by doing. Their skills improve when they have jobs. The idleness of our youth, the large proportions of women and minorities unemployed or out of the labor force because they despair of finding decent jobs represent not only a current loss but a huge loss in productive capacity in output for years and decades ahead. Many who do not find good jobs now and develop the habits or skills to make them permanently productive members of society may drift into chronic idleness and dependence on "welfare" or criminal activity for survival. A tax advantage for giving a youth or other marginal member of the labor force a job is likely to do far more for employment and for economic growth than a tax advantage to buy machinery which would not otherwise seem profitable.

Some form of exemption or rebate on employment taxes might be of special benefit to small business. For a variety of reasons, small business has tended to pay lower wages and hire more marginal workers than many of our largest corporate enterprises. Increases in minimum wage requirements may then strike small business particularly hard. I do not share the view of those who see in reduction or elimination of minimum wage requirements solutions to problems of large unemployment among youth and minorities and overwhelming unemployment among young blacks. In general it should be feasible for a nation as productive as ours to see to it that enough is invested in all of our workers and potential workers so that they can enjoy an adequate wage. But we undoubtedly create a problem for those employers who might be ready to hire inexperienced workers if we insist that in addition to bearing the costs and risk of their training they must pay mounting employer payroll taxes as well as take out of employees' relatively meager wages a so-called employee contribution.

A proposal to reduce, or else subsidize or eliminate payroll unemployment tax for the young and possibly others is consistent with one of the basic requirements to justify government intervention which I offered early in this statement. For as long as we do not have a slave economy, investment in human capital, in on-the-job-training and developing socially advantageous habits of work fall in the category of "externalities." Employers cannot own employees or the human capital invested in them. This may be all the more true of small firms which may have neither the longevity nor the attributes to hold a given body of workers together over all or most of their work careers. The skills and benefits which workers acquire from their early job experiences hence accrue to later employers and society at large. This means that an initial employer, balancing wage costs and tax costs of putting on a new employee may find it individually unprofitable because he is in no position to include in his calculus the external benefits to future employers and the economy generally. In the case of machinery, since he can own it for its entire useful life, there is no such externality or argument for government subsidy. In the case of employment of human labor and particularly the young, untrained or marginal members of or entrants into the labor force, such government tax subsidies may well be most justified. And these benefits may be both larger in amount and more necessary in the case of small business.

As we contemplate the needs of small business and justifiable measures of government support, through the tax system and otherwise, we should be clear as to the areas in which small business suffers disadvantages because of institutional characteristics of the economy or government itself which have nothing to do with the inherent efficiency of small business. One, for example, relates to research and development. As with human capital embodied in workers, it is difficult, even with our system of patents, for individual firms to retain enough of the benefits of research and development, before competition begins eating away at their fruits, to warrant the amount of expenditures that may be socially optimal. Large firms are in a better position to cope on their own. One major government answer might be the provision of research and development know-how to business generally, including small business, as is now done most exclusively in agriculture and in military-space areas which are of most benefit to large corporations.

But finally, I must call attention to one of the greatest difficulties under which small business labors, one which is endemic to the nature of our economic system and the cost of information but which is greatly aggravated by institutional arrangements of our banking system and monetary policy. This is the great difficulty a small business has in obtaining credit to finance its operations and the high cost of that credit when it is obtainable. Large corporations can sell shares of equity and can borrow in organized markets or from banks because they are

well known and large enough to pool risks. One of the greatest difficulties that small business has in competing with large business has to do not with great economic efficiency but rather with the unavailability or huge costs of credit. A major benefit to both small business and to the economy can hence be provided by reform of our banking system and financial markets to provide much readier access by small business to sources of capital. Where reforms by financial institutions and private banking systems as currently controlled by the Federal Reserve are inadequate, we may well wish to seek direct government guarantees in financing to see to it that efficient small business can make use of its real efficiency, thus adding not only to its own profits but to the output of the entire economy.

I have discussed in this statement certain general principles and certain specific policy measures and proposals, some in my opinion clearly to be rejected and others to be implemented. I should like to submit for the record a number of recent articles which enlarge upon some of these matters. I hope this will help provide a useful framework and introduction to the further highly important work of this Committee.

[From Business Week, Dec. 14, 1974]

Ideas and Trends—A Hard Look at Corporate Taxes

(By Robert Eisner)

Last year, a commission sponsored by the Fund for Public Policy Research recommended—along with a number of loophole-closing reforms—elimination of the corporate income tax. The proposal should be considered squarely on its merits, which are many.

Probably the question most frequently raised in opposition to such a plan is: Can we expect the U.S. Treasury to do without or make up the $48-billion in corporation income taxes it has counted in its estimated receipts for fiscal 1975? The answer is simple: The government could recapture a substantial part of the lost revenue by allocating corporate income directly to stockholders and requiring them to pay individual income taxes on all earnings, whether distributed in the form of dividends or not.

Ideally, this system should be reinforced by taxing accrued capital gains to the extent that they exceed retained earnings (and by allowing full deductions of capital losses). But even without this extension, the elimination of the corporate income tax and the integration of corporate income into the individual income tax structure would go a long way toward improvement equity in our tax structure. It would also encourage better function of capital markets, and it would remove some of the tax incentives to business inefficiency and waste.

A fairer way. Investors have frequently complained about the inequity of so-called "double-taxation" of the portion of corporate income paid out in dividends. Eliminating the tax would answer their complaint, but that is perhaps the least of the gains in equity that would result. The ultimate incidence of the corporate income tax is uncertain, and in the last analysis we all are paying double, triple, and multiple taxes all along the line.

More important, economists and tax experts can hardly doubt that some significant portion of the burden of corporate taxes is passed on to the ultimate consumer of the corporate product and to the corporate employees as well. That makes the tax equitable only in the almost random sense that it hits people in some proportion to the amount of product they buy from or the services they supply to corporations.

To the extent that the corporate tax is really borne by stockholders, its equity is even more questionable. Far from being clearly progressive with respect to individual incomes, the essentially flat marginal corporate tax rate of 48%, or the current "effective" rate (the ratio of actual tax liabilities to corporate earnings before taxes) of approximately 38%, has little to do with the presumably progressive taxes on individual incomes. Thus, the proverbial poor widows and orphans, whom we do not wish to tax heavily, suffer the same 38% to 48% bite out of their return on equity as the millionaire in a 70% tax bracket who finds himself better off if the corporation pays the tax and accumulates the net earnings instead of paying dividends. This gives him relatively tax-free unrealized or deferred capital gains.

In terms of improving the flow of capital, eliminating the corporate income tax would remove a major difference in the treatment of bonds and stocks. Both

interest and dividends would be treated as deductions from gross earnings in the calculations of undistributed earnings to be allocated to shareholders for tax purposes. Companies would no longer be pushed by tax considerations into debt financing. The danger of a liquidity crisis brought on by a top-heavy debt-to-equity ratio would be reduced.

Further, corporations would no longer have an incentive to retain earnings when their own investment opportunities are not relatively good. Under the current tax laws, many stockholders find it desirable to have corporations retain earnings and plow them back into relatively marginal projects or use them as the base for outside acquisitions. The object is to generate capital gains rather than dividend income, which must pay high tax rates.

With the integration of corporate and individual income for tax purposes, the pressure will be all the other way. Since stockholders will have to pay taxes on corporate income anyway and will have to pay capital gains taxes if earnings are retained, they will generally much prefer to have the earnings paid out so they can pay taxes with them and also reinvest them in whatever promises the highest return. Corporations may well offer their stockholders the chance to invest earnings in additional shares, and they could offer evidence that their companies are better than alternative investments. But the individual investor would decide whether or not to plow his earnings back into General Motors or IBM uninfluenced by arbitrary tax considerations. A major element in the appropriately bemoaned "lock-in" effect would be eliminated.

More efficiency. The integration of corporate and individual income taxes would have a healthy effect on the U.S. economy. It would end a peculiar incentive for tax-deductible business expenditures. For a 48% tax on corporate earnings is, in a sense, a 48% subsidy of all business expenses. If the tax were abolished, Uncle Sam would no longer be routinely paying almost half the cost of three-martini lunches and winter conventions in sunny climes. Corporate management would have to reckon them as a 100% charge against stockholder earnings. And while it is true that any reduction in stockholder earnings would also reduce stockholders' tax liabilities, it hardly appears likely that the owners of American business would see that as adequate compensation in a period of increased concern about raising productivity to combat inflation, elimination of the corporate income tax could prove a welcome goad to greater efficiency. Furthermore, it would lessen the pressure to raise prices in an effort to improve earnings. Under the present system, a company must increase its gross profit by almost $2 for every $1 that it carries through to net after-tax earnings. This gives the whole system an inflationary tilt, especially at a time when companies can attract equity capital only by showing high rates of return.

Surmountable obstacles. There would be problems, of course, in implementing such a change in the tax structure. For one thing, if individual tax rates remained unchanged, there would be some revenue loss. The average effective rate of tax on the additions to adjusted gross income for individuals would be about the same as the 38% effective rate of the present corporate income tax. It might even prove to be a bit higher, thus gaining a few billion dollars. But eliminating the double taxation of dividends would cut the take by some $11-billion, and there might also be some reduction in capital gains taxes. The net loss might be made up by eliminating or reducing certain exclusions from taxable income—the special treatment of capital gains, for example—that have allegedly been justified by the need to offset the discouraging effect of corporate taxes on investment.

Other problems would arise from the fact that 20% to 25% of corporate earnings would be allocated to nonprofit institutions or other stockholders who are not liable for individual income taxes. Some substitute tax might have to be devised if we did not want the tax-exempt recipients to get a bonus from corporate tax elimination.

Finally, we would have to give some thought to the most efficient way of collecting taxes on the considerable addition to individual taxable income. The best procedure probably would be to have corporations withhold individual income taxes on stockholders' earnings as they do on employees' earnings. This would allow us to get at foreign owners of American firms, whether individual or corporate.

There is, of course, one last problem: what to do with the hundreds of thousands of corporation employees, tax accountants, lawyers, and major groups in the Internal Revenue Service itself who are all currently occupied with the immense tasks of devising, amending, implementing, executing, and avoiding the volumes and volumes of regulations involving corporate income taxes. We might indeed have some transitional unemployment.

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BUSINESS INVESTMENT PREFERENCES

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Business Investment Preferences

ROBERT EISNER*

Tax incentives for business investment are neither equitable nor economically efficient. They contribute to the misallocation of resources and a consequent reduction of economic output and growth. They also contribute to a redistribution of income from working people to property owners and, generally, from moderate income Americans to the relatively rich. By unduly reducing the burden for some, they must in the long run, if not immediately, raise the burden for others.

I have estimated the current cost of several major business investment tax incentives to the Treasury, and hence to taxpayers in general, as $26 billion per year.[1] With continued growth and continued inflation that annual amount will tend to rise. What are these "business investment preferences?" What is their purpose and rationale? How effective are they in achieving their stated purpose? And how, in terms of basic principles of economics and justice, are we generally to evaluate them and possible alternatives in our tax structure?

The Substance of the Major Preferences

Major provisions of the Internal Revenue Code of 1954 affecting business investment relate to depreciation deductions, the investment credit, and the treatment of capital gains. Supporters have sought to justify them as increasing business capital expenditures. The extent

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1. Eisner, *Bonanzas for Business Investment*, 16 CHALLENGE, Nov.-Dec. 1973, tables 1 & 2, at 40-41.

March 1974 Vol. 42 No. 3

to which each does increase investment, singly or in combination with each other and with additional tax provisions, has been disputed. I shall discuss that dispute below, and shall also come back to what is properly a primary question, whether the overall purpose is appropriate.

Depreciation Deductions

The basic federal income tax provisions for depreciation provide that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business . . . ."[2] There has been considerable disagreement as to what constitutes "a reasonable allowance." Furthermore, there has been considerable agitation, with much success, to increase these allowances, whether "reasonable" or not.[3]

In World War II, presumably to encourage acquisition of facilities of limited, war-time use, firms were allowed under "certificates of necessity" to write off many capital additions in five years for tax purposes, regardless of normal expected lives. Similar five-year amortization was permitted for Korean War-related facilities. The major revision of the tax code in 1954 introduced on a permanent basis "liberalized" or more rapid depreciation in the form of the "double-rate declining balance" and "sum of the years digits" methods. While these new methods were widely advertised as offering merely more rapid "recovery" of capital investment,[4] they actually constituted both initial and continuing reductions in tax liabilities for firms making capital expenditures. And the more capital-intensive the firm, the greater the tax advantages.

The gain to the taxpayer and loss to the Treasury resulting from accelerated depreciation is not always fully understood. Since total depreciation charges on individual units of plant and equipment or on all the capital additions of a single year are unaffected by acceleration, but are merely moved forward in time, it is sometimes incorrectly inferred that accelerated depreciation merely decreases total tax payments in early years but increases them correspondingly in

2. INT. REV. CODE OF 1954, § 167.
3. *See* Terborgh, *Tax Depreciation*, in 2 TAX REVISION COMPENDIUM 857 (1959); *Hearings on General Revenue Revision Before the House Comm. on Ways and Means*, 83d Cong., 1st Sess., pt. 2, at 743-75 (1953). *See also* TERBORGH, REALISTIC DEPRECIATION POLICY (1954); Barlow, *The Tax Law Bias Against Investment in Production Facilities*, 26 NAT'L TAX J. 415 (1973); Domar, *The Case For Accelerated Depreciation*, 67 Q.J. ECON. 493 (1953).
4. *See, e.g.*, Barlow, *The Tax Law Bias Against Investment in Production Facilities*, *supra* note 3, at 428-29.

la r years.[5] This incorrect inference is not to be confused with the correct statement that more rapid depreciation for tax purposes may be viewed as interest-free loans in the amount of the tax deferrals.[6] Such interest-free loans are enormously valuable, even when rates are below the 10 percent prime figure of the late summer and early fall of 1973. At a 10 percent rate, the cost of a dollar of tax payments next year is only 91 cents today; a dollar ten years from today has a present value of less than 39 cents.

But if rapid depreciation for tax purposes is viewed as an interest-free loan on a single piece of plant and equipment or all the capital expenditures for a single year, it must be recognized that business firms go on acquiring plant and equipment year after year. To the interest-free "loans" of the first year are superimposed additional interest-free loans in each of the years in the future. For stationary firms, which merely replace plant and equipment at constant prices, the initial interest-free loans become permanent, hence outright gifts. In growing firms, for which the money value of gross capital expenditures generally grows year after year, that is, for almost all large United States corporations, the gifts and lower taxes are repeated year after year, indefinitely, for as long as the tax and depreciation regulations remain in effect. Thus, the annual excess of depreciation charges stemming from the 1954 "liberalization" or acceleration of depreciation is now running in the neighborhood of $12 billion, or some $6 billion in reduced taxes.[7]

By the early 1960's, the clamor for further reductions in business taxes via still higher tax depreciation charges was again loud. In response, the 1962 "guidelines"[8] generally speeded depreciation by

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5. A particularly egregious example may be found in a statement by President Nixon announcing the Asset Depreciation Range System. "A liberalization of depreciation allowances is essentially a change in the *timing* of a tax liability. The policy permits business firms to reduce tax payments now, when additional purchasing power is needed, and to make up these payments in later years." Office of the Pres., Press Release (Jan. 11, 1971). An accompanying statement by then Treasury Secretary David M. Kennedy declared, "It should be kept in mind that a liberalization of depreciation allowances primarily involves a postponement of the tax payment, and that this payment will eventually be added to government revenues." TREASURY DEP'T. NEWS RELEASE, 717 CCH 1971 FED. TAX. REP. ¶ 6366. This author responded to such statements in *Panel Discussion on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 3, at 380 (1973):

> These statements are false. At the worst they represent a conscious effort on the part of some to deceive the public. At best they represent a confusion between the consequences of the "liberalization" in depreciation for a single asset or assets of a single year or even a limited number of years and the permanent "liberalization" envisaged in the proposed system.

For supporting analyses, *see id.* at 380-90; Eisner, *Depreciation and the New Tax Law*, 33 HARV. BUS. REV. 66 (1955); Eisner, *Conventional Depreciation Allowances vs. Replacement Cost*, 21 THE CONTROLLER 513 (1953); Eisner, *Depreciation Allowances, Replacement Requirements and Growth*, 42 AM. ECON. REV. 820 (1952); Eisner, *Accelerated Amortization, Growth and Net Profits*, 66 Q.J. ECON. 533 (1952).

6. *See, e.g.*, TURE, ACCELERATED DEPRECIATION IN THE UNITED STATES, 1954-60, at 14 (1967).

7. Projected from data of the Bureau of Economic Analysis, largely published in SURVEY OF CURRENT BUS., Aug. 1968, Aug. 1971, Jan. 1972, and Jan. 1973.

8. Rev. Proc. 62-21, 1962-2 CUM. BULL. 418.

lowering the old "Bulletin F"[9] lives which were to have been considered in setting depreciation formulae. Along with the liberal guidelines came the "reserve ratio test," which was intended to keep each firm's actual depreciation charges consistent with its replacement experience.[10] The test was never really enforced.

The reserve ratio test was abandoned when the Treasury[11] instituted the new "Asset Depreciation Range System" (ADR). Congress formally enacted ADR into law after considerable protest and the initiation of litigation against the Treasury's action.[12] Its central element was the permission to depreciate properties at rates up to 20 percent faster (or slower!) than those indicated in the guidelines. Evidence has developed that ADR is not being utilized as widely as envisaged because many firms, in the long secular move toward more "liberal" depreciation, had already taken to writing off capital considerably more rapidly than indicated in the guidelines. Picking my way through a variety of figures, involving all of the "liberalizations"—the double-rate declining balance and sum of years digits speedups, the 1962 guidelines, the shortening of tax lives, and the ADR system—I have been able to estimate total reductions in 1973 taxes stemming from accelerated depreciation as amounting to $11 billion.[13]

The Investment Tax Credit

Proponents of business investment preferences are rarely satisfied with accelerated depreciation. In 1962 the so-called investment tax credit was introduced.[14] It entailed a reduction in taxes of up to 7 percent of the amount of business purchases of eligible new equipment. This measure has had a varied and checkered career, with changing interrelations with depreciation: suspension and reinstitution in 1966-67, abandonment in 1969, and reinstitution again in 1971.

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9. *See, e.g.*, Barlow, *The Tax Law Bias Against Investment in Production Facilities*, *supra* note 3, at 415 n.3: "Bulletin F was first published in 1921 without any schedule of standardized depreciable lives. Schedules of suggested standardized lives were added in 1931 and revised in 1934 and subsequent years." *Id.*

10. The reserve ratio test was intended to provide objective standards for determining whether taxpayers were justified in claiming depreciation based on the useful lives suggested by Rev. Proc. 62-21 for guidelines classes. Reserve ratios were computed for each guideline class by dividing the actual cost of class property still in use into the total amount of claimed depreciation. The actual ratio was then compared with a range of test ratios furnished in Rev. Proc. 62-21. To the extent that the firm's class ratio fell outside the parameters of the test range, adjustments in useful life were recommended unless the taxpayer could otherwise justify his treatment.

11. TREASURY DEP'T NEWS RELEASE, ASSET DEPRECIATION RANGE (ADR) SYSTEM, 717 CCH 1971 FED. TAX REP. ¶ 6736.

12. INT. REV. CODE OF 1954, § 167(m)(1).

13. Eisner, *Bonanzas for Business Investment*, *supra* note 1, at 40.

14. INT. REV. CODE OF 1954, § 38.

Recent high-level proposals, particularly from Arthur F. Burns, Chairman of the Federal Reserve Board,[15] to have the credit vary with counter-cyclical considerations, seem to have been scuttled by the Nixon Administration. In its current form the equipment tax credit is saving business taxpayers and costing the Treasury some $4 billion per year.[16]

The Capital Gains Exclusions

Investment or saving is capital accumulation. But for many, if not most individuals, and many businesses, the bulk of capital accumulation takes place not through what is ordinarily accounted as investment or saving but rather by means of capital gains. Yet, income or saving through capital gains has some very special tax treatment. Half of realized capital gains on assets held six months or more are excluded from adjusted gross income for tax purposes.[17] All of capital gains generally escape income taxation when they are passed as testamentary gifts.[18] These exclusions amount to $10 to $12 billion per year in tax savings to the lucky taxpayers and in lost revenues to the Treasury.[19]

It is enlightening to note the distribution of advantages on realized capital gains, even leaving aside the gift and bequest exclusions. Calculations from *Statistics of Income* for 1970 reveal that the realized capital gains exclusions resulted in average tax savings in the order of only 0.2 percent for those with incomes under $2,000. By contrast, in the $1,000,000-and-over category for adjusted gross income, some 63 percent of total income, including capital gains and losses, came from net capital gains, and the tax savings ran to about 20 percent of total income.[20]

Realized capital gains, however, are literally only the tip of the iceberg. It may matter for tax purposes whether an asset is sold and repurchased or whether another asset is purchased in its place.[21] But

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15. *See, e.g.*, Statement by Arthur Burns, *Hearings on the President's Economic Report Before the Joint Economic Comm.*, 93d Cong., 1st Sess. (1973); Address by Arthur Burns, *Some Problems of Control Banking*, Internat'l Monetary Conf., June 6, 1973.

16. It is estimated that the tax credit "lowered corporate taxes by $3 billion in 1972." *The U.S. Economy in 1972*, 53 SURVEY OF CURRENT BUSINESS 12, 27 (1973). The substantial increase in dollars spent on investment in machinery and equipment since 1972 and the additional tax savings to noncorporate business are clearly sufficient to warrant the $4 billion figure.

17. INT. REV. CODE OF 1954, § 1202.

18. *Id.*, § 1014.

19. Total net long term capital gains in 1970 amounted to $20.2 billion. *See* TEASURY DEP'T, PUB. NO. 198 (2-72), PRELIMINARY 1970 STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS (1972). Of these, well over half were reported on tax returns with adjusted gross incomes of over $30,000. Taxes on the excluded portions of these gains would certainly have averaged close to 50%, indicating tax savings then of at least $5 billion. The general secular growth in all forms of income would make a current estimate of $7 billion appropriate, aside from short run stock market fluctuations. Estimates of $4 billion for tax savings on capital gains untaxed in bequests brings the total into the $10 billion range.

20. Calculated from tabulations contained in TREASURY DEP'T, STATISTICS OF INCOME, INDIVIDUAL TAX RETURNS, 1970.

21. INT. REV. CODE OF 1954, § 1231.

in the case of marketable goods, value or the accrual of value exists equally whether the good is actually sold or not. A meaningful economic definition of income is that which can be consumed while maintaining wealth or net worth intact. On the assumption that savings could be consumed, income is the total of consumption and saving. For saving then is the increase in net worth or wealth, which is identical in amount whether it occurs from the growth in value of existing assets, sold or unsold, or the use of salary or income to buy other new assets.

Accrued capital gains in most of the last quarter century have significantly exceeded the total amount of traditionally measured personal saving (the difference between disposable personal income, which does not include capital gains, and consumption.)[22] But the accrued capital gains are not taxed unless and until they are "realized,"[23] frequently many years after accrual. As pointed out above, time is money and a dollar of taxes to be paid years in the future has a present or discounted cost much less than a dollar. This factor, compounded by the gift and bequest exclusions, results in an effective rate of taxation on accrued capital gains, according to at least one carefully constructed estimate,[24] of about 8 percent, far below the 50 to 70 percent rates associated with the total incomes of the major recipients of the capital gains benefit. The tax loss to the Treasury from these "interest-free loans" that delay even the half taxation on capital gains until "realization," is yet to be measured.

Effectiveness of the Tax Preferences

These various tax advantages are presumed by many of their backers to increase business investment. The rationale is varied, but in some cases clearly illustrative of the fallacy of composition: What may be true for individual firms cannot be true for the entire economy.

A major argument is that tax concessions give would-be investors necessary funds. It is suggested that there is a shortage of capital and that individuals and businesses would increase investment by the amount of their tax savings. But if more resources are to be devoted to capital accumulation, given an economy at full employment, resources must somehow be taken from use in providing for consumption or government purchases.

22. *See* McElroy, *Capital Gains and the Concept and Measurement of Purchasing Power*, in 1970 PROC. OF THE BUS. AND ECON. STAT. SEC., AMER. STATISTICAL ASSOC. 132.
23. INT. REV. CODE OF 1954, § 1001.
24. *See* Bailey, *Capital Gains and Income Taxation* in THE TAXATION OF INCOME FROM CAPITAL 26 (Harberger & Bailey eds. 1969).

Recognizing this, probably the single greatest feasible stimulus to investment would be drastic cuts in the defense budget, although this solution is rarely offered by proponents of business investment. Comparison of the post-World War II records of the United States and Japan is suggestive on this point. Japan has shown a tremendous rate of growth and a much higher ratio of business investment to GNP than has the United States. But the difference can be accounted for largely by the much larger proportion of United States GNP which goes to defense.

If consumption and government expenditures for defense or elsewhere are not cut, reduction of business tax liabilities frees no resources for business investment. Each firm or individual might have more funds to invest with lower tax liabilities if all other parameters were unchanged, which would imply that all other taxes, demand, prices, and costs were unchanged.

But this, in the economy as a whole, is not possible. Given the needs of a sound fiscal policy, lower taxes relating to business investment preferences must be matched by higher taxes elsewhere. A firm may believe that higher depreciation allowances or the equipment tax credit gives it more funds. This assumption will not generally be true if these tax reductions are matched by higher corporate or individual income taxes that reduce the funds coming in through purchases of the firm's products or securities. If a sound fiscal policy gives way to an inflationary one, the flow of funds for investment may still be restricted by the need for greater expenditures to purchase higher priced goods and services, as well as by the high interest rates likely to be engendered. Of course, if investment tax preferences are introduced in a depressed economy requiring stimulative action, more investment along with more spending in other directions is likely to result. This, however, would be generally true for stimulative fiscal policy, with or without special incentives for investment.

The more likely effect of business investment preferences may be explored initially in a model of determination of business investment which involves maximization of expected profits or the present value of the enterprise. This model can be used to note effects on business investment demand functions. In the economy as a whole, however, business investment demand must be related to competing demands for capital and to the supply of saving. Viewed this way, the various tax advantages must effect their consequences by means of one or more of the following:

1. Lowering the price of capital relative to other factors of production, or of more durable or substantial capital relative to less durable capital, so as to bring about more capital-intensive methods of production;

2. Causing a substitution of certain kinds of favored capital, such as equipment or plant and equipment, for other forms of capital;

3. Bringing about a substitution of business investment for

investment by government, non-profit institutions, and households;

4. Increasing the total supply of saving and hence total investment.

There have been a number of econometric analyses focusing on at least some of these issues.[25] Results have been varied. Where investigators have assumed particular forms and parameters of functions that imply large quantitative impacts of changes in the cost of capital such as might be brought about by tax incentives, substantial effects on business investment have been claimed. More generally, however, where such assumptions have not been made, the effects, particularly of accelerated depreciation and the equipment tax credit, appear to be severely limited. In general, estimates of added investment have been significantly less than the sacrifices in tax revenues used to promote them.

This conclusion is reinforced by analysis of individual firm responses in *McGraw Hill Capital Expenditure Surveys.*[26] Specific questions inquiring as to the amount of investment due to new and revised depreciation schedules, tax credits for new equipment, and reductions in corporate tax rates indicate generally minor increases. Questions were asked in successive years and anticipated effects were actually less after tax incentives were in operation long enough to prove more potent. Moreover, *ex post* reports of actual investment resulting from the tax measures were less than *ex ante* anticipations. The mean estimates of effects of investment incentives proved less in the surveys than all except the smallest of estimates from several econometric models considered, and these, as noted above, have not generally been high. When the variables were fitted into investment equations including other determinants of capital expenditures, evidence suggested, as in earlier work with quarterly SEC data for manufacturing,[27] that the independent effects of the incentives were, if anything, less.

But this is still essentially a partial equilibrium analysis. Suppose tax incentives for business investment do have some positive

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25. *See generally,* TAX INCENTIVES AND CAPITAL SPENDING (Fromm, ed. 1971); Hall & Jorgenson, *Tax Policy and Investment Behavior,* 57 AM. ECON. REV. 391-414 (1967); Eisner, *Tax Policy and Investment Behavior: Comment,* 59 AM. ECON. REV. 379-88 (1969); Coen, *Tax Policy and Investment Behavior: Comment,* 59 AM. ECON. REV. 370-79 (1969); Hall & Jorgenson, *Tax Policy and Investment Behavior: Reply and Further Results,* 59 AM. ECON. REV. 388-401 (1969); Eisner, *Tax Policy and Investment Behavior: Further Comment,* 60 AM. ECON. REV. 746-52 (1970).

26. *See* EISNER & LAWLER, TAX POLICY AND INVESTMENT: AN ANALYSIS OF SURVEY RESPONSES (1973).

27. *See* Eisner, *Tax Policy and Investment Behavior: Comment,* 59 AM. ECON. REV. 379-88 (1969); Eisner, *Tax Policy and Investment Behavior: Further Comment,* 60 AM. ECON. REV. 746-52 (1970).

consequences for the particular forms of business capital expenditures favored. What does that do to total investment? Even within the business sector, the results must surely be mixed. Where the investment credit is limited to equipment, may there not be some substitutions of equipment for plant? The credit is limited to equipment with depreciable lives of at least three years.[28] Is purchase of equipment with a life of less than three years not then discouraged? Only one-third of investment in qualifying property is eligible for the credit where useful life is at least three years but less than five years, and two-thirds of the investment is eligible if the useful life is at least five years but less than seven years. Is there not therefore some encouragement for expenditures for durable equipment lasting at least seven years, at the expense of all less durable equipment?

But further, to anticipate an issue to which we shall return, what is the effect on more broadly defined business investment, which includes the output of all resources applied to the increase of future capacity or productivity? Will not investment in research and development, manpower training, and management know-how now be made relatively more expensive as compared to plant and equipment expenditures? By focusing only on forms of investment directly affected by tax preferences, we may forget the full interrelations of the economic process. One does not stimulate in one area without having consequences elsewhere.

Some of the consequences are felt outside of the business sector. Increased expenditures for business plant and equipment will put pressure on the supply of construction services for residential housing as well as buildings for non-profit institutions and government. Given the supply of saving and, particularly, the consequent desire of monetary authorities to curb inflation by limiting total spending, money is likely to become "tight" and interest rates rise. These consequences indeed impinge on the primary positive effects of business investment. Neither econometric estimates nor surveys focusing on business investment will catch this negative fallout if they assume that other factors such as interest costs and supply prices remain unaltered with tax preferences.

The consequences for non-business investment expenditures can be marked. Not only do they lack the favorable stimuli directed to profit enterprises, but they are frequently struck severely by stringencies of physical and monetary supply. The very tax deductibility of expenditures makes profitable enterprises ready to bid high for the equipment and construction services they need. But tight money becomes notoriously critical to investment in housing and in construction by school districts, states, and municipalities. And while the federal government can presume to raise all the money it wishes, infla-

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28. Revenue Act of 1971, Pub. L. No. 92-178, § 102, 85 Stat. 499. *See* TREASURY DEP'T PUB. No. 572 (10-72) *Tax Information on Investment Credit*, at 7 (1972).

tionary pressures fueled by heavier business capital expenditures surely increase the resistance to federal investment spending.

An overriding issue regarding total investment is the nature of the saving function, a matter surprisingly ignored on occasion. Early Keynesian analysis raised serious questions as to the elasticity or proportional response of saving to changes in the rate of interest or other measures of its rate of return. Contemporary analysis has, in fact, underscored these questions. Dominant views of economists regarding the determinants of savings tie them to the "permanent income" formulation of Friedman[29] and the basically analogous life cycle model of Modigliani.[30] While both envisage effects from the return on saving, they bring to the fore the more basic considerations of providing for a lifetime of consumption. Indeed, the mixture of income and substitution effects resulting from higher rates of return after taxes continues to leave ambiguous the very direction of response to changes in rates of return on saving. Put simply, we save out of income in the primary income-earning years of life in order to have wealth available for consumption during retirement or other future periods when current expenditures are likely to exceed current income. A higher rate of return makes us able to meet relatively fixed future needs with less current saving.

Paradoxically, business investment in plant and equipment as well as other capital accumulation might receive more stimulus from certain measures, at first thought far afield, that might have major impact on private saving. In particular, the motive for much saving is to provide for retirement. Our increasingly comprehensive Social Security system tends, desirable as it may be—and I do not want to be interpreted as opposing Social Security—to obviate some of the need for private saving. It is not necessary to put aside income now to provide for the future if retirement expenses will be taken care of by the government.

Of course, employer and employee contributions for social insurance deprive households of income which might otherwise be spent in consumption, but current Social Security payouts have compensated for this. Moreover, recent substantial increases in Social Security benefits and in associated medical assistance have tended to make traditionally defined consumption expenditures higher than they would otherwise be. In an economy operating close to full capacity, given existing institutional arrangements, increased consump-

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29. FRIEDMAN, A THEORY OF THE CONSUMPTION FUNCTION (1957).
30. Modigliani & Brumberg, *Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data*, in POST-KEYNESIAN ECONOMICS 388 (Kurihara ed. 1954).

tion must come from somewhere, and as we trace the involved interrelations in our complex economy we can expect to see some fallout on business investment. Hence, if we really want to stimulate investment, we might well consider sacking the Social Security system! By reserving less for comfortable years of retirement and less for medical services, more resources can be made available for machines and factories. And if American households cannot expect to be taken care of by their government, they can be expected to save more themselves for the rainy days in the future, entrusting their savings, directly or indirectly, to investment in profit-making enterprises.

Usefulness of the Tax Preferences

Suppose the investment tax preferences were more effective than I indicate, or suppose that they were made so massive that they would bring about substantial business investment in any event. What would the added business investment accomplish? If the economy were suffering from inadequate aggregate demand and large scale unemployment, the increase in investment would raise total demand, output, and employment. The same result could be accomplished by other fiscal and, perhaps, monetary measures that might do less to distort resource allocation, but this is not the issue currently posed. Rather, it is argued that we need more business investment to increase the rate of growth, presumably of productive capacity, which it is implicitly assumed will be utilized, and to modernize our productive facilities so as to improve our "competitiveness in the world market place."[31] Let us consider these arguments in turn.

Böhm-Bawerk argued persuasively for the greater productivity of more "roundabout" or capital-intensive methods of production. The pail is more productive than the hollow of a man's hand in collecting water from the spring. And the "runnel or rhone which brings a full head of water" to the man's cottage is more productive still.[32] But should the peasant be given a tax incentive to build large tanks, a reservoir, or a dam for his own use? Not so clear!

Surely not every capital addition is worthwhile. Not every new plant or new piece of machinery adds to future products more than its own cost. Yet, in making investment decisions apart from tax considerations, businesses must pick among all possible capital expenditures those that promise sufficient advantage. Why should they be persuaded by special tax preferences to incur capital expenditures that would not appear sufficiently advantageous without such preferences?

Indeed, the basic notion underlying Böhm-Bawerk's view of the in-

31. *See, e.g.*, Madden, *Is Our Tax System Making Us Second-Rate*, 26 NAT'L TAX J., 403 (1973).
32. EUGEN VON BOHM-BAWERK, POSITIVE THEORY OF CAPITAL (1891), excerpted in READINGS IN ECONOMICS 30-32 (Samuelson 7th ed. 1973).

crease in productivity from using capital for more roundabout production is precisely that in a free market, decision-makers would be acquiring those additional units of capital that would pay for themselves in added production and pay enough more to justify the delay in current satisfaction while the investment is undertaken. If an additional unit of capital costing $100 returns in discounted future value $105 of additional output or cost savings, it will be profitable for the businessman and a benefit to the economy as a whole. In general, tax concessions for investment, if effective, induce business to sacrifice the economy's opportunities for current consumption to invest for future consumption at terms that consumers would *not* accept freely. At the extreme, if the marginal rate of time preference were zero—if we were indifferent as between additional units of future or present consumption—incentives for investment would be attempts to induce business to acquire units of capital which would pay back less than their own original costs: 100 units of final output now would be sacrificed to get 95 units later. This is a path of decay, not economic growth!

The arguments for subsidizing business investment to improve competitiveness in world markets are no better. For they generally ignore the basic principles of international trade and competition that go back to the law of comparative advantage enunciated early by the great classical economist, David Ricardo. Given free exchange rates, the poorest economy in the world, with the most obsolete plants, will find itself "competitive" in some products and unable to meet foreign competition in others. Even a nation less productive in all commodities than the rest of the world will find it profitable for itself and the rest of the world to produce and export those goods which it can produce at a lesser absolute disadvantage, or comparative advantage, and import those goods which it can produce at a greater absolute disadvantage. Making such a nation more productive by providing additional capital may increase trade to the extent it increases total output and income. It will not, however, provide the nation with a greater capacity to undercut the rest of the world. As productivity increases and costs come down, the foreign exchange rates will adjust. The nation will still find it more profitable to produce and export those commodities in which it has a comparative advantage and to import those in which it has a comparative disadvantage.

Of course, comparative advantages may shift from one industry to another. And this may be precisely the effect of business investment incentives on competitiveness with foreign producers. A direct subsidy to one industry or one set of industries may well enable it to sell more cheaply abroad. The increased foreign demand for the

product of the subsidized industry implies an increased foreign demand for dollars and a higher price of the dollar in terms of foreign currencies. This in turn will make all American products more expensive for foreigners, thereby injuring the "competitiveness" of products of unsubsidized industries. Tax incentives for business investment have precisely this kind of effect indirectly. They tend to decrease costs most for capital-intensive industries which benefit most from the tax subsidies. The products of these industries will then be more competitive in foreign trade, but only at the expense of the products of less capital-intensive and less subsidized industries which suffer more from the increased cost of the dollar to foreigners than they gain in decreased costs of production.

While business investment tax preferences do not make American goods generally "more competitive," they do make it easier for some (capital-intensive) goods and harder for other goods to compete. In so doing, they shift some production from goods in which, by free market criteria, we are more efficient, to goods in which we are relatively less efficient. They thus lower real income and the standard of living for the country as a whole. If, for example, American agriculture, and grain producers in particular, experience a huge, unmanipulated demand for their products, giving the United States an export balance that raises the value (cost to foreigners) of the United States dollar, thus making it more difficult for at least some American manufacturers to sell abroad, we should not subsidize those manufacturers. To do so is to divert resources from grain production, in which we are more efficient, to the use of less efficient manufacturers. These manufacturers, and their workers, may well prove gainers, but it is not only the grain producers but the nation as a whole, on balance, that will prove the losers.[33]

All this shades into the broader issue of when and where it is desirable to have government intervention, by controls or tax policy, in the workings of the economy. It is perhaps strange that many self-proclaimed business spokesmen, presumably wedded to the virtues of free enterprise, are quick to espouse government intervention in the form of tax preferences from which they believe they will gain. But free enterprise has more virtues than are apparently recognized by some of its supposed adherents. Most economists recognize the need for government action in the way of general fiscal and monetary policy to establish the conditions for full employment, hopefully with reasonable price stability. They further recognize the need for government action to preserve workable competition where that is possible, and to regulate quasi-monopolies where competition is unfeasible or prohibitively costly. They also recognize the need for government intervention to improve the flow of information essential to intelligent purchasing, whether of securities or cigarettes.

33. Arguments relating to international considerations are discussed more fully in Eisner, *Investment, Obsolescence and Foreign Competition*, CONFERENCE BOARD RECORD, reprinted in VITAL SPEECHES 285-88 (Feb. 15, 1972).

And they recognize increasingly the need for government intervention in instances where capital markets are seriously imperfect or externalities are involved in production or consumption.

These last considerations suggest a major government role in assuring sufficient investment in human capital, in education and training, and in health. Since in a non-slave economy human capital cannot readily be sold, nor under our laws can its product be readily indentured, it does not pay private producers to invest in it to the extent that its productivity may warrant. The owners and prospective owners of human capital correspondingly may have insufficient access to funds, confidence in their prospects, and willingness to bear risk to lead them to invest sufficiently in themselves. Furthermore, investment in human capital frequently has external effects which benefit others than those who embody the investment. A more educated population may, for example, be less productive of crime.

Somewhat analogously, investment in research and development takes on much of the aspect of a public good. New ideas, new techniques, and know-how are not easily appropriated for long periods by their discoverers. Benefits to the economy may thus considerably outweigh those that can be retained by original investors. In this situation, also, society or government is called upon to subsidize private investment or to undertake it itself.

A hint as to the relative impact or significance of the "intangible" investment that does not usually profit from business investment preferences was given in a classic article by Robert Solow, who reported some years ago that only a small portion of growth and output in the United States economy could be accounted for by increases in the usually observed inputs of labor and capital.[34] The major share of growth was accounted for by a trend factor "T," which has been taken by some to stand for technical progress, but which may better be seen to encompass all of the many elements of investment, human and non-human, which do not get the benefit of tax preferences.

Government intervention may well be justified to encourage much non-business investment. In addition to child-rearing, education and training, job mobility, health, and research and development, it may be desirable to encourage public investment or subsidize private investment in our natural resources, in our environment, and in all of the large-risk but vital overhead capital which makes the functioning of a modern economy possible. And we may further see

34. *See* Solow, *Technical Change and the Aggregate Production Function*, 39 REV. OF ECON. & STATISTICS, 312 (1957). *See also* Denison, *The Sources of Economic Growth in the United States and the Alternatives Before Us*, Supp. Paper No. 13, Comm. for Econ. Development (1962).

value in subsidizing individuals to own certain forms of physical capital, such as housing and home or personal tools and appliances that permit more efficient, personalized production of goods and services than can be expected to flow through the market.

But what about business investment in plant and equipment? This has been a major recipient of tax preferences. Such investment is properly the last candidate for public support. Where it is worthwhile for the economy it should appear worthwhile for the profit and wealth maximizing firm, and should hence be undertaken without government support. If it does not appear worthwhile to the business firm without such support it may be safely assumed that it should not be undertaken.

It is time to turn away from the entire program of business investment preferences along with other "tax expenditures" whose justification is ultimately to be found in private self-interest rather than economic principles relating to the public good. Tax depreciation more rapid than true or economic depreciation, equipment tax credits, exclusion of capital gains from taxable income, and the deductibility of interest expense should all be eliminated in a comprehensive revamping of the tax structure. As far as possible, business should be taxed for the services it receives from government: police and defense, education, and general government, as well as roads and postal services. It should quickly be conceded that business income taxes, including the corporate profits tax, are very poor methods of payment for government services rendered. They penalize the more profitable and productive companies and encourage the incurring of current costs, whether for labor or other services or capital, and thus promote inefficiency. Ideally, where taxes cannot be related directly to the government services received, they might better be based on a reasonable proxy measure of those services, that is, the size of the enterprise. And perhaps the best single measure of size would be the total amount of invested capital.

The direction in which to move is then not that of increasing or maintaining business investment preferences. Rather, the whole set of these preferences, along with business income taxes and the corporate profits tax to which they are tied, should be removed. Taxes on business should be related, as far as possible, to the services received by business, and where particular taxes for services received are not feasible it may be preferable to impose a general tax not on earnings but on capital. This would help establish a correct market price for capital so that in a competitive society we can properly economize its use along with that of all other scarce resources. Government would best move to promote free enterprise and away from the use of the public purse for private profits![35]

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35. Further discussion by the author of issues raised in this paper may be found in *Panel Discussion on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 3 at 370-90 (1973); *Tax Incentives for Investment*, 26 NAT'L TAX J. 397 (1973); *Men and Machines and Taxes*, 4 SOCIAL POLICY 44 (1973).

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TAX POLICY AND INVESTMENT: AN ANALYSIS OF SURVEY RESPONSES

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Tax Policy and Investment: An Analysis of Survey Responses

By ROBERT EISNER AND PATRICK J. LAWLER*

Economic policy in the United States in recent years has included tax measures designed to affect the level of business investment. These have taken several forms: accelerating rates of tax depreciation on capital goods, thus lowering the present value of expected tax liabilities and actually decreasing annual tax payments; tax "credits" amounting to subsidies for the purchase of equipment; and alterations in business income tax rates. With additional acceleration of tax depreciation in the "Asset Depreciation Range" system and reenactment of an equipment tax credit in 1971, and recent proposals for suspension and then for increases in the credit, the issues are particularly current.

A number of analyses have attempted to estimate the effects of investment tax incentives by incorporating their presumed implications in more general variables, such as the cost or "rental price" of capital, and estimating the parameters of these more general variables.[1] In some instances attempts have been made to estimate effects more directly, either entering tax rates separately or isolating the specific changes in more general variables which have been due to the tax measures.[2] Our efforts here are directed primarily at what business respondents in McGraw-Hill surveys *said* a number of tax measures would do or had done to their anticipated or actual capital expenditures and comparing these with several econometric projections. We shall also report briefly on inconclusive results of inclusion in general investment functions of the survey responses as to anticipated or actual effects of the tax measures on expenditures.

I. The Survey Data

The current analysis utilizes McGraw-Hill capital expenditure surveys of firms in nonfinancial industries. The following questions in the 1963, 1964, 1965, 1966 (fall), and 1968 surveys deal with the effects of tax measures on investment.[3]

In the survey for the spring of 1963, McGraw-Hill included the question, "Of the total amount you now plan to invest in 1963, roughly how much is due to: a) New depreciation schedules? ___ %; b) Tax credits for new equipment? ___ %." In the survey of the spring of 1964, a similar question referred to plans to invest in 1964.

The spring survey of 1965 asked, "Of the amount you invested in 1964, roughly how much more did your company spend than it would have because of: a) Reduction in corporate tax rate? ___ %; b) Revised depreciation schedules? ___ %; c) Tax credits for new equipment? ___ %."

Then in the fall of 1966, McGraw-Hill asked, "How much have you reduced your 1967 capital investment plans because of suspension of: a) Investment tax credit? \$___; b) Accelerated depreciation on structures? \$___."[4]

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[1] See, for example, Charles Bischoff, Robert Coen, Robert Hall and Dale Jorgenson, and Lawrence Klein and Paul Taubman in the collection of papers edited by Gary Fromm; also Coen and Jorgenson.

[2] See Eisner (1969), in particular.

[3] The authors are indebted to the Department of Economics of the McGraw-Hill Publishing Company for making available the actual questionnaires used and individual firm responses, with firms coded by number to preserve the confidentiality of the data.

[4] We divided these responses in dollars by anticipated

TABLE 1—SURVEY RESPONSES AND INDEPENDENT ECONOMETRIC ESTIMATES[a] OF THE EFFECTS OF TAX POLICY ON CAPITAL EXPENDITURES

(Shown in Percent)

		Percent Effects on Capital Expenditures					
		Mean of Survey Responses[b]		Econometric Estimates			
	Year	Simple	Weighted	Hall and Jorgenson	Bischoff	Klein and Taubman	Coen
Proportion of anticipated capital expenditures due to:							
New depreciation guidelines	1963	4.2 (339)	1.9 (277)	2.1 *(ex post)*	0.2[d]	0.3	1.9
Equipment tax credit	1963	2.8 (337)	1.4 (274)	4.4	0.6[d]		
New depreciation guidelines	1964	2.8 (301)	1.3 (273)	—	—	—	—
Equipment tax credit	1964	1.1 (299)	0.8 (271)	—	—	—	—
Proportion of actual capital expenditures due to:							
Corporate income tax reductions	1964	0.8 (275)	0.5 (245)	−0.4[c]	0.05	—	3.5
New depreciation guidelines	1964	1.5 (273)	0.9 (243)	2.2	1.0[d]	0.9	
Equipment tax credit	1964	1.3 (272)	1.1 (242)	6.8	3.9[d]		
Proportion anticipated capital expenditures reduced due to:							
Suspension of accelerated depreciation on structures	1967	−0.7[e] (331)	−0.1[e] (332)	−1.4	—	−2.8	—
Suspension of equipment tax credit	1967	−2.2[e] (331)	−0.7[e] (339)	−6.8	—		
10 percent corporate tax surcharge	1968	−1.6 (281)	−0.2 (160)	—	—	—	—

[a] For data base, see Appendix.
[b] Number of responses in parentheses.
[c] Assumed no effects on output.
[d] Bischoff's estimates relate only to equipment. If the depreciation guidelines and equipment tax credit had no effect on expenditures for structures the implicit estimate of their percent effect on all capital expenditures would be roughly two-thirds of the figure shown.
[e] McGraw-Hill reported, as to the aggregate, that suspension of accelerated depreciation on structures and of the equipment tax credit had reduced fall 1966 capital expenditure plans by $1.5 billion out of a total of some $63.4 billion (Press release, February 10, 1967, "McGraw-Hill's Special Check-up on 1967 Investment Plans") or about 2.4 percent, a somewhat higher figure than the weighted mean total of 0.8 percent but less than the simple mean total of 2.9 percent calculated from our partial sample.

Finally in the spring of 1968, we have the question, "If the proposed 10% surcharge on corporate income taxes is enacted, how much do you estimate this will reduce your capital spending plans for 1968? ___ %."

Table 1 presents information regarding all of the responses available. Working with the raw means of survey answers as to the percent effect of the various measures on anticipated or actual expenditures, we find respondents generally indicating small movement in the presumably correct directions, and usually somewhat larger effects from

capital expenditures reported in answer to an accompanying question, thus securing observations in ratio form comparable to those relating to questions on the other surveys.

liberalized depreciation than from the tax credits for new equipment.[5] Thus the unweighted mean proportion of anticipated investment in 1963 attributed to the new depreciation schedule was 4.2 percent while that attributed to tax credits for new equipment was 2.8 percent. The similar question in 1964 again shows a larger amount of anticipated investment attributed to liberalized depreciation than to the tax credit but, interestingly, considerably smaller proportions for both than in the previous year.

That this is so, despite the cumulative gains from continued accelerated depreciation and the fact that 1964 investment should have reflected the lagged results of earlier as well as current stimuli, raises some question as to the internal consistency of the responses. This concern may be heightened by the *ex post* response in early 1965 regarding actual 1964 expenditures. For the proportion then attributed to the revised depreciation schedule was only 1.5 percent, little more than half of the 2.8 percent which had been indicated in previous anticipations of those expenditures and little more than a third of the 4.2 percent mean figure noted with regard to the 1963 anticipations.

The suspension of accelerated depreciation on structures instituted in the fall of 1966, presumably to last until the end of 1967, was reported on average to have reduced 1967 capital investment plans by only 0.7 percent. In this case, where depreciation related only to structures, the equipment tax credit seemed more potent, inasmuch as the mean percentage reduction in investment plans as a consequence of its suspension was 2.2 percent.

In early 1965 the effective reduction in 1964 corporate tax rates of 3.8 percent, or 2 percentage points, was reported to have brought about an average increase of only 0.8 percent in 1964 investment, although profits before taxes were between two and three times investment. Thus each dollar of tax reduction was reported to bring in the neighborhood of some 20 cents in added capital expenditures. The proposed 10 percent corporate tax surcharge, raising the effective tax rate by some 4½ percentage points, was estimated in early 1968 to reduce capital spending plans for 1968 by a mean figure of 1.6 percent, implying again only about a 20 cent reduction in corporate capital expenditures for each dollar of increased corporate taxes.[6]

Both the accuracy and consistency of these responses is questionable. The bulk of individual survey answers as to percentage effect were "zero." There is no evidence that lack of information was translated into zero responses, but to the extent that it was, means would of course be biased toward zero and effects of tax measures underestimated. Running the other way, a number of relatively extreme observations, including figures of "+ 100 percent," contribute to higher means and make the differences between means of doubtful significance. Large percentage responses seem to come predominantly from small firms. We have consequently calculated *weighted* means of survey responses, and the estimated incentive effects, measured as total indicated changes in expenditures divided by total expenditures, are universally more moderate. Thus the anticipated total effect of depreciation guidelines in 1963 amounted to 1.9 percent of total expenditures, rather than the 4.2 percent which was the unweighted or simple mean of survey percent responses. For the equipment tax credit, a weighted mean of 1.4 percent for anticipated effects in 1963

[5] This despite estimates indicating that the present value of tax advantages due to the equipment tax credit was, for reasonable rates of discount, greater than that due to the depreciation guidelines, a fortiori, since it turned out that many firms had been "liberalizing" their depreciation before the new guidelines and hence had less additional gain. Hall and Jorgenson, pp. 50, 51, 55, estimate the impact on the rental price of capital as roughly one and one-half times greater for the equipment credit in 1963 and roughly two and one-half times greater in 1964, after firms were no longer required to deduct the credit from an asset's depreciable base.

[6] These figures are interestingly comparable with those of Coen (1971, p. 179). Dealing with manufacturing only, for the entire period 1954 to 1966-III, he estimated increased capital expenditures of $4.8 billion to be associated with total tax reductions of $13.7 billion, a ratio of some 35 percent.

TABLE 2—PERCENTAGE EFFECTS ON CAPITAL EXPENDITURES, SIMPLE AND WEIGHTED MEANS, VARYING AND IDENTICAL PANELS OF RESPONDENTS

		All Observations Available		Identical Panels: Anticipations, 1963 and 1964			Identical Panels: Anticipated and Actual, 1964		
					Panel for Weighted Means			Panel for Weighted Means	
Expenditures	Tax Measure	Simple Means	Weighted Means	Simple Means	Simple Means	Weighted Means	Simple Means	Simple Means	Weighted Means
Anticipated for 1963	Depreciation Guidelines	4.2	1.9	4.4	2.8	1.2	—	—	—
	Equipment Tax Credit	2.8	1.4	2.6	1.2	0.7	—	—	—
Anticipated for 1964	Depreciation Guidelines	2.8	1.3	3.0	2.7	1.3	2.7	2.1	1.2
	Equipment Tax Credit	1.1	0.8	1.1	1.2	0.8	1.1	1.1	0.7
Actual, 1964	Depreciation Guidelines	1.5	0.9	—	—	—	1.5	1.5	1.0
	Equipment Tax Credit	1.3	1.1	—	—	—	1.5	1.5	1.4
Number of Respondents		[a]	[a]	217	178	178	206	182	182

[a] Varies as indicated in Table 1.

replaces the 2.8 percent unweighted mean.

Some inconsistency stems from the fact that samples were not identical from year to year (or for simple and weighted averages, because a number of observations did not include the actual dollar expenditures required in weighting). In particular, no downward trend in anticipated effects from 1963 to 1964 is apparent when we examine identical panels of respondents, as may be noted in Table 2.

It is possible to compare survey responses with *ex post* estimates derived from econometric estimates by Hall and Jorgenson, Bischoff, Klein and Taubman, and Coen. The survey responses generally indicate considerably less effectiveness of the various tax incentives, especially in terms of weighted means, than the predictions of Hall and Jorgenson. The 1964 expenditure effects viewed *ex post* come midway between those estimated by Klein and Taubman and by Coen and, for the depreciation guidelines, come quite close to those estimated by Bischoff. The largest discrepancies occur in estimates of effects of the equipment tax credit, where the econometric estimates, particularly those by Hall and Jorgenson, are much higher than the survey responses, and in the case of the short-run 1967 suspensions, where the econometric estimates are again higher. Only corporate income tax reductions, viewed as perverse or trivial in their results in two econometric estimates, appear to have greater, though still very small, effects in the surveys.

Examination by industry of the means of reported survey effects in Table 3 shows wide variations with particularly large figures reported for railroads and generally negligible ones for utilities, where the credit was only 3 percent and where indeed other evidence has indicated that capital expenditures are substantially dominated by demand and output considerations.

II. General Investment Equations Including the Tax Measure Survey Responses

The survey responses have been introduced as variables in regressions which also include the sales change, profits, and depreciation variables which were used earlier in explaining these capital expenditure data.[7] In such regressions, if a particular tax measure always had precisely the effect on capital expenditures indicated by respondents it would enter with a coefficient of unity. For example, if the respondent indicated that the new depreciation schedule increased the investment he planned for 1963 by 5 percent, an increase in planned investment by 5 percent over and above the

[7] The underlying investment model into which the tax policy response variables were fitted may be seen in Eisner (1967), particularly Tables 3 and 5, pp. 376 and 380.

TABLE 3—PERCENTAGE EFFECTS ON CAPITAL EXPENDITURES, SIMPLE MEANS OF SURVEY RESPONSES, BY INDUSTRY[a]

Expenditures	Tax Measure	Primary Metals	Metal Working	Chemical Processing	Other Manufacturing	Mining	Utilities	Petroleum	Railroads	Stores	Transportation and Communication Other Than Railroads
Anticipations for 1963	Depreciation Guidelines	2.5 (19)	4.3 (99)	5.6 (42)	5.6 (58)	11.7 (18)	0.2 (28)	0 (9)	9.8 (12)	1.0 (25)	2.3 (11)
	Equipment Tax Credit	0.5 (18)	2.8 (98)	1.5 (42)	5.7 (57)	6.5 (18)	0.7 (28)	0 (9)	3.8 (12)	1.0 (27)	4.5 (10)
Anticipations for 1964	Depreciation Guidelines	2.3 (15)	4.6 (84)	2.5 (41)	3.1 (57)	0.7 (14)	0.3 (27)	0 (7)	9.5 (6)	1.7 (25)	0.8 (8)
	Equipment Tax Credit	1.1 (15)	1.7 (84)	1.1 (41)	1.1 (57)	0.7 (14)	0.6 (25)	0 (7)	1.3 (6)	0.7 (25)	0.2 (8)
Actual, 1964	Corporate Income Tax Reductions	0.1 (14)	0.9 (81)	0.9 (33)	1.1 (46)	1.4 (14)	0.3 (19)	0.2 (8)	0.6 (7)	0.2 (24)	1.7 (9)
	Depreciation Guidelines	0.9 (14)	1.1 (81)	1.3 (33)	2.2 (45)	0.7 (14)	0.4 (18)	0.1 (8)	13.4 (7)	1.7 (24)	2.2 (9)
	Equipment Tax Credit	0.6 (14)	1.4 (81)	1.6 (33)	1.6 (45)	0.7 (14)	0.4 (17)	0.4 (8)	1.9 (7)	0.8 (24)	5.0 (9)
Anticipations for 1967	Suspension of Accelerated Depreciation on Structures	−0.4 (19)	−2.7 (100)	−2.9 (41)	−5.2 (55)	0 (9)	−0.1 (30)	0 (9)	−1.9 (13)	0 (26)	0 (10)
	Suspension of Equipment Tax Credit	−0.4 (19)	−1.4 (100)	0 (41)	−1.2 (55)	0 (9)	−0.0 (30)	0 (9)	0 (13)	0 (26)	0 (10)
Anticipations for 1968	Corporate Income Tax Surcharge	−1.6 (19)	−2.5 (82)	−0.3 (33)	−4.0 (42)	0 (14)	0 (23)	0 (6)	−2.1 (12)	−0.5 (22)	0 (10)

[a] Figures in parentheses are numbers of firms responding.

amount planned as a consequence of sales changes, profits, and depreciation charges, would imply a coefficient of unity for this response variable. If anticipated investment, despite the response, were actually only 2 percent more than indicated by the regression on the other variables, then the coefficient of the response variable would be 0.4. If the response variable in fact proved, despite respondents' claims, irrelevant to their anticipated expenditures, the coefficient should turn out to be zero. If ancipated expenditures actually moved counter to the direction indicated by the response, the coefficient would prove negative.[8]

Despite the availability of over 3600 observations, regression results were inconclusive. The depreciation guideline coefficients in firm time-series regressions, and less consistently in cross-sections and industry regressions, were roughly in the neighborhood of unity. But coefficients of the equipment tax credit variables were generally negative and of outlandish values in the time-series, while usually positive but varying substantially in cross-section regressions. Coefficients relating to the suspension of accelerated depreciation in 1966 were wildly negative (of the "wrong" sign as the variable was defined), while those of the suspension of the equipment tax credit were more often positive, but of considerable variance. Coefficients for the corporate income tax surcharge anticipated in 1967 and early 1968 were less than unity in firm time-series and cross-section regressions. In all cases standard errors were so high that parameter estimation and statistical inference were unreliable. There was, however, little in the results to suggest that the relatively moderate survey responses *underestimated* the effects of the tax measures, and the various negative coefficients raised further questions

[8] Algebraically, the regressions were of the form:

$$i = b_0 + \sum_{j=1}^{m} b_j x_j + \sum_{k=m+1}^{n} b_k x_k + u$$

where i = the ratio of capital expenditures, actual or anticipated, to gross fixed assets; x_j = the current and lagged relative sales change, profits and depreciation variables; and x_k = the tax policy survey response variables, expressed as ratios of actual or anticipated capital expenditures.

in some instances as to the positive effects reported.[9]

III. Conclusion

It is of course possible that survey respondents are unaware of all the influence, direct and indirect, that particular policies may have on investment. For what they are worth, however, survey responses have indicated only modest effects of tax measures designed to stimulate, or discourage, capital expenditures. Means of survey results were usually less than all except the smallest of estimates from several econometric models. Each dollar of loss or gain in taxes appeared to generate only very minor compensating capital expenditure. An attempt to estimate parameters of survey variables in general investment equations was inconclusive, but did not suggest that the survey responses, while of questionable accuracy, were underestimates.

Appendix

Basic data for econometric estimates in Table 1 are taken from Fromm as follows:

1. *Hall and Jorgenson*

Table 2-5 on pp. 46–47 lists gross investment divided into equipment and structures, by year:

	Equipment	Structures	Total
	(billions of 1965 dollars)		
1963	31.191	19.418	50.609
1964	35.116	20.604	55.720
1967 (est.)	39.408	24.433	63.841

Table 2-7, p. 52, lists estimated capital expenditures due to the guidelines and tax credit:

	Guidelines	Tax Credit
	(billions of 1965 dollars)	
1963	1.062	2.238
1964	1.220	3.765

[9] Detailed tabulations of some of the regression results involving observations from all of the surveys from 1955 through 1968 are available on request to the authors.

Table 2-8, p. 54, reports estimated capital expenditures in 1964 due to the corporate tax cut, assuming no effect on the level of output, as −0.248 billions of 1965 dollars.

All of these incentive effects were divided by total gross investment to obtain the percentages shown in Table 1.

Table 2-11, p. 58, reports estimated effects on capital expenditures due to 1966 suspensions on the assumption that the suspensions would last through 1967:

	Equipment (tax credit)	Structures (accelerated depreciation)	Total
	(billions of 1965 dollars)		
1967	−4.062	−0.864	−4.926

Table 2-10, p. 56, reports estimated effects on capital expenditures associated with the actual abbreviated suspensions.

	Equipment	Structures	Total
	(billions of 1965 dollars)		
1967	−0.870	−0.289	−1.159

A figure for anticipated capital expenditure plans in the fall of 1966 when the suspensions were expected to last through 1967 was then obtained by subtracting from actual 1967 capital expenditures the difference between these two sets of effects. The percentages shown in Table 1 are the estimated full-term suspension effects divided by this reconstruction of anticipated capital expenditures:

$$\$63.841b - (\$4.926b - \$1.159b) = \$60.074b$$

2. *Bischoff*

Table 3-15, p. 117.

3. *Klein and Taubman*

Table 5-4, p. 238, offers gross investment estimates on the various assumptions: (1) no change in tax law; (2) changes in cash flow as a result of the equipment tax credit and the new guidelines; (3) changes in rates of return as well as cash flows:

	(1)	(2)	(3)	(4)	
	No. Change	Change in cash flow only	Change in rate of return and cash flow	Ratio of incentive effect to investment (2)−(1) / (2)	(3)−(1) / (3)
	(billions of dollars)			(percent)	
1963	57.825	58.000	58.975	0.3	1.9
1964	63.350	63.925	66.400	0.9	4.6

Following Klein and Taubman's preference for the "cash flow only" estimate, the difference between "no change" and cash flow only, divided by the latter, is presented in our Table 1.

Table 5-2, p. 234, gives estimates of 1967 investment under the assumption of no suspension of incentives and that of a temporary suspension lasting through 1967.

No Suspension	Temporary Suspension
(billions of dollars)	
84.475	82.175

The difference in estimates divided by the temporary suspension figures yields the percentage effect.

4. *Coen*

Table 4-12, p. 178, reports actual investment in manufacturing and estimates of investment attributable to the whole package of tax incentives including the accelerated depreciation dating from 1954. Coen offers several sets of estimates. For his preferred variable-adjustment-speed model with a twelve-quarter inverted-V lag and user cost based on declining balance depreciation, the relevant figures are:

	Attributable to Incentives	Manufacturing Investment	Ratio of Incentive Effects to Investment
	(millions of 1964 dollars)		(percent)
1963	422	12,673	3.3
1964	704	14,848	4.7

Our estimate for 1963 and 1964 incentive effects exclusive of the 1954 acceleration of depreciation was obtained by subtracting the $179 million of investment Coen finds attributable to incentives for 1961, when this depreciation effect was last isolated. The figure had been decreasing according to Coen's results. Thus later estimates listed for Coen, entailing the $179 million subtraction, are probably a bit too low.

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Robert Eisner "Tax Incentives for Investment," pp.397-401

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TAX INCENTIVES FOR INVESTMENT

ROBERT EISNER*

1. *Preface*

RUSSELL B. LONG, Chairman of the Senate Finance Committee, has recently been credited with a little doggerel describing "Most people['s] . . . philosophy about taxes":

Don't tax you,
Don't tax me,
Tax that fellow behind the tree.[1]

As this audience certainly knows well, economic policy in the United States in recent years has included a number of tax measures ostensibly designed, at least in part, to affect the level of business investment. These have included accelerated rates of tax depreciation on capital goods, tax "credits" for the purchase of equipment, alterations in business income tax rates and, probably most important and of longest standing, the major exclusions of capital gains from taxable income. Twenty-five billion dollars per year would not be a bad estimate of current cost of these measures to "that fellow behind the tree."[2]

2. *Capital Gains Exclusions*

Exclusion of half of "realized" capital gains from adjusted gross income and exclusion of all of capital gains in estates or in gifts amounts to some ten to twelve billion dollars per year in lost revenues to the United States Treasury. And this is not a broadly distributed boon. Leaving aside the gift and bequest exclusions, clearly benefit only to the rich, calculations from *Statistics of Income* for 1970 show that capital gains were trivial for the great bulk of taxpayers, resulting in average tax saving in order of 0.2 per cent for those with incomes under $25,000. In the 1,000,000-and-over category for adjusted gross income, by contrast, some 63 per cent of total income including capital gains and losses came from net capital gains; the tax savings in this group ran to about 20 per cent of total income.

Realized capital gains are only the tip of the iceberg. Income amounts to consumption plus saving, and saving is the increase in net worth, whether it occurs from the growth in value of existing assets, sold or unsold, or the use of salary or other income to buy new assets. Accrued capital gains exceed significantly total "personal saving," defined as the difference between disposable personal income and consumption. But they are taxed, even at half rates, only at realization, frequently many years after they accrue. With appropriate discounting of such delayed taxes and recognition of the gift and bequest exclusions, the effective rate of taxation on accrued capital gains has been estimated at about 8 per cent by one competent analyst,[3] far indeed from the 50 to 70 per cent tax brackets of their major recipients.

The special treatment of capital gains offers a basic bias in the tax system in favor of saving and investment in marketable capital assets and hence to a very considerable extent in corporate enterprise and, specifically, corporate equity. And since corporate enterprise finds plant and equipment a predominantly appropriate form of investment, the tax structure, with its special treatment of capital gains, offers an incentive to business expenditures for plant and equipment.

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[1]Reported in William B. Mead, "Congress Tackles the Income Tax," *Money*, July 1973, p. 55.

[2]See Eisner, "Bonanzas for Business Investment," *Challenge*, forthcoming.

[3]Martin J. Bailey in "Capital Gains and Income Taxation," in A. Harberger and M. Bailey (editors), *Taxation of Income from Capital*, Washington, D.C.: Brookings Institution, 1969, p. 26.

3. *"Liberalized" Depreciation and the Equipment Tax Credit*

Despite this major largess to investors, business spokesmen and other have fostered and secured significant subsidization by means of special equipment tax credits and depreciation allowances in excess of true economic depreciation. All of these measures, in their unwarranted interference with free market forces, contribute to a misallocation of resources and a consequent reduction of economic output and growth. And they contribute to a redistribution of income from working people to property owners and, generally, from moderate income Americans to the relatively rich. By unduly reducing the burden for some they must in the long run, if not immediately, raise the burden on others.

"Liberalization" or acceleration of depreciation has taken many forms: five year amortization on "certificates of necessity"; the switch to double rate declining balance and sum-of-the-year digits in 1954; varied but persistent reductions in tax depreciation lives throughout the post-war period; further, formalized reduction of lives in the 1962 "guidelines"; subsequent delay in enforcement and eventual abandonment of the reserve ratio test; and finally the asset depreciation range system and related measures in 1971 and 1972. This "liberalized" depreciation is widely proclaimed as offering merely more rapid "recovery" of capital investment, and some choose to view acceleration of depreciation for tax purposes simply as an interest-free loan.

Such a perception, while correct for each single piece of plant or equipment or all of the capital expenditures for a single year, is incomplete and readily subject to distortion. For since business firms go on acquiring plant and equipment year after year, to the interest-free loans of the first year are added interest-free loans in each of the years in the future. Hence, even stationary firms, which merely replace expiring plant and equipment at constant prices, find that their initial interest-free loans become permanent, thus mathematically indistinguishable from outright gifts. In growing firms, for which the *money* value of gross capital expenditures tends to grow, that is for almost all large United States corporations, the gifts in lower taxes are repeated, year after year, as long as the liberalized depreciation remain in effect. On the basis of projections from data of the Bureau of Economic Analysis, largely published in the *Survey of Current Business,*[4] I estimate the tax savings from added depreciation charges in 1973 alone as approximately $11 billion. And similar tax savings will be enjoyed throughout the future, indeed eventually growing in annual amount as the rate of capital expenditures continues to grow.

The so-called investment tax credit or even more misnamed "job development credit," amounts to a further tax subsidy of some $4 billion in 1973, and this subsidy too will be repeated in growing amounts as business equipment expenditures increase. But it may be well initially to clear up some semantics; what we have here is not a general tax credit for investment. First, the credit does not apply to plant, but only to equipment. Second, it applies only to investment by business. It therefore excludes the vast amounts of investment in physical capital by non-profit institutions and by state and local as well as federal government. Third, it does not apply to investment in durable goods by households. And fourth, it does not apply to any form of intangible investment, that is the investment in research and development and in human capital which modern economists recognize as the perhaps decisive to economic growth and prosperity.

4. *Investment Subsidies and the Free Market*

It is curious that conservatives claiming to believe in free enterprise and a minimum of government intervention in the economy should favor special tax advantages for business capital expenditures in general and special further advantages for equipment expenditures. It is frequently argued that such tax preferences or subsidies are necessary to make our industrial system more productive. But in a free market, where investment will raise productivity and prove profitable, we might expect that

[4]April 1968, August 1971, January 1972, and January 1973.

businessmen would be undertaking it already, in plant and equipment or in research, development, technology and knowledge. Government subsidies to capital expenditures encourage that one kind of investment — as opposed particularly to investment in human capital and public goods — where the market should prove adequate. If a $100 piece of equipment will raise productivity and add $110 to returns we can expect a profit-maximizing firm to acquire it. If the $100 in new equipment will add only $95 in returns, it is not generally good economics to give the firm a $15 subsidy to encourage it to incur what in real terms, aside from the government aid, will be a $5 loss.

The one argument that defenders of economic freedom may offer for such interference in the market is that the tax structure is somehow already rigged against business investment. While this idea is undoubtedly widely held and frequently expressed, it does not withstand rigorous analysis. It is of course true in a period of insufficient aggregate demand that any tax, by further diminishing demand, is likely to reduce investment. But the notion that business income taxes somehow bear specially on investment is not correct.

For one thing, a profit tax in the short run does nothing to affect the equilibrium level of profit-maximizing output and hence does nothing to affect total factor inputs. It also does not in itself affect the relative price of capital and other inputs and hence does not induce substitution of other factors for capital.

In the longer run, it is true that resources may move out of a taxed sector into a non-taxed sector. But then where do they move, if we are talking of business income taxes which affect the great bulk of conventionally measured productive activity? There may conceivably be some move into non-profit, government or non-market activity but it is hard to see that this can amount to very much and it is also not clear that this would reduce total investment; it might at most substitute investment in non-business activity for investment in the business sector.

But further, this argument quite ignores the tax deductibility of interest costs. Since firms have the option of borrowing to finance capital investment (or in some cases selling interest bearing securities which they hold) and since capital goods are quite preferred items on which to lend (generally better than human capital), the combination of business income taxes and right to charge interest costs against taxable income may well constitute a tax bias in favor of business physical investment. And further, as can be seen by applying the analysis of a recent article by Stiglitz,[5] within a tax structure that includes full taxation of ordinary income, the capital gains loopholes may offer a most substantial tax advantage to corporate investment. Accelerated tax depreciation and investment credits then only serve to aggravate an already major distortion.

The prime determinant of business investment is demand. Investment in plant and equipment falls off when the economy is sluggish and excess capacity makes additional plant and equipment unnecessary. In such a situation, moderate annual tax benefits to business would appear to have little effect, particulary in the short run. Well-run firms will not be led to invest by tax reductions which increase after-tax earnings but do not make *additional* equipment profitable in the face of existing idle capacity. Where demand is brisk, firms will invest without special subsidy. Theoretical analysis, empirical studies and the candid responses of businessmen supplemented by my own work with McGraw-Hill survey data all tend to confirm this view. Over a long run, given the level of employment, it may well be argued that it is people's propensity to save that determines total investment. Various governmental measures, including special treatment of capital gains, accelerated tax depreciation and equipment tax credits, may then essentially only alter the mix of investment — toward the corporate business sector and expenditures for plant and equipment.

[5]Joseph E. Stiglitz, "Taxation, Corporate Financial Policy, and the Cost of Capital," *Journal of Public Economics*, February 1973, especially pp. 24-32. See also Eisner, "An Appraisal of Proposals for Tax Differentials Affecting Investment," Chapter XII in Tax Institute, *Income Tax Differentials*, Princeton, N.J., 1958, especially pp. 167-168.

5. A Variable Tax Credit or Subsidy

The one meritorious argument for subsidizing business capital expenditures, and expenditures for equipment in particular, might be that in a period of unemployment, something is better than nothing. Even then, it would be better to stimulate production of the human capital and public goods which the absence of appropriate market incentive may have left at sub-optimal levels. But if our problem is that of unemployment, cyclical or secular, more appropriate policy tools may be proposed. For the major current subsidies to business capital spending all tend to be pro-cyclical rather than counter-cyclical. In times of boom, capital gains are likely to be greatest, as are current and recent capital expenditures. The equipment tax credit in a sense is also of larger benefit in time of boom than in time of recession. Similarly, accelerated depreciation ties depreciation charges more closely to current and recent capital expenditures and hence also increases tax benefits in booms as opposed to recessions.

A variable equipment tax might be introduced, however, for counter-cyclical purposes. Such a credit ideally would have marginal rates much higher than those in the current law but would be concentrated on the stimulus of purchase that would not have taken place without it. It should vary widely in amount, with all concerned recognizing that any rate is temporary and likely to vary not only between a large positive number and zero but to a negative number, thus becoming a tax rather than a credit, when it becomes necessary to discourage expenditures in order to cool off the economy. A variable tax credit would be much more potent than a permanent one, in that its effects would rest upon inter-temporal substitution rather than inter-factor substitution which may be limited, particularly in the short run.

One simple device for concentrating the credit or tax on marginal investment would be to relate it to only the *excess* of capital expenditures over depreciation charges. Some rough notion of the orders of magnitude involved may be gleaned from figures for 1969, which indicate business expenditures for new plant and equipment totalling about $76 billion,[6] with business tax depreciation at about $63 billion.[7] Coverage is not identical in these two series. Further, some firms have depreciation charges in excess of capital expenditures so that the sum of positive differences between capital expenditures and depreciation charges must be larger than the aggregate difference. We may estimate roughly that the total excesses of plant and equipment expenditures over depreciation charges in 1969 would nevertheless have been no more than $20 billion. A tax credit of 21 per cent on this amount would cost less than 7 per cent on the $76 billion total.

Not too dissimilar results might be seen if we confined the credit to the two-thirds of capital expenditures which went to equipment. And of course a variable marginal credit of this kind could well be considerably higher than 21 per cent in periods where increased expenditures were desired. It would still cost the Treasury and the general taxpayer relatively little on the average, or nothing at all if adequately balanced by added taxes (or "negative credits") in periods when business investment were to be discouraged. Ideally, the program would relate not only to business but to non-profit institutions such as universities, hospitals and private schools, and to state and local governments. It should hence probably generally take the form of a direct subsidy rather than of a tax credit and be arranged to benefit small, unprofitable and new firms which may have little in the way of income on which to enjoy tax savings.

6. A Real Job Development Credit and Investment in Human Capital

In addition to and aggravating the cyclical problem is that of structural unemployment. This is significantly identified with new entrants into the labor force and especially the young. A real job development credit would be one that encourages the hiring of labor and particularly of

[6] *Economic Report of the President*, 1973, p. 240.

[7] U.S. Treasury Department, Internal Revenue Service, *Statistics of Income: Business Income Tax Returns 1968-1969*, 1972, p. 3.

youth, where the incidence of unemployment is highest.

There are currently some million and a half persons from 16 to 21 years of age listed as unemployed, over 12 per cent of the 12 million youths in the civilian labor force. There are another 10 million not in the labor force, many of them because they have given up looking for jobs which seem to be unavailable. And there are another half million youths listed as working part-time who are looking for full time employment. Jobs for young people is one of our greatest potential investments, not only in their own human capital as individuals but in the capital of the economy and the nation.

If, as has been suggested by Herbert Stein, Chairman of the Council of Economic Advisers and Arthur Burns, Chairman of the Federal Reserve Board, we were to suspend or temporarily reduce the investment tax credit, we might encourage businesses to postpone expenditures for new equipment, thus reducing the boom in business investment which has contributed substantially to the high demand we associate with inflation. Yet, to the extent this suspension were successful, it would keep the output of business equipment below what it would otherwise be and thus reduce employment in the capital goods industries. As a general rule, tax increases, or other fiscal or monetary measures aimed at reducing inflation, run the serious risk of raising unemployment. But there is a change in the tax structure or tax mix which might reduce the rates of inflation *and* unemployment and contribute to economic growth. In a forthcoming article,[8] I have proposed such a tax package, which would combine suspension of the investment tax credit with suspension (if not permanent repeal) of part (or all) of the payroll or employment tax on workers under the age of 22.

Suspension of the investment tax credit could be expected to cause some cooling of the economy by reducing demand for capital equipment. But the effects would be slow. And since much equipment is produced in oligopolistic industries where prices are notoriously rigid in a downward direction, we might well fear more unemployment than reduction in prices. Suspension of the equipment tax credit, could be counter-balanced, however, by elimination of the employer portion of the payroll tax for employees up to 21 years of age. This would mean a reduction of over 5 per cent in labor costs for youths currently employed. But what is more, employers would have an incentive to hire additional young people and to give full-time jobs to many now working only part-time.

The gains from such increased employment of youth are likely to be lasting. Employers are frequently understandably reluctant to hire young people without experience and training. If new employees work out well there is no guarantee that they will remain long with the employers who invest in their first job. Yet that first job, before the frustration of idleness has wreaked its toll, may be critical to establishment of life-long skills and the "work ethic."

In terms of magnitudes, the six million full-time and four million part-time employees 16 to 21 years of age are earning in the neighborhood of $50 billion per year in covered employment, so that the employer portion of the payroll tax amounts to some three billion dollars, somewhat less than reasonable estimates of investment tax credit costs in 1973. And if further incentives are necessary for hiring youths one might consider crediting employers with the 5.85 percent that they contribute for employees.

Reducing the supply price of a portion of labor, thus cutting current costs, would operate both to curb the rate of inflation and to reduce unemployment. As I have written in my forthcoming paper, "It would halt unjustified government intervention to encourage investment in machines while reducing government discouragement of investment in man." And in addition to stimulating investment in vital human capital, by increasing employment, output and income, it would almost certainly increase traditionally measured saving and investment.

[8] "Men and Machines and Taxes," *Social Policy*, September 1973.

from Social Policy, September/October 1973, pp. 44-45.

POLICY PROPOSALS

ROBERT EISNER

Men and Machines and Taxes

Four billion dollars a year! That is what the U.S. Treasury can expect to lose in presumably needed tax revenues as a result of the investment tax credit. This provision, designed ostensibly to encourage capital expenditures, reduces business taxes by up to 7 percent of the amount of purchases of new machinery or equipment. By contrast business taxes are generally increased by 5.85 percent of all wages, the employer contribution of the payroll tax.

Why should business get a special tax break when it buys new machinery and equipment? Some say that such purchases contribute to economic growth. But if they do, that is, if a $100 machine will, with proper discounting for the future, produce more than $100 in extra output or cost savings, any profit-seeking firm should be expected to install the new equipment without special government encouragement. And if the $100 piece of machinery will only return $95, it does not contribute to economic growth to have the U.S. Treasury pay out an extra $7 to make the investment profitable.

While in a free enterprise system businesses should be expected to acquire on their own an optimal amount of plant and equipment, economic growth might well be stimulated by government encouragement of other forms of investment that businesses cannot handle on their own. These include, in particular, investment in human capital, training, know-how, and basic job skills, many of which can come only from experience.

There are currently some million and a half persons from sixteen to twenty-one years of age listed as unemployed, over 12 percent of the 12 million persons in the civilian labor force. There are another 10 million not in the labor force, many of them because they have given up looking for jobs, which seem to be unavailable. And there are another half million youths listed as working part-time who are looking for full-time employment. Making jobs available for young people is one of the greatest investments we can make, for the investment is not only in them but in the economy and the nation.

Despite repeated insistence by President Nixon and his administration that there will be no increase in taxes, Herbert Stein, Chairman of the President's Council of Economic Advisers, now suggests that higher taxes might prove desirable to combat inflation. He adds that one particularly appropriate increase might be a suspension of the investment tax credit. By suspending the credit, we might encourage businesses to postpone expenditures for new equipment, thus reducing the boom in business investment which has contributed substantially to the high demand we associate with inflation. Yet to the extent that this suspension were successful, it would keep output of business equipment below what it would otherwise be and thus reduce employment in the capital goods industries—this with 5

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percent of the total labor force and 12 percent of youths still unemployed.

Ironically, when the investment tax credit was reincarnated in 1971, it was dubbed in best Madison Avenue fashion, a "job development credit." Many of us were skeptical then, but it is true that tax increases, or other tight fiscal and monetary measures aimed at reducing inflation, run the serious risk of raising unemployment. Yet there is a change we can effect in the tax structure or tax mix that would reduce the rates of inflation *and* unemployment and contribute to economic growth.

I propose a tax package that would include suspension of the investment tax credit along with suspension (if not permanent repeal) of part of the payroll or employment tax on all workers up to the age of twenty-one. This will reduce inflation while keeping to the targets of full employment and economic growth.

The proposal has much to commend it in terms of equity. The total payroll tax now amounts to 11.7 percent of employee incomes up to $10,800. According to President Nixon's budget, it will account for 29 cents of every dollar of federal tax revenues, second only to the personal income tax in the aggregate and far in excess of the 14 percent of tax revenues now accounted for by corporations. Yet it is a highly regressive tax with no deductions or exemptions and with smaller proportions of income taken the more income exceeds the $10,800 limit. Thus for an individual with an income of $100,000 the maximum payroll tax of $1,263.60 is only 1.25 percent rather than the 11.7 percent for those with incomes up to $10,800. To redress the balance, withdrawal of the investment tax credit by cutting corporate after-tax earnings would reduce the boon of lightly taxed capital gains enjoyed most by the rich.

Suspension of the investment tax credit could be expected to cause some cooling of the economy by reducing demand for capital equipment. But the effects would be slow, and since much equipment is produced in oligopolistic industries where prices are notoriously rigid in a downward direction, we might well fear more unemployment than reduction in prices. This could be counterbalanced by elimination of the employer portion of the payroll tax for employees up to twenty-one years of age. As far as that applies to the 6 million currently working full-time, it would mean a reduction of over 5 percent in labor costs. That in turn should reduce prices. But what is more, employers would have an incentive to hire additional teen-agers and those twenty and twenty-one years of age and to give full-time jobs to many now working only part-time. The gains from such increased employment of youth are likely to be lasting. Employers are frequently understandably reluctant to hire young people without experience and training. Risks are considerable and if new employees work out there is no guarantee that they will remain long with the employers who invest in their first job. Yet that first job, before the frustration of idleness has wreaked its toll, may be critical to establishment of lifelong skills and the work ethic.

In terms of magnitudes, this switch in taxes is entirely feasible. We may estimate the investment tax credit as approaching $4 billion in 1973. If we assume that 6 million full-time and 4 million part-time employees sixteen to twenty-one years of age are earning $50 billion per year in covered employment, the employer portion of the payroll tax amounts to $3 billion.

It may be objected that a special incentive to hire youths will result in less employment for adults. This is hardly likely. While there might be some "substitution effect" in the economists' jargon, the expansion effect of added employment should considerably outweigh it. A more serious objection might be that the 5.85 percent reduction in labor costs (more precisely, 5.85 divided by 105.85, or 5.53 percent) would not be enough either to induce significant additional hiring of young workers or to have much effect on prices. The answer to this might be to offer employers still further incentives to hire youths, such as crediting them with the 5.85 percent that they contribute for employees. In the interest of increasing employment generally and lowering prices, one might extend the reduction or elimination of taxes beyond those under twenty-two years of age, for example, by applying to the payroll tax the $750 personal exemption in the individual income tax.

But whatever the limitations of my proposal, eliminating the employer payroll tax for youths as we suspend the investment tax credit would clearly be a step in the right direction. It would help to reduce unemployment and the rate of inflation. And it would halt unjustified government intervention to encourage investment in machines while reducing government discouragement of investment in man.

"While in a free enterprise system businesses should be expected to acquire on their own an optimal amount of plant and equipment, economic growth might well be stimulated by government encouragement of other forms of investment that businesses cannot handle on their own."

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Mr. EISNER. I would like to indicate certain basic principles that I think should guide us in terms of government policy, tax policy toward small business and indeed, toward the economy in general. I start from the premise that, unless there are reasons to indicate otherwise, there should essentially be a policy of nonintervention. This hardly means that the government will have nothing to do with what goes on. Indeed, as I proceed, I will indicate principles which will call for significant intervention, but intervention that does not interfere with the optimal allocation of resources and efficient operation of enterprises.

The basic principles which would call for intervention in aid of small business or in aid of anybody else, or restricting anybody fall, I would think, into three categories. First we have the matter of imperfections in markets. Where there are imperfections in markets such that competition is not operating adequately, or there is inadequate access to capital funds, we may want to correct those imperfections or compensate for them.

A second phenomenon calling for intervention involves what in economists' jargon is called externalities, that is, in the area even of perfect competition there may be things that an individual firm will do which involve costs or benefits to others than those who are involved in the transactions. The obvious case in point we are all familiar with now involves pollution. A firm producing competitively may find it best to burn a kind of coal or engage in a process which is cheaper for it, cheaper for the customer, but imposes costs elsewhere.

However, there are also positive externalities; that is, a firm may, for example, by hiring youth, by training people, convey benefits to society for years and years to come—by talking youngsters off the street, by building in them a kind of human capital that will enable them to be productive members of society for the rest of their lives.

Now, a final basis for intervention might be, very frankly, that we want to redistribute, we want to take from some and give to others. I think if we keep these categories in mind, we will find on the one hand that many of the proposals, however well intentioned, that have been advanced in behalf of small business or anybody else, really fall to the ground with proper analysis, but other proposals come to the fore.

Underlying this there has to be recognition of the simple truth, the aphorism that there is no free lunch—someone has to pay for it. That has to be immediately qualified by the recognition that when there is massive unemployment, as there is now, and there is a huge amount of capacity unused, there may be lunches waiting to be eaten. They are already there. There is no cost to eating them.

Now, I can begin rather negatively by suggesting that a lot of the proposals in the way of encouragements to business capital expenditures in my opinion are very much misguided. They are misguided for large business, and misguided even more for small business. These are the whole variety of proposals, including a lot of policies we already have, and extensions of them for equipment tax credits, in which businesses are told if you spend money to buy eligible equipment, you get a tax break.

Similarly, there are proposals for increasing depreciation allowances beyond true economic depreciation—again, there are tax advantages, giveaways, loopholes, tax expenditure—however you want to call it.

There are other proposals in the way of changing capital gains taxation, already very liberal, already a very large loophole, in the direction of somehow giving favor to small businesses and to their owners. All of these proposals I consider incorrect—incorrect in terms of violating the basic principles I have enunciated, encouraging businesses to spend on things they would not otherwise spend, indeed distorting the economy. If we think about it quickly, take the equipment tax credit, misnamed the investment tax credit, that does not cover all investments, not even all business investments, more arrogantly and I think mischievously misnamed at times, the job development credit—there are far better ways of developing jobs. If anything, an equipment tax credit would, as compared to other stimulatory devices, tend to encourage expenditures on equipment as opposed to expenditures on people.

Another objection to the equipment tax credit and the whole collection, really, of devices to encourage business spending on investment, is that it tends to be procyclical, rather than countercyclical. The higher the business investment, the higher equipment spending is, the more the tax break. The higher equipment spending is, the more we are in a boom. That is exactly when we do not want to give more in the way of tax breaks.

On the other hand, in a recession where equipment spending is down, then the benefits would be less, and then, indeed, the stimulatory effects are likely to be less.

I might add that my own research suggests that the benefits from these things usually are far less than the costs. We may find ourselves giving away $5 billion in tax advantages to get $1 or $2 billion in increased investment spending.

There is, however, a final note in regard to this that I might stress, of particular relevance in the case of small business.

Subsidies for business investment tend to help those businesses that are most capital intensive. It is reasonably well known that this is not likely to be small business. The very nature of capital intensity, as such, is to require large businesses, large investment. It means then that the investment credits that we have or those proposed, the increases in them, would much more favor large business than small business. Figurately speaking, small business will be picking up the crumbs from the table.

I hope then that I have made clear that this is an unfortunate intervention in the system, one which again is understandable, but one on which I think the Congress in an enlightned fashion should be vigilant. Everybody wants something for himself. Everybody can figure out a reason why a tax advantage to him will somehow help the country, help the economy, help economic growth, and these items actually become very attractive for any individual. Of course, it seems to make sense for the individual.

But the classic argument for the equipment tax credit or investment credit is that it favors economic growth. There is first an issue to be raised as to whether Congress has any business biasing the economy in the direction of more or less economic growth. For a prosperous country, the free market decisions of how much we want to save or invest for growth might well be respected. Second, the notion that more machinery or more business investment stimulates growth is, after

all, a notion which comes from a competitive economy, from the idea that business firms normally left to themselves will acquire equipment, will invest when it adds to their own profits, to productive capacity. That is well true when the Government does not intervene: but if the Government is giving, let us say, a 10-percent tax credit, what it means is that businesses that might contemplate a $100 million investment which would net them perhaps $95 million in increased productivity in the future, would now undertake that loss investment; such investment means $100 million will get you not more but less, $95 million, which they undertake because when they enter into their own calculus they recognize that the Government handout of another $10 million from a 10-percent credit will put them ahead.

Now, as opposed to investment credits, there are ways to stimulate the economy to help small business and to be consistent with the principles that I have suggested. I think a major one here would be subsidizing investment in human capital. It is notorious in our system, since we are not a slave economy, that businesses really have no incentive other than good will to invest adequately in the human capital, in the training of people, the hiring of young, inexperienced workers, because they cannot own them. If you take a young kid of 17 or 18, a dropout from high school, or a recent graduate whose future is uncertain, and you hire him, in the first place it may be a bust and you have lost, and in the second place it may be a success and there is no way you can keep him or her from going elsewhere. Not that, of course, is a problem of all business. But I submit it is a problem of particular import for small business. With a large concern there may be much more in the way of longevity. People think of lifelong pensions and careers. Small businesses will tend to have a greater turnover. There is therefore more reason than ever to help small business in the hiring of people and the keeping of people.

I would suggest that there may be some tendency for small businesses for a variety of reasons to pay low wages. There will therefore be arguments that the way to help small business would be to remove the minimum wage law requirements. This is a path that I would not follow.

However, let me come to a proposal that I would follow, that I think would help small business and would help the economy, and would involve investment in human capital—that is to have a true job development credit—not the misnamed one for equipment, but one which would subsidize businesses in the hiring of labor. That would be a very simple device. We, by this time, have an 11.7 percent tax on the hiring of labor—not a subsidy, not a credit, but a tax. Everytime an employer hires a worker, he has to in effect pay to Uncle Sam 5.85 percent which is pulled out of the employee's salary, and another 5.85 percent on top of that. An appropriate thing to do might be—and you can work out the bookkeeping, the accounting, the legal niceties as you wish—to have business excused or credited for some or all of these payments. The Government then would, perhaps out of general Treasury revenues or however it would do it, take over some portion of this 11.7 percent. Indeed, what I would suggest is that they pay all of it for those under 21. By doing that you would have a major subsidy, perhaps not adequate, but a significant step in that direction to businesses to hire the young, to give them

training, to give them developing careers and in that way help not only themselves, but to help the economy as a whole, to get the kids off the streets and into the habits of work and into long lifetime jobs.

This would also, by the way, hardly be inflationary, because it would be increasing the degree of effective demand by lowering labor costs, by lowering the costs of production; by so doing, you would make prices lower under competition and would give increased real incomes, that would actually increase demand.

Senator NELSON. You would apply this provision to any business?

Mr. EISNER. I would, unless there was some reason to suggest otherwise, I think it might well be applied to any business. In fact, that was the original form in which I mentioned it in several publications. But obviously it is possible to apply it only to small business. I think there are some arguments that it is even more meaningful for samll businesses than it is for large businesses along the lines I have suggested.

Senator NELSON. Have you thought of what implications that might have in the job market competition of young versus middle-aged or older, in low skilled jobs?

Mr. EISNER. It would undoubtedly make the hiring of the young somewhat more attractive. I think the measure could be extended to others who are marginal in the labor force, to women, to new entrants generally. It could be a provision, let us say, that the payroll tax be excused or paid for for the first year of employment of anybody. This would be one way of encouraging people to enter the labor force.

I, of course, do not believe that our economy has only a fixed number of people that it can employ. I think measures to stimulate employment will tend to increase employment generally. On the one hand, if businesses hire more young, I am afraid some uninformed people may say they are taking away the jobs of the elderly or the middle-aged or the normal adult workers; but, as a matter of fact, the theory is, as these people get jobs, they will be working, producing, buying, creating demand which will put other people to work. I will strongly urge and argue that the total effect will be favorable for all.

I might quickly conclude with just a few other related points. I think one area where small business suffers acutely in the competition with large business and in the simple quest for survival is the effort to secure funds. It finds itself for good reasons—institutional costs of information—it finds it very difficult to get the funds it needs for expansion, for investment, for carrying inventories, for carrying on operations. I think this committee and the Congress should look into means of equalizing this. This would mean that we would be helping the economy and helping small business, and I might submit that many of the policies followed by the Federal Reserve and more or less by the Congress have, in fact, further aggravated the problems of small business in getting funds. When you tighten money, we well know that large corporations can get the funds. It is the small businesses that get stuck. They are the ones that are locked out. They do not have capital markets, equity markets to which they can readily turn, and the costs of funds become prohibitive if they do not become completely unavailable.

Some of the measures like the equipment tax credits and subsidies to invest can aggravate this, because to the extent they do encourage business generally to buy more machinery, they increase investment demand, they raise machinery prices, the cost of investment for everybody, and they raise the cost of credit for everybody, and that means disproportionately for small business.

In sum, then and there is obviously more detail in my prepared statement and also in a number of articles that I have submitted for the record, we should be careful about intervention in the system, where we intervene. We should be careful that we are not contradicting our basic principles, giving some direct help in the short run, but stimulating a backwash out of our interference in the economy that in the end injures a great many people and may even injure those that we are endeavoring to help more than the direct help that we could give them.

Senator BENTSEN. Thank you very much, Professor Eisner. Dr. Holt, would you proceed with your testimony now?

STATEMENT OF CHARLES C. HOLT, DIRECTOR, INFLATION AND UNEMPLOYMENT RESEARCH, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. HOLT. Senators Bentsen and Dole, I am very pleased to be here. I am testifying on my own behalf and not as representative of the Urban Institute. I am submitting a written statement and I will try briefly to summarize it.

The role of small business in our economy is critically important in its contribution to technological innovation, to growth in employment, and to competition.

Unfortunately, small business faces difficult problems that are directly attributable to the Federal Government, in the areas of taxes, financing, and inflation.

These problems are much clearer than their answers. While I will propose some policy approaches, I do so very tentatively. One of the key points that I want to make is that we have neglected the basic and applied research and the policy analysis that Congress and the administration need to make good decisions in these areas.

I would first like to underscore many of the things that Professor Eisner has said. I thoroughly concur with his general thrust.

Turning to tax problems, every group, of course, complains about its taxes, and small business is no exception. But, what we need to seek is changes in our present tax structure which is especially detrimental to small business, relative to that of larger business.

The Federal tax system is a morass for small business as a result of its complexity, uncertainty, administrative burden, and the costs for legal, tax, and accounting services. As a result, some small business managers are seriously distracted by these burdens from running their businesses.

Small business is especially risky, and as the manager seeks to limit his liability and raise more capital, he considers moving from a simple proprietorship into other forms of business organization: a partnership, a limited partnership, a limited partnership with an incorporated general partner, a subchapter S corporation, or a conventional cor-

poration whose earnings are taxed. With each of these successive alternatives comes more complex rules and restrictions, or more adverse taxes.

In short, none of the alternatives are very attractive for the small businessman facing problems of raising capital on the one hand, and facing high levels of risk on the other.

Even the routine preparing of withholding taxes and other routine tax forms are differentially difficult for the small business as a result of the tremendous complexity.

The first objective of tax reform should be a drastic simplification of structure, and to eliminate adverse costs and incentives. Professor Eisner talked a good deal about the Government intervening in the private economy and questioned whether they were socially sound.

We need to review carefully our whole tax structure and areas of regulations—SEC and so on—that actually produce preverse incentives and preverse problems for small business. The least the Government can do, if it does not choose to favor small business, is to not cause unique difficulties for it.

There are many indirect repercussions of making any structural changes in the tax system. In the proposals I make, I do so very tentatively, and urge that they be very critically examined for indirect effects.

One approach to some of these problems would be to make the corporation income tax continuously progressive, starting at a zero tax rate for the first $25,000 of earnings and increasing in steps for larger earnings.

This would allow very small corporations to have the advantages of limited liability using a simple corporate structure, and be free of many of the restrictions that are associated with the subchapter S corporation, and limited partnerships, and so on, which would be a tremendous advantage in operating small business, and would avoid the heavy burden of the corporation income tax.

Now, carrying that idea to its logical conclusion, we might have a corporation income tax, progressive up to the point that size itself would be a detriment and hence would give a negative incentive for merging, and a positive incentive for corporations voluntarily to split into smaller business organizations.

These proposals—and some of the others I mentioned—should be carefully researched to make sure they would contribute effectively to a simpler, more effective tax system for small business.

Unfortunately, no agency is doing the kind of economic, legal, and administrative research that such problems require to understand the important indirect effects as well as the direct ones.

The efficiency, equity, and incentive effects need to be considered for the economy generally, for the small businesses themselves, but also for the government bureaucracy and the supporting legal, tax, and accounting services. New types of basic, applied, and policy research are needed to get good answers. I will return to this shortly.

In the area of equity capital and employment, Professor Eisner has made a number of extremely good points, and I would ally myself with them.

Small businesses are in critical need of equity capital. The stock market has been badly disrupted for large firms as the result of tight

monetary policy, but for small businesses a market for equity capital has been virtually nonexistent for almost half a decade.

Part of this difficulty is directly attributable to the fact that high-income people, who are the ones who can most readily carry the risk of investing in small corporations and small businesses, are unduly attracted to tax shelters. And these tax shelters tend to absorb a great deal of equity capital that would otherwise be available, if investors were examining normal business returns.

One example is the program by which the Federal Government leaves municipal and State bonds tax-free. This is an effort of the Federal Government to do a type of revenue sharing and support State and local governments. But, it has the effect of siphoning off what otherwise might be capital available for risk investments into very conservative bonds. If we are concerned about the availability of risk capital for not only small businesses but large businesses as well, there are other ways that the Federal Government can subsidize interest payments to State and local governments that would avoid short circuiting the redistribution effects of the progressive income tax and the absorbtion of potential risk capital into ery conservative investments.

This is simply one example. One can point to various other typ.. of investment that appeal to high-income people—the capital gains loophole; the investment tax credit can accrue to individuals through organizations designed specifically to capture the tax benefits through such things as oil depletion allowance and other government programs that may be desirable, in and of themselves, but do have the effect of tending to attract risk capital into such things as land speculation and real estate, instead of making it available for investment and equity capital.

As you can see, although we start with the concerns of small business the issues spill over into the whole tax structure, both for large corporations and for personal income.

Effective solutions are far from obvious, but a good starting point would be to close the tax loopholes that divert investors from being attracted to sound business investment opportunities many of which would be found in small business.

There are various kinds of biases that affect institutional investors in the form of mutual funds, banks, pension funds, and trust departments, which dissuade them from engaging in equity investments.

Senator BENTSEN. Why is that?

Mr. HOLT. One of the considerations is that very large mutual funds are concerned with their market impact and simply because the mutual fund is large, they have to look for investment opportunities that will abosrb very large amounts of money. They are concerned, when they make transactions in their portfolios, that they may in the process of unloading a particular investment unduly depress their prices and thereby essentially suffer investment performance. So by having very large portfolios, they are biased toward seeking very large volume securities.

Senator BENTSEN. Also, when the institutions concentrate their investments in a few of those major companies, if, for example, you get a legal opinion that IBM is violating the antitrust laws and had the judge not reversed his opinion 3 days later, all of the institutions

try to get out of that gate at the same time and it gets awfully narrow, and you could see some very precipitous drops in the price of stocks.

Mr. HOLT. One of my points is the solutions are far from obvious. The indirect effects of the institutional changes that we are talking about need to be very carefully examined. If someone comes before you and pretends to have a panacea, you need to be very careful.

These problems are exceedingly difficult.

One other response to our tax laws is that large corporations that naturally earn a great deal of the profits in the economy have a tendency to reinvest in their own companies—even though that may not be the socially best investment—because if they pay out in dividends, their stockholders will pay a personal income tax. If they reinvest and run up the value of their own corporation, the stockholders will benefit by delaying their taxes and be able to use capital gains tax rates that are lower than for ordinary income.

You start with a situation in which a large part of these capital funds are in the hands of large businesses and there are tax incentives to keep it from going back into the capital markets, where small businesses would have a better crack at it.

Senator BENTSEN. Suppose we took away the corporate tax completely on the first $25,000? Have you run any numbers as to what we would lose in the way of tax revenue?

Mr. HOLT. No, I have not. It would be very easy to get the first order impact. Estimating the second order impact, what the indirect effects would be as business firms change their forms of organization, would be difficult.

One of the things that characterizes a great deal of the research that is done at Treasury is very much directed at what will the tax revenue be? Joe Pechman at Brookings has a model of the structure of income for individuals. And he can readily determine if we change the tax structure what the change in revenue will be.

However, in that model, no account taken of how people will change their behavior in response to the tax laws, so that it explicitly excludes the really tough indirect effects. A great deal of ingenuity by taxpayers goes into trying to minimize taxes, and when we change the tax structure, obviously there will be changes in behavior by individuals and businesses that were not fully anticipated in advance when the legislation was passed.

This leads one to want to be cautious and to try to anticipate, insofar as possible, what kinds of responses will occur.

Senator BENTSEN. When you speak of "preverse" incentives, are you referring to the investment tax credit as one of them?

Mr. HOLT. I would think that the remarks that Professor Eisner made with regard to the investment tax credit should be taken very seriously. We now collect taxes on employment that are associated with retirement, loss of life of the wage earner, and so forth, that are not directly employment connected.

We have legislation that is very likely to pass in the near future that will pay a large part of the medical bill not only of employees but of the country as a whole from an additional payroll tax.

There are many things that we are now doing that really taxes *employment*. On the other hand, we are subsidizing particular kinds of capital goods investment.

Senator BENTSEN. Which ones would you try to negate? You know, a case has been made for each of these tax preferences and that is why we have them on the books.

Now, which ones do you think we haye overemphasized and that we ought to be trying to do away with?

Mr. HOLT. Well, I would be inclined to question very seriously the investment tax credit, for the reasons that we have been discussing. If you look at the distribution of income among different demographic groups, you find that women, blacks, and young people are seriously left out of the labor market.

Now I would not ascribe that to any one single cause, but one of the causes, to the extent that the investment tax credit is effective in stimulating expenditures on capital goods, is to increase the demand for skilled labor. The type of labor that can be most readily displaced by the use of machinery is unskilled labor.

One of the effects of the investment tax credit will be to change the distribution of unemployment in favor of skilled labor, and adversely effect unskilled labor.

Senator BENTSEN. Senator Dole, do you have any questions?

Senator DOLE. I have a short statement I would like to make a part of the record, following the statement of the chairman.

Do you want to finish with Mr. Holt before we ask questions? Or, maybe he is finished?

Mr. HOLT. Well, I am just about through.

Senator BENTSEN. Well, why do you not go ahead and finish, then. I assumed you were. I am sorry.

Mr. HOLT Well, I would say that if we do want to use the investment tax credit, the very least we ought to do is accompany it with manpower training credits in order to upgrade the labor force, along with upgrading equipment.

I think there are problems of distortion that may be associated with the investment tax credit that may have adverse effects, and it is far from obvious that it is in the social interests to try to promote any particular type of investment.

I agree with Professor Eisner on this, that we have a price-guided economy, and the challenge really is to make it work better. I think that one of the spillover effects of the investment tax credit is to distort the investment decisions made by business firms, and, to some extent, soak up capital that would otherwise be available for other purposes.

Turning to the need for business research, I have tried to spotlight difficulties facing small business and to propose "solutions."

However, even when such hearings are as extensive as this one, and political consensus is finally reached on legislation, all too often we find that unexpected consequences ensue.

Simplifications lead to complications, or the administration of the law changes its whole thrust. Such outcomes are especially likely in the area of taxation where a great deal of talent always is devoted to bend the regulations for private advantage.

Unfortunately, the knowledge that is needed cannot always be quickly generated. Depending on the problem involved, some or all of the following may be needed: Basic research, applied research, programmatic research, and operational research.

Universities, institutes, profitmaking research organizations, and governmental agencies may all be called on for significant contributions to the knowledge-generating process.

The political pressure for practical answers *now*, or at least before the next election, cannot be reconciled with a time-consuming research process unless the problems requiring research are identified well in advance and action taken.

No instrument of the Federal Government now has the responsibility and authority to see that this job gets done in the area of social and economic policy, and an adequate job is, in fact, not getting done despite many relevant contributions by the operating agencies.

Most university research is concerned with basic relationships and usually stops short of considering the specific programmatic and operational issues about which governmental decisions must be made.

And I think that one concern that this committee needs to have is not only to focus on the problem, but to look ahead to what knowledge we need to be in a position to answer those problems. We are dealing with very subtle problems and, in a serious sense, we simply do not know the answers.

Thank you.

[The prepared statement of Mr. Holt follows:]

Statement before the Select Committee on Small Business of the U.S. Senate and the Subcommittee on Financial Markets of the Senate Finance Committee

TAXES, EQUITY CAPITAL, EMPLOYMENT, AND POLICY RESEARCH

by

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TAXES, EQUITY CAPITAL, EMPLOYMENT, AND POLICY RESEARCH

by

Charles C. Holt

Senator Gaylord Nelson, Select Committee on Small Business, Senator Lloyd Bentsen, and the Financial Markets Subcommittee of the Senate Finance Committee: I am pleased to be asked to testify at your hearings on Taxes, Capital, Small Business, and the Economy. I speak as an individual, and not for The Urban Institute or its sponsors.

The role of small business in our economy is critically important in its contribution to technological innovation, growth in employment, and competition. Unfortunately, small business faces difficult problems that are directly attributable to the federal government in the areas of taxes, financing, and inflation. These problems are much clearer than their answers. While I will propose some policy approaches, I do so very tentatively. One of the key points that I want to make is that we have neglected the basic and applied research and the policy analysis that Congress and the Administration need to make good decisions in these areas.

Before considering the substantive problems, it is pertinent to review the criteria that the government should use in considering intervention in the operation of the market-regulated sectors of the economy. In the past, excessively simple rationales often have been accepted as justifications for tax incentives and other measures. We can have most confidence that governmental intervention will actually improve on the outcome of independent decisions by consumers and businessmen, if one or more of the following conditions are met: the governmental action improves the fairness of income distribution, improves knowledge of action alternatives or outcomes, compensates for impacts external to the decision makers or reduces imbalances of market power.

Tax Problems

Every group complains about taxes and small business is no exception, but we should be more concerned about problems that arise from the structure of the tax system that are especially detrimental to small business. The federal tax system is a morass for small business as a result of its complexity, uncertainty, administrative burden, and costs for legal, tax, and accounting services. Some small business managers are seriously distracted by these burdens from runnings their businesses.

Small business is especially risky, and as the manager seeks to limit his liability and raise more capital, he considers moving from a proprietorship to alternative forms of business organization: a partnership, a limited partnership, a limited partnership with an incorporated general partner, a Subchapter S corporation, or a conventional corporation whose earnings are taxed and whose losses can be carried backward or forward, but not passed on to the owners. With each of these successive alternatives comes more complex rules and restrictions, or more adverse taxes.

Because small businesses are much more risky than large businesses, limiting liability is relatively more important. However, if the small business limits its liability by forming a conventional corporation, the effect of its high risk is much more adverse, relative to larger firms when the federal government shares in profits but not in losses. The "in between" forms of business organization surround the small businss with complex artibrary restrictions on forms of capital structure, etc. The overall effect of these tax-oriented and SEC laws is to adversely affect small business relative to large business that generally is subject to less risk.

Even preparing routine the great variety of forms and tax reports works to the relative disadvantage of small business in mastering all the ever-changing regulations and forms.

When a small firm seeks to raise equity capital, often through a limited partnership because of tax shelter considerations for its investors, it can encounter complex legal and tax issues that cannot be answered with certainty,

thereby adding the IRS risk to normal business risk. Because the typical career path of the IRS attorney leads to the private law firms in a few years, there is some incentive for IRS staff to promulgate regulations that, by being both complex and vague, create uncertainty and make work for their future employers. The first objective of tax reform should be a drastic simplification of structure, and the elimination of perverse costs and incentives. In doing so, key changes would be needed.

One approach to these problems would be to make the corporation income tax continuously progressive, starting at a zero tax rate for the first $25,000 of earnings and increasing in steps for larger earnings. Then small independent businesses could take full advantage of the simplicity of the corporate form of organization without being taxed for it. Another approach that would reduce risks for small independent corporations in the $25,000 earnings bracket without eliminating taxation would be for losses to produce tax refunds rather than loss carry forwards.

Extending the corporate income tax rate progressively to above the 50% level could give firms an incentive to split rather than to merge with a resulting lessening of corporate concentration.

Paralleling restrictions on government contract officers going to work for the contractors, IRS staff should be prohibited from working for a period of two years for law firms specializing in tax work.

These proposals should be carefully researched to make sure that they would contribute effectively to a simpler, more effective tax system for small business. Unfortunately, no agency is really doing the kind of economic, legal, and administrative research that such problems require to understand the important indirect as well as direct effects. The efficiency, equity, and incentive effects need to be considered for the economy generally, the small businesses, and for the government bureaucracy and its supporting legal, tax, and accounting services. New types of basic, applied, and policy research are needed to get good answers. I will return to this below.

Equity Capital

Small businesses are in critical need of equity capital. The stock market has been badly disrupted for large firms as the result of tight monetary policy, but for small businesses a market for equity capital has been virtually nonexistent for almost half a decade.

Because of their relatively high risks, few people will invest in small business. Those who can carry such risks tend to have high incomes and are attracted inordinately by tax shelters. Sometimes this works to the advantage of small businesses that can take advantage of partnerships' flexibility in allocating tax shelters among investors. But more often the tax break given long-term capital gains, oil depletion, etc., attracts risk money into specific types of capital intensive investments such as land speculation, real estate, oil exploration, etc.

The zero tax rate on municipal bonds gives a federal subsidy to state and local governments, but also attracts potential risk capital into highly conservative investments and reduces the progressivity of the personal income tax. Mutual funds, pension funds, and bank trust departments, even though they boast of professional management, tend to favor the large blue-chip investments. A large part of the earnings of the economy that could be available for investment are controlled by large corporations that first satisfy their internal capital needs before paying out the residual as dividends to stockholders. For all these reasons, equity capital which could be used to start and expand small businesses is scarce and growing scarcer. Of the federal programs aimed at this problem, the Small Business Administration and Small Business Investment Companies are relatively small and the former is a loan program rather than a source of equity capital.

Effective solutions are far from obvious, but a good starting point would be to close the tax loopholes that divert investors from being attracted by sound business investment opportunities many of which would be found in

small business. Next, institutional investors should be encouraged to extend their diversification to small business by being required to file public reports which analyzed the sizes of the companies in their portfolios. The argument that big mutual funds must invest in high volume securities might be met by questioning whether such large financial blocks may not themselves contribute to excessive economic concentration in big companies.

The federal government can easily share its revenue with state and local government by directly subsidizing part of their bond interest rather than doing it indirectly through the tax system with adverse effects on equity capital and income distribution.

If the promotion of small business is taken as an explicit social objective, then public policy would need to go beyond the elimination of government-induced problems for small business and consider specific incentives, such as subsidizing equity capital for small business. But the latter measures require careful justification.

Employment

I recently testified[1] concerning employment before Senator Bentsen's JEC Subcommittee on Economic Growth that it was essential to organize a coordinated program of aggregate demand, manpower programs and broad structural change, if we are to attain full employment without inflation. I need not repeat except to note that the type of issues which you are investigating today with respect to small business is a good example of the painstaking reform that we must seek on many fronts. Progress will be slow--there are no shortcuts.

Currently, the federal government subsidizes capital investment but the wage bill, through the Social Security tax, carries pensions, survivors insurance and other fringes that are not inherent components of

1. "Unemployment, Inflation, and Structural Reform," by Charles C. Holt, June 3, 1975.

compensation for employment. Soon a major health program probably will be added to the "tax on employment." It can be argued that the investment tax credit helps to pay for new productive machinery that makes workers more productive. However, the subsidy to capital and the "tax" on labor could produce an imbalance in business incentives which could induce businessmen to substitute capital for labor, thus producing more jobs for highly skilled workers, but because of displacement by machines, fewer jobs for unskilled workers. The large number of unemployed youth, women, and blacks today suggests that this distortion in incentives may be operating.

At the very least, investment tax credits should be accompanied by manpower training credits to upgrade the workforce along with the new equipment.

Subsidies can be designed for new jobs and for the employment of particular types of workers. Such developments may have important contributions to make. However, reform of perverse incentives should have top priority. Much more work is needed in determining the best policy choices.

The Need for Research

I have tried to spotlight difficulties facing small business and to propose "solutions." However, even when such hearings are extensive and political consensus is finally reached on legislation, all too often we find that unexpected consequences ensue. Simplifications lead to complications, or the administration of a law changes its whole thrust. Such outcomes are especially likely in the area of taxation where a great deal of talent is always expended to bend the regulations for private advantage.

The breath-taking rush of new developments and new problems that occurred during the last two years should stimulate the federal government to review the effectiveness of its legislation, policies, programs, and organizations

bearing on many structural porblems, and to seek practical improvement. However, such improvements are difficult to achieve because of the tempo of change, the complexities of issues and the increasing recognition of the importance of the indirect impacts which governmental programs have. In many areas governments are asked to solve important problems for which adequate knowledge is simply not available for designing effective actions. Just to name some of the recently conspicuous, interacting problems such as energy, transportation, pollution, inflation/unemployment, population, and urban development, not to mention the complex problems of small business that you have been investigating, suggest both the urgency and the difficulty of obtaining better knowledge for policy purposes. Also, old problems take on new dimensions as the traditional policy solutions provide inadequate for current requirements.

Unfortunately, the knowledge that is needed cannot always be quickly generated. Depending on the problem involved, some or all of the following may be needed: basic research, applied research, programmatic research, and operational research. Universities, institutes, profit-making research organizations, and governmental agencies may all be called on for significant contributions to the knowledge-generating process.

The political pressure for practical answers now, or at least before the next election, cannot be reconciled with a time-consuming research process unless the problems requiring research are identified well in advance and action taken. No instrument of the federal government now has the responsibility and authority to see that this job gets done in the area of social and economic policy, and an adequate job is, in fact, not getting done despite many relevant contributions by the operating agencies. Most university research is concerned with basic relationships and usually

stops short of considering the specific programmatic and operational issues about which governmental decisions must be made. The result is that when a problem reaches the agenda for governmental action, we usually are forced to rely on the basic semi-relevant research that happened to get done at universitities and last-minute crash studies made by Congressional or agency staff, usually with partial data. The answers typically are far from adequate and the policy actions that are taken fall short of being fully effective. This is not to suggest that research can "solve" our policy problems, but rather that it can help to reduce the risk of Congress enacting programs that are ineffective or hit the wrong target. Considering the need for better policy-oriented research, it is ironic that research budgets in many agencies are being cut. But the problem goes deeper than funding. We need to build the capability for doing more powerful problem-oriented studies. Reformulating the interactions between government and small business, and structural reform in general raises critical issues. Finding good policy answers will not be simple or easy.

Senator BENTSEN. Thank you very much. Senator Dole?

Senator DOLE. Thank you, Mr. Holt. I want to find out for my own benefit—we are talking about small business. Now, is your statement compiled with any definition of small business? We sort of throw that term around; it has different meanings in different areas of the country. It certainly does in my State, and I am certain it does in others.

Dr. Eisner, you are talking about small business in your statement. What are you talking about?

Mr. EISNER. That is an excellent question, Senator Dole. I raised that with the staff, and I notice that the figures——

Senator DOLE. 500 employees or so many dollars?

Mr. EISNER. I really had, I have to confess, nothing specific in mind, although I think it would be a rather considerably narrower definition than what has been used in statements by, I think, members of your committee, which suggest that small business accounts for something like 53 percent of total employment. That, I think, would be carrying it pretty far.

I understand there are various definitions which are relevent to Small Business Administration and other actions of Government. I have no operating definition of my own.

Senator DOLE. Well, my point was, when I read your statement whether it applied in each instance, or in what instance it might apply. You indicate that there is some concern with reference to the investment tax credit. You might have a different view based on the number of employees or the volume, or whatever it might be. I am just trying to define, delineate, or somehow limit the impact of your statement—or maybe it should not be limited.

Mr. EISNER. It is hard to be precise, but I can just sort of paint the image. The corner grocer, the traditional small businessman, is not using anywhere near the same proportion of equipment in his operations as United States Steel or General Motors or IBM is. Obviously there will be occasional small businesses that are relatively capital intensive. But generally, where a lot of capital is required, the small business is in difficulty, because he cannot raise the funds. So small businesses tend to be not as capital intensive, in businesses that are using relatively less equipment. There will be exceptions, but I think if we drew a graph, we would find that the proportion of equipment of capital generally used in business by some measure will tend to grow as businesses get larger.

Senator DOLE. Dr. Holt, do you have any specific thing in mind in your statement?

Mr. HOLT. No; I do not. In facing the same problem, I relied on the annual report of your committee, which does present some statistics, which surprised me, rather, if I understood them. The cutoff of firms that had something like 10 employees or less were indicated as accounting for 53 percent of employment; and furthermore, the very startling finding that 75 percent of the growth in employment was in this category of small business, associated with the growth of services.

Senator DOLE. I think it is fair to assume that the remarks of both witnesses were addressed to a broader group than 10 or less employees.

Mr. EISNER. Oh, yes.

Mr. HOLT. Yes.

Senator DOLE. Now, Congress had demonstrated some willingness to deal with the problems of the small business during this session. In the Tax Reduction Act, we increased the corporate surtax exemption $50,000, lowered the tax bracket to 20 percent on the first $25,000 of corporate income, increased to $100,000 the amount of used property eligible for the investment tax credit, and increased the amount of investment credit itself to 10 percent. Now, is there anything in that bag that you believe can be justified insofar as small business is concerned, and that may be helpful for small business? I will start with Dr. Eisner.

Mr. EISNER. Well, the one thing I would not look unkindly on is the lowering of the corporate tax rate on small business, which is involved in raising the point at which the surcharge becomes effective. I think there is some justification for that, simply in terms of keeping up with inflation, and leaving the tax structure where it was intended to be some time ago. I also am on record for eliminating the corporate income tax altogether, and have it integrated with the personal income tax, so as to have the flowthrough to individual holders. The corporate income tax is a very deceptive tool. Economists have a hard time agreeing what its ultimate incidence is, but it is clear it encourages a great number of wasteful expenditures. Uncle Sam is literally the partner, not only in close to half of the profits, but in close to half of the costs, which is an invitation to businesses to have, as I remark in my statement, conventions in happy vacationlands and free martini lunches and the like. And I would argue strongly, if we are concerned about the rate of taxation on business, the road is not to look for more loopholes, to leave the rate high and say, let us give an increased credit for equipment spending or for this or that, but just lower that rate. Then, you will not be distorting the economic process as much.

Now, I realize that that is politically more difficult to do, because the general public may well howl if they see a reduction in the corporate tax rate, and they hardly understand anything about depreciation allowances, and not much more about equipment credits. But I think that is really the economic way to proceed if we want to lower business taxation, and therefore the only one I feel I would have some sympathy for is the lowering the rate on small business; and as I say, that is consistent where inflation has taken place, to leave us in the same place we were some years ago, and in line with the general policy of trying to lower the rate of taxation as opposed to increasing the loopholes or the special advantages.

Senator DOLE. Dr. Holt, do you have any additions?

Mr. HOLT. I would agree with that, I think, even including the possibility of the passing through to stockholders the earnings of the corporations, and taxing them at that point, and doing away with the corporation income tax. However, the point I made about the need for better research applies here. We need to know what we are doing before we do, because these taxes do have tremendous impacts. However my inclination would be to feel it would be an improvement.

There is one very good thing about the corporation income tax that should not be lost sight of, and that is it is a very good *countercyclical* tax. In other words, when we head into a depression, and profits drop fast, the associated tax revenue also drops fast. That tends to contribute to economic stability. There are other ways of

doing that. We can have automatic formula changes in tax rates that accomplish the same thing. But it does work well as a countercyclical tax, and if you did want to make some of these institutional changes, we certainly need to look at the dynamic effects.

Senator BENTSEN. I wonder if we could proceed with the other witness, so he could be a part of this series of questions?

Senator DOLE. Oh, that is fine.

Senator BENTSEN. Our next witness is Mr. Jim Harwell, who is the executive director of the Texas Industrial Commission.

STATEMENT OF JAMES H. HARWELL, EXECUTIVE DIRECTOR, TEXAS INDUSTRIAL COMMISSION

Mr. HARWELL. Mr. Chairman, distinguished members, ladies and gentlemen. My name is James H. Harwell. I am executive director of the Texas Industrial Commission, whose primary purpose is to promote and encourage the development of business, industry, agriculture, and commerce within and without the State of Texas.

At the present time, at least 196,449 Texas companies qualify as small businesses having less than 100 employees or less than $1 million in annual gross receipts. Total employment of these companies is 1,625,406 people; and this, Senator, is out of a total labor force of 5.2 million.

Senator DOLE. What was the number employed?

Mr. HARWELL. They employ 1,625,406 people out of a total of 5.2 million labor force. Now, these are companies having less than 100 employees or less than $1 million in gross receipts, which is the definition that we used in this particular one, because of a bill that was proposed before the Senate of our state legislature. And this does not go along necessarily with the SBA's qualification, but was one which we used.

The purpose of my appearance before this Senate Select Committee on Small Business is to inform you of the importance of new industry and new business to our State economy. I shall focus upon four important factors as follows: the employment, or numbers of jobs; Federal taxes generated, State taxes generated, and local taxes generated.

The present Texas economy is a well-balanced regional economy in that all of the major groups of sectors are represented in major proportions. Texas has significant agriculture, mining, construction, manufacturing, communications, utilities, transportation, wholesale and retail trade, finance, insurance, real estate, and personal and business services. Thus, the Texas economic community has raw materials, energy, and services needed by new and growing industries.

During the period 1968–72, the Governor's Division of Planning Coordination collected data from all segments and regions of the Texas economy, and calculated input-output models of nine regions and of the Texas statewide economies.

From the time of release in 1973, the Texas input-output models have been used to analyze the impacts of resource supply changes, natural resources investments, public sector spending, new industry locations and public policies of proposed related actions upon the economy of the State. Water agencies have used regional models in their work of estimating benefits of alternative water projects.

The Governor's office, members of the State legislature, our Texas Industrial Commission, the Texas Education Agency, the Greater South Texas Cultural Basin Commission, the coastal resources management program, councils of government, educational institutions, and other State agencies have calculated needs and made future plans based on these input-output models. This approach to to analyses and planning is serving to improve the coordination of the natural resources, human resources, and economic development programs of Texas.

The Texas Industrial Commission uses the Texas input-output models to identify industries that have potential to fill gaps in regions of the State's economies. A search of the imports data shows the size of local markets now served by outside suppliers. Likewise, an analysis of exports data shows where unfinished materials are leaking away. A followup feasibility analysis is then used to determine whether or not a new or an expanded industry would be a successful and profitable venture in that region. In addition, the input-output models are used to calculate the economywide impacts of new industries upon employment, and taxes paid to each level of government. Such an analysis is provided in the printout that I have prepared, and will have for distribution to the Senators.

During the period September 1, 1973 to August 31, 1974, which is the State's fiscal year, there were 186 new or expanded manufacturing plants announced in Texas. The list is shown on the computer printouts. From the input-output models, the Industrial Commission computed the total employment generated, both the direct plus indirect employment, and annual new taxes generated and paid to the Federal, State and local governments from each of these new plant locations. The computations are determined by the tax rates and employment technology in existence at the time the input-output models are calculated. Thus, the tax estimates depend upon the tax structures as determined by each level of government. If tht tax rates change, then business profits will be affected and tax collections will change. The input-output models can be modified to reflect such changes and thereby can be used to evaluate potential impacts of new taxes or tax changes upon individual sectors of the economy, the entire economy and the tax revenues collected by governments.

During the 1973–1974 period for which analyses were made, it was estimated that the 186 new plant locations in Texas would employ 11,429 people annually. Due to the interdependencies among these new plants and the remainder of the Texas economy, an additional 20,653 people will be employed by business and industry already located in Texas, for a total employment effect of 32,082. This new economic activity, once fully operational, will result in more than $69 million of new annual taxes paid to the Federal Government, $5 million in new annual taxes to State government, and $5 million in new annual taxes to local governments of Texas. The estimated contributions by each individual new establishment are shown on our printout listing. It can be seen that the economywide employment and tax contributions by different types of industries are different; that is, the employment multiplier for Standard Industrial Class—SIC—2221 is 2 whereas, the employment multiplier for SIC 2335 is only 1.4.

If tax rates are changed, then each individual establishment will be forced to evaluate his profit expectations on the basis of the new tax, other things equal. Obviously, higher taxes will result in lower earnings to capital and new or expanded operations will be discouraged. We have not thoroughly analyzed the sensitivity of new plant location in Texas to different tax rates, but with the input-output model such analyses can be undertaken. However, these analyses would require some additional data about production costs of each new industry, data about markets for products, and data about proposed tax changes.

On behalf of the Texas Industrial Commission, I wish to express our sincere thanks for this opportunity to be here with you today, and like Senator—if I might introduce the gentleman behind me, who is the section chief for the economic analysis branch of the Governor's office of planning, Dr. Herbert Grubb. Dr. Grubb put together our input-output model.

[The prepared statement and attachments of Mr. Harwell follow:]

Statement By

James H. Harwell

before

Senate Select Committee on Small Business
Senator Gaylord Nelson, Chairman

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1. Employment or jobs
2. Federal taxes
3. State taxes
4. Local taxes

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During the 1973-1974 period for which analyses were made, it was estimated that the 186 new plant locations in Texas would employ 11,429 people annually. Due to the interdependencies among these new plants and the remainder of the Texas economy an additional 20,653 people will be employed by business and industry already located in Texas, for a total employment

effect of 32,082. This new economic activity, once fully operational will result in more than $69 million of new annual taxes paid to the federal government, $5 million in new annual taxes to state government, and $5 million in new annual taxes to local governments of Texas (see page 10, total line). The estimated contributions by each individual new establishment are shown on the listing. It can be seen that the economywide employment and tax contributions by different types of industries are different; i.e., the employment multiplier for Standard Industrial class (SIC) 2221 is 2 whereas, the employment multiplier for SIC 2335 is only 1.4. (Page 10, lines 4 and 5).

If tax rates are changed, then each individual establishment will be forced to evaluate his profit expectations on the basis of the new tax, other things equal. Obviously, higher taxes will result in lower earnings to capital and new or expanded operations will be discouraged. We have not thoroughly analyzed the sensitivity of new plant location in Texas to different tax rates, but with the input-output model such analyses can be undertaken. However, these analyses would require some additional data about production costs of each new industry, data about markets for products, and data about proposed tax changes.

On behalf of the Texas Industrial Commission, I wish to express my sincere thanks for this opportunity to be here with you today.

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES M. HARWELL
PLANTS LOCATED 9/1/73-8/31/74-B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL /	STATE /	LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
RECREATION SPORTS INTERNAT'L I	3732	250	220	470	828,426	41,507	46,599	4,046,027	11,895,319
HOUSING BY VOGUE, INC.	2451	100	201	301	590,404	39,427	37,054	4,190,587	10,685,997
KIMCO, INC.	3711	120	271	391	1,639,891	73,324	62,844	17,769,880	27,187,916
RENDRAG, INC.	3731	18	16	34	59,647	2,988	3,355	291,313	856,460
AMERICAN MOLDING CORPORATION	3079	25	26	51	91,176	4,573	5,864	517,630	1,444,188
PAGE GULFSTREAM, INC.	2531	150	93	243	321,141	18,479	20,381	2,116,342	5,460,162
SHINTECH, INC.	2821	50	71	121	362,673	17,079	23,552	1,719,217	4,745,039
GENERAL CRUDE OIL COMPANY	2911	150	1,136	1,286	3,807,492	587,939	266,635	27,031,897	68,931,337
ROTOCAST PLASTIC PROD.OF TEXAS	2519	20	12	32	42,819	2,464	2,718	282,178	728,019
INGRAM READY MIX, INC.	3273	8	11	19	33,224	3,179	2,677	212,117	559,989
TEXAS OIL & GAS CORPORATION	1321	10	135	145	517,131	74,811	39,564	3,431,708	8,304,732
PYRAMID DERRICK	3533	50	45	95	166,533	8,638	10,098	945,859	2,572,736
BROWNSVILLE QUALITY SALES MFG.	2531	50	31	81	107,047	6,160	6,794	705,447	1,820,053
ANDY INTERNATIONAL, INC.	3731	140	123	263	463,919	23,244	26,095	2,265,775	6,661,379
SANDY MANUFACTURING COMPANY	2335	100	42	142	168,492	9,719	11,121	1,209,262	2,745,025
VISOR INDUSTRIES	3079	15	15	30	54,705	2,744	3,519	310,578	866,513
PINE-O-PINE COMPANY	2842	44	85	129	541,369	17,043	20,532	2,982,646	6,263,557
ANDREWS LUMBER, INC.	2448	60	44	104	131,984	7,680	12,659	926,183	2,324,719
DURI-LINK MANUFACTURING CO.	3496	9	10	19	43,294	2,058	2,488	262,291	600,646
BRADSHAW MANUFACTURING COMPANY	3496	10	11	21	48,104	2,287	2,765	291,434	667,384

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ENTERPRISE PRODUCTS COMPANY	3299	3	3	6	12,425	685	793	75,214	179,009
TUGGLE MANUFACTURING COMPANY	3792	50	101	151	295,202	19,714	18,527	2,095,293	5,342,997
TRUS JOIST CORPORATION	3441	15	16	31	45,567	2,536	3,110	336,995	798,678
K & B ENGINEERING COMPANY	3662	50	31	81	129,814	6,265	7,654	750,626	1,921,603
DONALDSON MANUFACTURING CO.	2439	12	9	21	26,397	1,536	2,532	185,236	464,942
GRAY ENTERPRISES, INC.	3079	25	26	51	91,176	4,573	5,864	517,630	1,444,188
W & F MANUFACTURING, INC.	3369	4	16	20	68,227	3,043	3,335	366,401	919,667
CONCRETE PRODUCTS MFG., INC.	2891	5	3	8	18,285	883	850	99,802	240,523
BEST & BETTER, INC.	3551	7	7	14	23,953	1,299	1,466	143,407	391,501
PRECISION FORMED PLASTICS,INC.	3079	12	12	24	43,764	2,195	2,815	248,462	693,209
PPG INDUSTRIES, INC.	3231	17	19	36	59,788	3,722	5,154	317,063	976,554
BAPTIST STANDARD PUB. CO. INC.	2721	19	14	33	41,842	2,101	2,553	197,400	621,810
VSL CORPORATION	3496	20	22	42	96,208	4,573	5,529	582,869	1,334,770
UNION CARBIDE CORPORATION	2813	24	55	79	180,920	10,120	14,530	1,431,468	3,621,614
U.S. FURNITURE INDUSTRIES	2511	25	16	41	53,523	3,080	3,397	352,723	910,025
GLITSCH CRYOGENICS, INC.	3443	50	56	106	218,152	11,461	13,437	1,571,042	3,597,606
GIFFORD-HILL COMPANY, INC.	3273	60	83	143	249,179	23,843	20,074	1,590,878	4,199,918
VARCO SEMICONDUCTOR, INC.	3674	150	92	242	389,443	18,854	22,965	2,251,880	5,764,812
FEATHER FABRICS, INC.	2281	50	49	99	161,256	8,015	11,698	807,676	2,261,493
SAFETY-KLEEN CORPORATION	2992	5	9	14	34,450	3,041	1,994	170,922	528,149

ECONOMIC IMPACT ANALYSIS
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TEXAS OIL & GAS CORPORATION	1321	8	108	116	413,705	59,849	31,627	2,745,367	6,643,788
MR. SID	2311	80	34	114	134,794	7,775	8,897	967,410	2,196,021
XEROX CORPORATION	3573	4,000	3,160	7,160	11,662,425	624,456	753,976	46,573,463	182,411,289
UNICO MILLS, INC.	2211	160	155	315	516,019	25,648	37,452	2,584,563	7,234,776
DELTRON, INC.	3679	10	6	16	25,963	1,257	1,531	150,125	384,320
NATIONAL TRANSFORMER CORP.	3612	30	29	59	119,259	5,719	6,579	948,706	2,039,718
SALTYS CAPS & APPAREL, INC.	2331	47	20	67	79,191	4,568	5,227	568,353	1,290,161
TURNER MANUFACTURING COMPANY	2311	20	8	28	33,698	1,944	2,224	241,852	549,004
J & H INDUSTRIES	2339	50	21	71	84,246	4,860	5,561	604,631	1,372,512
JOHN MEYER OF NORWICH	2331	150	63	213	252,739	14,579	16,682	1,813,894	4,117,539
LONE STAR PIPE COMPANY	3079	15	15	30	54,705	2,744	3,519	310,578	866,513
OEM BEARING COMPANY	3714	40	90	130	546,630	24,441	20,948	5,924,293	9,062,638
KERNCO INSTRUMENTS, INC.	3823	8	9	17	39,546	1,653	1,872	269,387	592,651
ROWE INDUSTRIES, INC.	3621	10	10	20	39,753	1,906	2,193	316,235	679,905
GENERAL ELECTRIC CORPORATION	3822	40	46	86	197,728	8,267	9,362	1,346,937	2,963,261
TEXAS LABEL COMPANY	2241	80	78	158	258,009	12,824	18,716	1,292,281	3,618,387
STEPHENVILLE MFG. COMPANY	2331	100	42	142	168,492	9,719	11,121	1,209,262	2,745,025
ROSEBUD'S, INC.	2331	30	13	43	50,548	2,916	3,336	362,778	823,506
PLASTIC ACTIVITIES	2499	14	10	24	30,796	1,792	2,954	216,109	542,434
EUROPAK, INC.	2047	75	541	616	797,127	47,405	97,052	4,588,839	18,217,691

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JOHNSTON	3533	60	54	114	199,839	10,366	12,117	1,135,030	3,087,282
DOTTY DAN, INC.	2337	40	17	57	67,397	3,888	4,448	483,705	1,098,010
STEELDIP GALVANIZING CO., INC.	3479	100	67	167	438,553	12,238	15,399	1,318,078	3,743,342
INDUSTRIAL CONTRACTORS, INC.	3443	100	111	211	436,305	22,923	26,873	3,142,085	7,195,375
THEE AND ME	2361	10	4	14	16,849	972	1,112	120,926	274,502
SANTONE INDUSTRIES, INC.	2327	150	63	213	252,739	14,579	16,682	1,813,894	4,117,539
RORER SYSTEMS CONSULTANTS,INC.	3569	20	21	41	86,454	3,758	4,596	518,726	1,291,628
DELTA, INC.	3469	150	95	245	335,126	21,226	28,302	2,211,378	5,639,014
POLAR CUBE ICE COMPANY	2097	3	6	9	19,419	848	1,533	173,943	356,583
MURPHY PRODUCTS, INC.	2048	3	18	21	34,560	2,047	3,785	197,693	682,041
CASEY'S WELDING & FABRICATING	3411	4	10	14	35,487	1,901	1,872	216,614	561,030
WILLIAMSON INSTRUMENT MACHINE	3599	5	4	9	14,578	781	942	83,216	228,012
B & W INDUSTRIES, INC.	3496	6	7	13	28,862	1,372	1,659	174,860	400,429
ARK-LA-TEX HEAT TREAT	3398	10	39	49	170,567	7,608	8,338	916,302	2,299,165
H.L. HAILEY ENTERPRISE, INC.	3531	10	7	17	26,389	1,417	1,620	174,913	437,283
BIG HORN, INC.	3714	15	34	49	204,986	9,165	7,856	2,221,235	3,398,490
CHEROKEE STAINLESS&CARBON,INC.	3325	15	14	29	54,941	2,753	3,107	251,025	763,116
GSR FEEDER PARTS, INC.	3585	20	40	60	130,566	6,948	8,671	1,091,167	2,433,302
CENTURY MOBILE-AIR MFG.&ENG.CO	3585	20	40	60	130,566	6,948	8,671	1,091,167	2,433,302
M & E MANUFACTURING COMPANY	3494	20	30	50	106,349	5,627	6,881	709,446	1,816,182

84-897 O - 78 - 6

ECONOMIC IMPACT ANALYSIS
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SOUTHMOST STEEL CASTING CO.	3325	35	32	67	128,196	6,425	7,251	585,725	1,780,604
FLOW-FREE PRODUCTS, INC.	3561	35	37	72	151,294	6,577	8,048	907,770	2,260,347
AMER-TRON, INC.	3662	35	21	56	90,870	4,399	5,358	525,438	1,345,121
ATP, INC.	3531	50	36	86	131,944	7,086	8,098	874,569	2,186,423
CHEROKEE STEEL FABRICATOR,INC.	3441	75	82	157	227,837	12,680	15,550	1,684,976	3,993,393
INDUSTRIAL STEEL FABRIC&WELD.	3441	75	82	157	227,837	12,680	15,550	1,684,976	3,993,393
STANDARD BRANDS, INC.	2021	100	352	452	704,072	41,068	93,335	4,341,031	14,629,274
ARMCO STEEL CORPORATION	3448	200	194	394	642,639	32,258	35,223	3,635,636	9,743,504
JOSEPH SCHLITZ BREWING COMPANY	3411	300	759	1,059	2,661,524	142,594	140,426	16,246,073	42,077,329
VULTEX ALLOY STEEL, INC.	3531	6	4	10	15,833	850	972	104,948	262,370
LEVI STRAUSS & COMPANY	2328	400	168	568	673,970	38,876	44,484	4,837,051	10,980,106
M. B. G. PRINTING COMPANY	2751	1	1	2	3,495	196	255	18,783	54,659
STOP & PRINT	2732	1	1	2	3,495	196	255	18,783	54,659
FRANK J. DAVID	2751	1	1	2	3,495	196	255	18,783	54,659
K & K MACHINE SHOP	3599	1	1	2	2,916	156	188	16,643	45,602
HOUSTON PRINTCRAFT, INC.	2751	1	1	2	3,495	196	255	18,783	54,659
CLEAR LAKE PRINTING	2752	1	1	2	3,495	196	255	18,783	54,659
J.&R. FABRICATION COMPANY	3499	2	2	4	9,621	457	553	58,286	133,475
STANDARD FASTENERS&SUPPLY CO.	3452	2	1	3	4,468	283	377	29,485	75,187
CRUSADER GRAPHICS, INC.	2791	2	2	4	6,557	380	427	30,867	95,688

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OGLETHORPE PRINTING COMPANY	2732	2	2	4	6,991	393	510	37,567	109,320
SWAGECO MANUFACTURING	3498	2	3	5	10,635	563	688	70,944	181,617
FARGO CAMPER COMPANY	3792	2	4	6	11,808	789	741	83,811	213,718
CHERRY INSTRUMENT CORPORATION	3599	3	2	5	8,747	468	565	49,930	136,808
METAL-FAB COMPANY	3441	3	3	6	9,113	507	622	67,399	159,736
ASTRO FURNITURE MANUFACTURING	2511	3	2	5	6,423	370	408	42,326	109,201
JOT FABRICATORS	3325	3	3	6	10,988	551	621	50,205	152,623
TUBULAR TECHNOLOGIST	3452	3	2	5	6,702	425	566	44,227	112,779
ROMIC CYCLE COMPANY, INC.	3751	3	6	9	17,712	1,183	1,112	125,717	320,578
HOUSTON PALLET COMPANY, INC.	2448	3	2	5	6,599	384	633	46,309	116,236
JMCO CHEMICALS, INC.	2816	3	10	13	32,868	3,881	3,366	211,148	703,123
INDUSTRIAL STEEL SERVICES	3599	4	3	7	11,662	624	754	66,573	182,410
MILWAUKEE ELECTRIC TOOL CORP.	3546	4	4	8	16,386	813	3,537	80,276	232,800
BUILDERS QUALITY MARBLE	3281	4	4	8	16,567	913	1,058	100,285	238,678
MONTGOMERY MACHINE WORKS	3599	5	4	9	14,578	761	942	83,216	228,012
VISSER-ROWLAND ASSOCIATES,INC.	3931	5	4	9	14,531	898	1,124	85,128	228,143
JONES PRECISION TOOL&INSTRUMEN	3599	5	4	9	14,578	781	942	83,216	228,012
MY WORK SHOP	2732	5	5	10	17,478	982	1,276	93,919	273,304
REDI BLUE PRINT	2732	5	5	10	17,478	982	1,276	93,919	273,304
WASHINGTON MANUFACTURING CO.	2328	5	2	7	8,425	486	556	60,463	137,251

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QUALITY SIGNS, INC.	3993	5	4	9	14,531	898	1,124	85,128	226,143
DURNAL OFFICE SUPPLIES&PRINT.	2732	5	5	10	17,478	982	1,276	93,919	273,384
STONE & SHAW PRINTERS	2732	6	6	12	20,974	1,179	1,561	112,703	327,966
CORR TECH, INC.	3079	6	6	12	21,882	1,097	1,407	124,231	346,604
ROL-DRI, INC.	3949	6	5	11	18,654	1,134	1,092	117,720	293,123
GLIDDEN ROOFING & SHEETMETAL I	3442	6	5	11	16,029	1,058	1,194	90,421	278,497
HUTCO CORPORATION	3599	7	6	13	20,409	1,093	1,319	116,503	319,218
L & Z INDUSTRIES, INC.	2434	7	5	12	15,398	896	1,477	100,054	271,216
FRAME FACTORY	2499	6	6	14	17,598	1,024	1,688	123,491	309,967
ACERO METAL FINISHING CORP.	3471	8	5	13	35,084	979	1,232	105,446	299,467
SCOTT STEEL, INC.	3499	10	11	21	48,104	2,287	2,765	291,434	667,384
UNIQUE BROTHERS MANUFACTURING	2392	10	9	19	31,125	1,722	2,151	220,278	544,087
CHROME CORPORATION	3499	10	11	21	48,104	2,287	2,765	291,434	667,384
POWER & PROPULSION SYSTEMS,INC	3519	11	19	30	56,904	3,602	7,383	444,606	1,115,961
ACCURATE FABRICATING, INC.	3444	12	12	24	38,558	1,936	2,115	218,138	584,610
TRUE-TECH MACHINE	3599	13	10	23	37,903	2,029	2,450	216,363	592,835
SCHUBERT COMPANY	3662	15	9	24	38,944	1,865	2,296	225,180	576,482
OLYMPIA CARPET MILL	2272	15	15	30	46,377	2,404	3,509	242,302	678,446
WESTERN STRESS	3398	15	59	74	255,851	11,412	12,507	1,374,003	3,448,748
GAUGES INTERNATIONAL, INC.	3823	15	17	32	74,148	3,100	3,511	505,101	1,111,222

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MASCO MANUFACTURING, INC.	3079	15	15	30	54,705	2,744	3,519	310,578	866,513
BLEMMER CHEMICAL CORPORATION	2869	16	64	80	202,798	20,910	21,074	1,610,792	4,300,815
DRUMMOND CORPORATION	3441	16	17	33	48,605	2,705	3,317	359,461	851,923
OAK CREEK PRESS, INC.	2751	25	26	51	87,391	4,912	6,378	469,598	1,366,530
HOUSTON HEAT EXCHANGERS	3317	35	48	83	148,673	8,888	9,455	1,220,064	2,928,154
DATA DOCUMENTS, INC. OF TEXAS	2641	40	58	98	175,081	9,978	17,126	1,217,841	3,312,528
SHELTON ENTERPRISES	3411	40	101	141	354,870	19,012	18,728	2,166,143	5,610,318
WALKER-HALL-SEARS, INC.	3662	45	27	72	116,833	5,656	6,889	675,564	1,729,444
NEWELL SALVAGE COMPANY	3341	50	94	144	364,627	22,267	26,950	2,802,847	6,502,605
ANNAK COMPANY	2819	50	190	240	687,912	42,881	43,732	4,409,559	10,671,133
AMCO CHEMICAL COMPANY	2911	100	757	857	2,538,328	391,959	177,757	18,021,265	45,954,226
FULLER COMPANY	3561	200	212	412	864,538	37,584	45,960	5,187,260	12,916,277
TENNECO CHEMICALS, INC.	2821	268	371	634	1,907,658	89,837	128,882	9,848,083	24,958,909
SMITH INDUSTRIES, INC.	3452	485	306	791	1,088,573	68,630	91,511	7,150,123	18,232,814
GULF PRINTING COMPANY	2751	500	510	1,010	1,747,817	98,248	127,562	9,391,964	27,338,615
BOWEN TOOLS, INC.	3533	650	585	1,235	2,164,928	112,294	131,273	12,296,167	33,445,574
UNITED STATES STEEL CORP.	3312	700	1,022	1,722	3,926,508	259,356	240,251	24,408,103	60,043,933
ROHM AND HAAS COMPANY	2822	900	3,105	4,005	8,791,180	720,934	773,705	79,113,924	214,398,734
EAST TEXAS PLATING COMPANY,INC	3471	20	13	33	87,710	2,448	3,080	263,615	748,667
DAVIS WATER & WASTE INDUSTRIES	3589	100	79	179	291,561	15,611	18,849	1,664,336	4,560,281

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES H. HARWELL
PLANTS LOCATED 9/1/73-8/31/74-B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL	/ STATE	/ LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
AMARILLO OIL COMPANY	1321	5	68	73	258,566	37,405	19,767	1,715,854	4,152,367
KERR-MCGEE CORPORATION	1321	20	270	290	1,034,263	149,622	79,067	6,863,417	16,609,469
OIL STATES RUBBER COMPANY	3069	40	22	62	81,378	4,459	6,182	455,783	1,298,982
INTERNATIONAL BUILDERS MART.I.	2439	8	6	14	17,598	1,024	1,688	123,491	309,962
VALLEY CORRUGATED BOX, INC.	2653	100	138	238	380,247	21,758	40,232	2,647,253	7,332,891
STILWELL FOODS, INC.	2037	300	615	915	1,343,641	77,770	116,338	8,979,885	26,580,460
PARKER SEAL COMPANY	3069	500	275	775	1,017,229	55,738	77,280	5,697,291	16,237,279
SUE ANN, INC.	2331	100	42	142	168,492	9,719	11,121	1,209,262	2,745,025
RABBIT INDUSTRIES, INC.	2016	14	74	88	86,725	5,128	18,462	438,678	2,048,626
DAIWABO, TEXAS INC.	2281	750	728	1,478	2,418,839	120,225	175,465	12,115,142	33,922,398
ENNIS BUSINESS FORMS, INC.	2761	10	10	20	32,779	1,926	2,431	207,869	565,404
TRAVEL QUEST COMPANY	3792	25	50	75	147,601	9,857	9,263	1,047,646	2,671,497
STROMBERG'S STATUARY	3272	24	33	57	99,671	9,537	8,030	636,351	1,679,967
GREAT WESTERN JEANS	2369	25	11	36	42,123	2,430	2,780	302,315	686,255
POLYFOAM INDUSTRIES, INC.	3079	40	41	81	145,881	7,316	9,383	828,208	2,310,700
SHERWOOD MEDICAL INDUSTRIES.I.	3069	150	83	233	305,169	16,722	23,184	1,709,187	4,871,183
LANCE, INC.	2051	300	321	621	995,745	58,189	77,551	6,691,201	18,266,979
WALKER MANUFACTURING COMPANY	3714	300	678	978	4,099,729	183,309	157,111	44,424,700	67,969,791
STATE WELDING & MACHINE	3731	50	44	94	165,685	8,301	9,320	809,205	2,379,063
PORT ARTHUR SHIPYARDS, INC.	3731	200	176	376	662,741	33,205	37,279	3,236,822	9,516,257

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES H. HARWELL
PLANTS LOCATED 9/1/73-8/31/74-B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL	STATE	LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
AMERICAN MOECHST CORPORATION	2818	300	1,206	1,506	3,802,471	392,065	395,185	40,202,355	80,640,288
TEXACO, INC.	2911	5,000	37,850	42,850	26,916,390	19,597,973	8,887,827	901,063,254	297,711,298
TARGET MANUFACTURING COMPANY	3599	3	2	5	8,747	468	565	49,930	136,808
PORT-A-SYSTEMS, INC.	3448	10	10	20	32,132	1,613	1,761	181,781	487,173
WILKERSON COMPANY, INC.	3171	20	8	28	33,597	1,704	2,170	198,662	482,749
TECHNICAL PLASTICS, INC.	3079	25	26	51	91,176	4,573	5,864	517,630	1,444,188
MERICO, INC.	2051	400	428	828	1,327,660	77,585	103,375	8,921,601	24,355,971
NUCOR CORPORATION	3312	250	365	615	1,402,324	92,627	85,804	8,717,179	21,444,260
CLEVELAND FORGE, INC.	3462	100	394	494	1,705,674	76,081	83,382	9,160,025	22,991,663
CHAMPION INTERNAT'L TIMHERLAND	2431	300	219	519	659,922	38,402	63,294	4,630,915	11,623,597
MISSION VALLEY MILLS, INC.	2211	300	291	591	967,536	48,090	70,186	4,846,056	13,568,957
MONROE TRAILER MFG. COMPANY	3715	12	27	39	163,989	7,332	6,284	1,776,988	2,718,792
FEATHER FABRICS, INC.	2281	3	3	6	9,675	481	702	46,460	135,682
B & G, INC.	2086	10	14	24	73,964	5,211	3,752	322,351	754,301
MAJESTIC MOBILE HOME MFG. CO.	2451	25	50	75	147,601	9,857	9,263	1,047,646	2,671,497
TEXAS INSTRUMENTS, INC.	3573	2,000	1,580	3,580	5,831,212	312,228	376,988	33,286,731	91,205,643
RIESEL ATHLETIC LETTERING CO.	2391	11	10	21	34,238	1,894	2,344	242,506	598,496
MULTI FITTINGS U.S.A., LTD.	3079	180	184	364	656,465	32,924	42,223	3,726,939	10,398,160
NAVIGATE, INC.	3535	40	24	64	132,426	5,028	6,098	719,851	1,619,665
DEANA K SPORTSWFAR	2339	80	34	114	134,794	7,775	8,897	967,410	2,196,021

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES H. HARWELL
PLANTS LOCATED 9/1/74-8/31/74-B.B.R.

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IRON STAR POTTERS	3269	8	5	13	20,734	2,356	1,312	94,160	290,013
EAST TEXAS ASPHALT COMPANY	2951	8	14	22	55,121	4,865	3,198	273,476	845,091
G & M MANUFACTURING COMPANY	2335	100	42	142	168,492	9,719	11,121	1,209,262	2,745,029
MCGRAW - EDISON COMPANY	3612	200	192	392	795,059	38,126	43,859	6,324,710	15,598,127
CORSICANA SPORTSWEAR	2339	125	53	178	210,615	12,149	13,901	1,511,578	3,431,282
WEATHERBY ENGINEERING COMPANY	3563	75	80	155	324,201	14,094	17,235	1,945,222	4,843,603
DUNTECH INDUSTRIES, INC.	3662	100	61	161	259,629	12,570	15,309	1,501,253	3,843,208
TEXAS MARITIME INDUSTRIES,INC.	3731	130	114	244	430,782	21,583	24,262	2,105,934	6,185,566
GEORGETOWN TEXAS STEEL CORP.	3312	1,000	1,460	2,460	5,609,298	370,508	345,215	34,868,719	85,777,049
GETTELMAN MANUFACTURING, INC.	3537	10	7	17	26,389	1,417	1,620	174,913	437,283
CORVUS CORPORATION	3873	178	189	367	861,919	38,831	44,674	5,099,848	11,933,644
ILLINOIS TOOL WORKS, INC.	3429	250	633	883	2,217,937	118,828	117,022	13,538,394	35,064,440
UNITED MAGNETIC PRODUCTS	3612	9	9	18	35,778	1,716	1,974	284,611	611,914
CHEMICAL DYNAMICS, INC.	3599	20	16	36	58,312	3,122	3,770	332,867	912,856
FLEX FOAM INDUSTRIES, INC.	3079	25	26	51	91,176	4,573	5,864	517,630	1,444,188
MR. D'S APPAREL MFG. COMPANY	2339	75	32	107	126,369	7,289	8,341	906,947	2,058,770
FRIONA INDUSTRIES	2048	200	1,192	1,392	2,303,974	136,489	252,334	13,179,571	45,469,520
CHAMPION INTERNATIONAL, INC.	2431	44	32	76	96,789	5,632	9,285	679,201	1,704,792
WINDOW FASHIONS	2392	15	14	29	46,688	2,583	3,197	330,418	816,132
CAL-TEX	2011	75	541	616	797,127	47,405	97,052	4,588,839	18,217,691

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES H. HARWELL
PLANTS LOCATED 9/1/73-8/31/74-B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL	/ STATE	/ LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
B J MANUFACTURING COMPANY,INC.	3523	80	58	138	211,110	11,338	12,956	1,399,310	3,498,275
STONEVILLE FURNITURE COMPANY	2511	180	112	292	385,369	22,175	24,458	2,539,610	6,552,194
INTRASTATE GATHFRING COMPANY	1321	3	41	44	155,139	22,443	11,860	1,029,512	2,491,419
GENERAL SHELTERS OF TEXAS, INC	2451	10	20	30	59,040	3,943	3,705	419,058	1,068,598
TEXAS EAST TIMES	2711	2	2	4	7,150	339	429	29,661	90,169
BROWDER AND YOUNG PAPER CO.	2646	7	10	17	30,639	1,746	2,997	218,122	579,692
DONELSON, INC.	3751	30	60	90	177,121	11,828	11,116	1,257,176	3,205,799
DONELSON, INC.	3751	30	60	90	177,121	11,828	11,116	1,257,176	3,205,799
BUDDY SCHOELLKOPF PRODUCTS,INC	2392	50	45	95	155,626	8,609	10,636	1,101,394	2,720,443
REX-HIDE, INC.	3011	100	145	245	428,185	28,774	37,087	3,899,699	10,334,202
GOOD TIMES, INC.	3079	2	2	4	7,294	366	469	41,410	115,534
SOUTHWEST PUPPET SUPPLY CO.	3652	3	3	6	12,968	564	689	77,808	198,742
WOODGRAIN MOLDING	2431	8	6	14	17,598	1,024	1,688	123,491	309,962
VICKI INDUSTRIES	3569	10	11	21	43,227	1,879	2,298	259,363	645,814
SEALED AIR CORPORATION	3079	11	11	22	40,117	2,012	2,580	227,757	635,442
TUBE AND METAL INDUSTRIFS	3599	15	12	27	43,734	2,342	2,827	249,650	684,041
LANCE, INC.	2099	17	34	51	110,039	4,405	8,685	985,678	2,020,640
BEHR OF AMERICA, INC.	3585	19	38	57	124,038	6,600	8,237	1,036,608	2,311,636
RICHMOND SCREW ANCHOR CO.,INC.	3496	25	28	53	120,260	5,716	6,911	728,586	1,668,462
PEPPERIDGE FARM, INC.	2051	48	51	99	159,319	9,310	12,405	1,070,592	2,922,716

88

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

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PLANTS LOCATED 9/1/73-8/31/74-B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL /	STATE /	LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
BLAN BAG & BOX COMPANY	2621	86	147	233	405,321	28,410	64,305	2,902,659	8,214,525
IGLOO CORPORATION	3079	115	117	232	419,408	21,035	26,976	2,381,100	6,643,269
RECTOR WELL EQUIPMENT CO.,INC.	3533	120	108	228	399,679	20,731	24,255	2,270,061	6,174,566
GRAHAM MAGNETICS, INC.	3573	310	245	555	903,838	48,395	58,433	5,159,443	14,136,874
MCDONOUGH POWER EQUIPMENT, INC	3524	700	1,407	2,107	4,132,829	275,990	259,376	29,334,115	74,801,993
CONTINENTAL TELE.&ELECTRONICS	3661	2,000	1,220	3,220	5,192,573	251,391	306,179	30,025,070	76,864,179
KANAWAY INDUSTRIES, INC.	2512	13	8	21	27,832	1,602	1,766	183,416	473,213
UNIVERSAL FOUNDRIES, INC.	3429	18	46	64	159,691	8,556	8,426	974,764	2,524,639
CROWN CORK & SEAL COMPANY,INC.	3411	35	89	124	310,511	16,636	16,385	1,895,375	4,909,021
TEXAS COCA-COLA BOTTLING CO.	2086	100	140	240	739,645	52,111	37,520	3,228,518	7,543,032
MARTIN SPROCKET & GEAR, INC.	3566	100	106	206	432,269	18,792	22,980	2,593,630	6,458,139
THE GEAR WORKS	2331	30	13	43	50,548	2,916	3,336	362,778	823,506
MASTERCRAFT INDUSTRIES, INC.	2511	40	25	65	85,637	4,928	5,455	564,557	1,456,041
INTERNATIONAL MARBLE, INC.	3281	7	7	14	28,992	1,598	1,851	175,500	417,690
AILEEN, INC.	2339	250	105	355	421,231	24,298	27,803	3,028,157	6,862,566
WEIGH SYSTEMS, INC.	3576	5	4	9	14,578	781	942	83,216	228,012
HILANDS MECHANICAL, LTD.	3451	20	13	33	44,683	2,830	3,774	294,850	751,868
MILWAUKEE ELECTRIC TOOL CORP.	3546	150	152	302	614,484	30,504	132,623	3,010,355	8,730,030
MALOUF COMPANY	2331	125	53	178	210,615	12,149	13,901	1,511,578	3,431,282
HEIL COMPANY	3715	25	57	82	341,644	15,276	15,093	3,702,058	5,664,149

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES H. HARWELL
PLANTS LOCATED 9/1/73-8/31/74-B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL /	STATE /	LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
LONE STAR GAS COMPANY	2819	7	27	34	96,308	6,003	6,122	617,338	1,493,958
WICKETT REFINERY COMPANY	2911	30	227	257	761,498	117,588	53,327	5,406,379	13,786,266
COMPANIA TEXTIL: AS MEXICANA	2211	25	24	49	80,628	4,008	5,849	403,838	1,130,746
JUMBOTEX MILLS CORPORATION	2281	100	97	197	322,512	16,030	28,395	1,615,352	4,522,986
SPEED FAB-CRETE	3272	25	35	60	103,824	9,935	8,369	662,866	1,749,966
CRYOVAC	3079	250	255	505	911,757	45,72[illegible]	58,643	5,176,309	14,441,888
CERTAIN-TEED PRODUCTS CORP.	3079	1,000	1,020	2,020	3,647,029	182,910	239,571	20,705,219	57,767,561
CENTURY INDUSTRIES, INC.	3531	25	18	43	65,972	3,543	4,049	437,284	1,093,210
DEAN K MANUFACTURING	2339	120	50	170	202,191	11,663	18,345	1,451,115	3,294,031
R. C. CRABB COMPANY	3253	20	13	33	51,836	5,890	8,281	235,402	725,038
KERMIT ATHLETIC SUPPLY COMPANY	2329	40	17	57	67,397	3,488	4,448	483,705	1,098,010
PORTA-STORAGE DISTRIBUTORS	3448	3	3	6	9,639	484	528	54,539	146,151
THRIFT WAY OIL COMPANY	2911	10	76	86	253,833	39,196	17,776	1,802,126	4,595,421
** TOTALS:									
# PLANTS = 273		34,776	75,848	110,624	59,181,630	28,215,806	17,997,569	771,705,547	2,521,798,015

88

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES M. HARWELL
PLANTS EXPANDED-9/1/73-8/31/74 -B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL /	STATE /	LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
J & W REFINING, INC.	2911	10	76	86	253,833	39,196	17,776	1,802,126	4,595,421
PERMOCAST CORPORATION	3361	10	39	49	170,567	7,608	8,338	916,002	2,299,165
TEXAS HYDRAULICS, INC.	3443	84	93	177	366,496	19,255	22,574	2,639,351	6,844,114
SOUTHWELL COMPANY, INC.	3079	1	1	2	3,647	183	285	20,705	57,767
MICRO-GEN EQUIPMENT CORP.	3559	4	4	8	13,687	742	848	81,947	223,715
KAISER CEMENT & GYPSUM CORP.	3241	10	14	24	41,530	3,974	3,346	265,146	699,985
LUCCHESE BOOT COMPANY	3143	45	18	63	75,593	3,833	4,882	446,991	1,086,180
MILLER CURTAIN COMPANY, INC.	2391	400	360	760	1,245,805	68,875	85,249	8,811,154	21,763,558
DATAPOINT CORPORATION	3573	508	401	909	1,481,128	79,306	99,755	8,454,829	23,166,231
3M COMPANY	2541	20	12	32	42,819	2,464	2,718	282,178	728,019
MAGNUM TRAILER COMPANY	3799	15	30	45	88,561	5,914	5,558	628,588	1,602,899
GULF PACKING COMPANY	2011	9	65	74	95,655	5,689	11,646	550,660	2,186,120
CTS OF BROWNSVILLE, INC.	3079	10	10	20	36,470	1,829	2,846	207,052	577,675
DURO PAPER BAG MANUFACTURING C	2643	40	58	98	175,081	9,978	17,126	1,217,841	3,312,528
HOWARD B. WOLF, INC.	2335	45	19	64	75,822	4,374	5,084	544,168	1,235,261
UNION CARBIDE CORPORATION	2869	50	201	251	633,745	65,344	65,856	5,033,725	13,440,046
COSAR CORPORATION	3674	70	43	113	181,740	8,799	10,716	1,050,877	2,690,245
EAGLE INTERNATIONAL, INC.	3711	200	452	652	2,733,152	122,206	109,741	29,616,466	45,313,193
MASON&HANGER SILAS MASON CO.I.	2892	350	228	578	1,279,924	61,801	59,500	6,986,167	16,836,662
WESTERN AMMONIA CORPORATION	2819	20	76	96	275,165	17,152	17,998	1,765,823	4,268,452

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

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PLANTS EXPANDED-9/1/73-8/31/74 -B.B.R.

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WARREN PETROLEUM COMPANY	1321	4	54	58	286,852	29,924	15,818	1,372,683	3,321,893
EAST TEXAS HANDBAG COMPANY	3171	25	10	35	41,996	2,130	2,712	248,328	683,437
MARTIN BRICK COMPANY	3251	20	13	33	51,836	5,890	3,281	235,402	725,038
COMANCHE MANUFACTURING COMPANY	2327	35	15	50	58,972	3,402	3,892	423,242	960,759
WEBER AIRCRAFT	2531	85	53	138	181,980	10,471	11,549	1,199,260	3,094,091
ARMCO STEEL CORPORATION	3533	100	90	190	333,066	17,276	20,196	1,891,718	5,145,473
QUALITY HEAT TREAT, INC.	3398	3	12	15	51,170	2,282	2,501	274,800	689,748
FIRST COMPANY	3585	4	8	12	26,113	1,390	1,754	218,233	486,668
ATLAS ARCHITECTURAL METALS,INC	3442	5	4	9	13,357	882	995	75,351	232,881
SOUTHLAND CORPORATION	2099	6	12	18	38,837	1,696	3,068	347,886	713,166
BURGESS INDUSTRIES, INC.	3561	8	8	16	34,581	1,503	1,838	207,490	516,650
L. L. RIDGEWAY ENTERPRISES, I.	2751	10	10	20	34,956	1,965	2,551	187,839	546,611
Q-DOT INDUSTRIAL PRODUCTS,INC.	3443	10	11	21	45,630	2,292	2,687	314,208	719,536
U.S. PLATING, INC.	3471	20	13	33	87,710	2,448	3,080	263,615	748,667
HENSLEY INDUSTRIES, INC.	3325	30	27	57	109,883	5,507	6,215	502,050	1,526,232
CORR TECH, INC.	3079	45	46	91	164,116	8,231	10,556	931,734	2,599,538
G P PLASTICS CORPORATION	2643	50	73	123	218,852	12,473	21,407	1,522,301	4,148,659
VARO SEMICONDUCTOR, INC.	3674	50	31	81	129,814	6,285	7,654	750,626	1,921,603
STECK-WARLICK COMPANY	2751	100	102	202	349,563	19,650	25,512	1,878,392	5,466,121
LIQUID PAPER CORPORATION	2641	150	219	369	656,555	37,418	64,222	4,566,905	12,421,982

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES H. HARWELL
PLANTS EXPANDED-9/1/73-8/31/74 -B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL	/ STATE	/ LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
ARMOUR & COMPANY	2011	60	433	493	637,702	37,924	77,642	3,671,071	14,574,152
MORRISON MILLING COMPANY	2041	5	43	48	89,292	5,297	11,030	559,910	1,842,104
OHIO RUBBER COMPANY	3079	40	41	81	145,881	7,316	9,383	828,208	2,310,700
TESORO PETROLEUM CORPORATION	2911	12	91	103	304,599	47,035	21,331	2,162,551	5,514,505
ORILCO	3532	21	19	40	69,944	3,628	4,241	397,260	1,080,547
GILES MONUMENT COMPANY	3281	1	1	2	4,142	228	264	25,071	59,669
PHOLER STEEL COMPANY	3341	25	47	72	182,313	11,133	13,475	1,401,423	3,251,301
PEYTON PACKING COMPANY, INC.	2011	60	433	493	637,702	37,924	77,642	3,671,071	14,574,152
INVADER BOAT COMPANY	3732	35	31	66	115,980	5,811	6,524	566,443	1,665,342
EL PASO NATURAL GAS COMPANY	1321	5	68	73	258,566	37,405	19,767	1,715,854	4,152,367
CELANESE CHEMICAL COMPANY	2891	12	8	20	45,885	2,119	2,040	239,525	577,259
PACKERLAND PACKING CO. TEXAS,I	2011	200	1,442	1,642	2,125,673	126,414	258,806	12,236,906	48,580,517
SHERMAN FOUNDRY	3321	11	10	21	40,290	2,019	2,279	184,085	559,618
HITCHCOCK INDUSTRIES	3361	500	1,970	2,470	8,528,369	380,405	416,910	45,800,128	114,958,321
LONGVIEW REFINING COMPANY	2911	4	30	34	101,533	15,678	7,110	720,850	1,838,168
DARBY EQUIPMENT COMPANY	3713	4	9	13	54,663	2,444	2,095	592,329	906,263
GIFFORD-HILL PIPE COMPANY	3272	6	8	14	24,918	2,384	2,007	159,087	419,990
PROFLO, INC.	3533	10	9	19	33,306	1,728	2,020	189,171	514,545
HAYWARD TANK COMPANY	3079	10	10	20	36,470	1,829	2,346	207,052	577,679
BUILDERS SUPPLY COMPANY	3273	10	14	24	41,530	3,974	3,346	265,146	699,985

ECONOMIC IMPACT ANALYSIS
SUMMARY SHEET
FOR

MR. JAMES H. HARWELL
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FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL	STATE	LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
E & S MACHINERY	3599	12	9	21	34,987	1,873	2,262	199,720	547,233
LONGVIEW BRASS & ALUMINUM CO.	3361	15	59	74	255,851	11,412	12,507	1,374,003	3,448,748
ENGINEERED CASTYNGS, INC.	3321	20	18	38	73,255	3,671	4,145	334,700	1,017,488
E.TEXAS CONSTR. SPECIALTIES,I.	3441	20	22	42	60,757	3,381	4,147	449,327	1,064,905
USI-AXELSON	3533	30	27	57	99,920	5,183	6,059	567,515	1,543,641
LEBUS MANUFACTURING COMPANY	3537	30	22	52	79,166	4,252	4,859	524,741	1,311,853
JOSEPH SCHLITZ BREWING COMPANY	2082	30	42	72	221,894	15,633	11,256	967,055	2,262,909
JOSEPH SCHLITZ BREWING COMPANY	2082	45	63	108	332,840	23,450	16,884	1,450,583	3,394,364
EUBANKS MFG. & ENGINEERING	3585	50	100	150	326,415	17,370	21,676	2,727,917	6,083,255
ARCHWAY COOKIES OF LONGVIEW	2052	60	64	124	199,149	11,638	15,506	1,338,240	3,653,395
HEAT RESEARCH CORPORATION	3559	75	73	148	256,640	13,915	15,706	1,586,507	4,194,664
TEXAS INSTRUMENTS INCORPORATED	3079	200	204	404	729,406	36,582	46,914	4,141,043	11,553,510
UNITED COTTON GOODS COMPANY	2328	20	6	28	33,698	1,944	2,224	291,852	549,004
HOLLY FARMS, INC.	2016	175	922	1,097	1,084,065	64,102	230,777	5,483,486	25,607,880
QUALITY SERVICE METALS COMPANY	3361	1	4	5	17,057	761	834	91,600	229,916
ARMOLOY	3471	2	1	3	8,771	245	308	26,361	74,865
GILMORE VALUE COMPANY	3494	2	3	5	10,635	563	688	70,944	181,617
SCHILL STEEL COMPANY	3481	3	3	6	14,431	686	829	87,430	200,215
UNISAFE, INC.	3832	3	3	6	14,830	620	702	101,020	222,244
NORTHWEST MACHINE SHOP	3599	4	3	7	11,662	624	754	66,573	182,410

ECONOMIC IMPACT ANALYSIS
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PLANTS EXPANDED-9/1/73-8/31/74 -B.B.R.

FIRM NAME	SIC CODE	NEW EMP.	ADDITIONAL EMPLOYMENT GENERATED	TOTAL EMPLOYMENT GENERATED	ANNUAL NEW TAXES GENERATED: (IN DOLLARS) FEDERAL	STATE	LOCAL	DIRECT ANNUAL OUTPUT OF FIRM (IN DOLLARS)	TOTAL ANNUAL ECONOMIC IMPACT OF FIRM ON THE ECONOMY (IN DOLLARS)
HILDEBRANDT ENGINEERING CO.INC	3823	5	6	11	24,716	1,033	1,170	168,367	370,407
HUGHES TOOL COMPANY	3728	5	4	9	20,545	1,031	1,221	126,355	279,245
BROOKS PRODUCTS OF TEXAS	3272	5	7	12	20,765	1,987	1,673	132,573	349,993
BEST INDUSTRIES, INC.	3498	7	11	18	37,222	1,969	2,408	248,306	635,663
PROTOLAB, INC.	3544	8	8	16	32,772	1,627	7,073	160,552	465,601
TEXBERRY CONTAINER CORPORATION	3079	8	8	16	29,176	1,463	1,877	165,641	462,138
FRED CLARK FELT COMPANY	2291	6	8	16	25,801	1,282	1,872	129,228	361,838
SCHUMACHER COMPANY, INC.	3471	10	7	17	43,855	1,224	1,548	131,807	374,332
BLUE RIBBON RICE MILLS, INC.	2044	10	86	96	178,584	10,594	22,061	1,119,820	3,684,208
TEXAS IRON WORKS, INC.	3494	10	15	25	53,175	2,814	3,441	354,723	908,091
FORGED PRODUCTS	3462	15	59	74	255,851	11,412	12,507	1,374,003	3,448,748
BYRON JACKSON INC.	3533	15	14	29	49,960	2,591	3,029	283,757	771,819
TEXAS SCIENTIFIC CORPORATION	3573	16	13	29	46,6[illegible]0	2,498	3,016	266,293	729,643
MERIDIAN STEEL CASTING COMPANY	3325	17	15	32	62,267	3,121	3,522	284,495	864,865
SKYVARA FOUNDRY, INC.	3325	20	18	38	73,255	3,671	4,143	334,700	1,017,488
HAHN & CLAY	3443	25	28	53	109,076	5,731	6,718	785,521	1,798,843
UPJOHN COMPANY	2819	25	95	120	343,956	21,440	21,866	2,204,779	5,335,565
BEAUMONT WELL WORKS COMPANY,I.	3312	35	51	86	196,325	12,968	12,013	1,220,405	3,002,196
S & R TOOL & SUPPLY COMPANY	3449	35	34	69	112,462	5,645	6,164	636,236	1,705,112
AMF TUBOSCOPE, INC.	3479	40	27	67	175,421	4,895	6,160	527,231	1,497,336

80

ECONOMIC IMPACT ANALYSIS
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VAN LEER PLASTICS (U.S.A.)INC.	3079	50	51	101	182,351	9,145	11,729	1,035,260	2,888,379
CHICAGO BRIDGE & IRON COMPANY	3443	50	56	106	218,152	11,461	13,437	1,571,042	3,597,686
PHILLIPS PETROLEUM COMPANY	2821	70	99	169	507,742	23,911	32,972	2,406,904	6,643,055
TEXAS INDUSTRIES, INC.	3273	74	102	176	307,320	29,406	24,758	1,962,084	5,179,902
GULF OIL CHEMICALS COMPANY	2911	75	568	643	1,903,746	293,970	133,317	13,515,948	34,465,667
ARMCO STEEL CORPORATION	3533	100	90	190	333,066	17,276	20,196	1,891,718	5,145,473
REED TOOL COMPANY	3599	100	79	179	291,561	15,611	18,849	1,664,336	4,560,281
TEXAS PIPE BENDING COMPANY	3498	125	190	315	664,684	35,169	43,008	4,434,039	11,351,140
ATLANTIC RICHFIELD COMPANY	2911	140	1,060	1,200	3,553,659	548,743	248,859	25,229,771	64,335,916
GRUMMAN HOLSTON COMPANY	3411	160	405	565	1,419,479	76,050	79,894	8,664,572	22,441,291
MOBAY CHEMICAL COMPANY	2821	230	324	554	1,668,294	78,564	108,338	7,908,400	21,827,184
POWDER RIVER CATTLE-HANDLING E	3523	7	5	12	18,472	992	1,134	122,439	306,098
CAMPBELL CHAIR FACTORY	2511	22	14	36	47,101	2,710	2,989	310,396	809,822
MR. FINE, INC.	2337	150	63	213	252,739	14,579	16,682	1,813,894	4,117,539
MAD-WAY-LER, INC.	3079	2	2	4	7,294	366	469	41,410	115,534
THE MARBLE FACTORY	3281	4	4	8	16,567	913	1,058	100,285	238,678
THE VALLEY TOWN CRIER	2711	10	8	18	35,750	1,694	2,145	148,306	450,850
MCALLEN COCA-COLA BOTTLING CO.	2086	15	21	36	110,947	7,817	5,628	483,527	1,131,453
KENNETH FOX SUPPLY COMPANY	2393	30	27	57	93,375	5,166	6,394	660,836	1,632,265
W.W. CRISWELL COMPANY	3569	75	80	155	324,201	14,094	17,235	1,945,222	4,843,603

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ECONOMIC IMPACT ANALYSIS
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PLANTS EXPANDED-9/1/73-8/31/74 -B.B.R.

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H. D. LEE COMPANY, INC.	2327	115	48	163	193,766	11,177	12,789	1,390,652	3,156,780
ALEE, INC.	2328	117	49	166	197,136	11,371	13,012	1,414,837	3,211,680
LAKE PRINTING COMPANY	2751	8	8	16	27,965	1,572	2,041	150,271	437,289
EASTEX, INC.	2611	575	983	1,558	2,709,998	189,948	429,943	19,407,317	54,922,707
GOODYEAR TIRE & RUBBER COMPANY	2821	12	17	29	87,041	4,099	5,652	412,612	1,138,809
E.I. DU PONT DE NEMOURS&CO.INC	2822	20	69	89	195,360	16,021	17,195	1,758,087	4,764,416
MARINE FUELING SERVICE, INC.	3731	30	26	56	99,411	4,981	5,592	485,523	1,427,438
RUSSELL-NEWMAN MFG. COMPANY	2342	100	42	142	168,492	9,719	11,121	1,209,262	2,745,029
KARKEN, INC.	2512	3	2	5	6,423	370	408	42,326	109,201
KASPAR DIE & TOOL, INC.	3544	5	5	10	20,483	1,017	4,421	100,345	291,001
MORGAN PORTABLE BUILDINGS CORP	3448	10	10	20	32,132	1,613	1,761	181,781	487,173
FRAZIER & FRAZIER INDUSTRIES	3321	15	14	29	54,941	2,753	6,107	251,025	763,116
KEY PRINTING ARTS	2731	1	1	2	2,202	111	134	10,389	32,725
FRITO-LAY, INC.	2099	5	10	15	32,364	1,418	2,554	289,905	594,505
MRS. BAIRD'S BAKERIES	2051	6	6	12	19,915	1,164	1,551	133,824	365,340
HALL FOUNDRIES & MFG. CO.,INC.	3361	10	39	49	170,567	7,608	8,338	916,002	2,299,165
UNDERWOOD'S FROZEN FOODS	2011	10	72	82	106,284	6,321	12,940	611,845	2,429,025
PLAINS COOPERATIVE OIL MILL	3499	10	11	21	48,104	2,267	2,765	291,434	667,384
DEVRO, INC.	2013	20	144	164	212,567	12,641	25,881	1,223,690	4,858,049
DEVRO, INC.	2013	25	180	205	265,709	15,802	32,351	1,529,613	6,072,564

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NUBRO CORPORATION	3541	35	35	70	143,300	7,118	30,945	702,416	2,037,006
TEXAS INSTRUMENTS, INC.	3571	600	474	1,074	1,749,364	93,668	113,096	9,986,019	27,361,692
UNIVERSAL RUNDLF CORPORATION	3261	60	40	100	155,500	17,671	9,845	706,206	2,175,114
N.PLAINS FERTILIZER & CHEMICAL	2873	10	40	50	126,749	13,069	13,171	1,086,745	2,608,009
MOORE BUSINESS FORMS, INC.	2761	100	102	202	327,796	19,268	24,312	2,078,699	5,654,061
NIBCO OF TEXAS	3432	300	120	420	706,448	27,300	27,902	4,079,911	8,690,210
OLSON-KESSLER MEAT COMPANY,INC	2011	5	36	41	53,142	3,160	6,470	305,922	1,214,510
SAM HAUSMAN MEAT PACKER, INC.	2013	10	72	82	106,204	6,321	12,940	611,045	2,429,025
SOUTHWESTERN REFINING CO.,INC.	2911	30	227	257	761,490	117,500	53,327	5,406,379	13,786,266
HORTON AUTOMATICS	3442	36	31	67	96,174	6,349	7,167	542,528	1,670,906
CHAMPLIN PETROLEUM COMPANY	2911	50	379	429	1,269,164	195,900	80,878	9,810,632	22,977,112
E.I. DU PONT DE NEMOURS&CO.INC	2821	25	35	60	181,336	8,540	11,776	859,608	2,372,510
OWENS-ILLINOIS, INC.	2631	75	128	203	353,470	24,776	56,000	2,531,309	7,163,831
TEXERAMICS, INC.	3253	26	17	43	67,387	7,657	4,265	306,022	942,548
JAMAK, INC.	3293	250	240	490	1,035,427	57,050	64,106	6,267,063	14,917,514
COOPER AND WOODRUFF, INC.	2951	25	44	69	172,252	15,203	9,970	854,615	2,640,754
AMARILLO INDUSTRIES, INC.	2077	35	71	106	226,551	9,893	17,001	2,029,338	4,160,143
BELL HELICOPTER COMPANY	3721	500	420	920	2,854,485	183,134	122,183	12,635,515	27,924,488
DAL-AIR TOOL COMPANY, INC.	3041	4	3	9	12,287	669	927	68,367	194,846
TEXAS PLASTICS, INC.	3079	3	3	6	10,941	549	704	62,115	173,301

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TRIPLE/S DYNAMICS, INC.	3523	10	7	17	26,389	1,417	1,620	179,913	437,283
BEVERAGE PACKING, INC.	2086	5	7	12	36,982	2,606	1,876	161,175	377,150
DOUGHERTY BROTHERS SOUTHWEST,I	3079	8	8	16	29,176	1,463	1,877	165,641	462,138
SUPERIOR HEAT TREATING COMPANY	3398	14	55	69	238,794	10,651	11,673	1,282,403	3,218,832
TEXAS LEISURE CHAIRS, INC.	3079	15	15	30	54,785	2,744	3,519	318,578	866,513
KIDS STUFF CREATIONS	2361	15	6	21	25,274	1,458	1,668	181,389	411,753
MRS. BAIRD'S BAKERIES	2051	16	17	33	53,186	3,183	4,155	356,864	974,259
BELL HELICOPTER COMPANY	3721	26	17	37	82,179	4,125	4,804	585,420	1,116,970
TARRANT CO. ASSOC. FOR BLIND	3951	40	33	73	116,246	7,183	8,989	681,024	1,825,144
MICRO MOLDING COMPANY, INC.	3079	75	77	152	273,527	13,718	17,595	1,552,891	4,332,566
BASS MANUFACTURING COMPANY	3171	20	8	28	33,597	1,704	2,170	198,662	482,749
PRIDE REFINING, INC.	2911	190	1,438	1,628	4,822,823	704,723	337,737	34,248,403	87,313,028
TIMEX CORPORATION	3873	600	636	1,236	2,905,346	130,891	150,587	17,190,499	40,225,768
TALK O'TEXAS BRANDS, INC.	2035	10	21	31	44,788	2,592	3,878	299,329	806,014
SAN ANGELO COMM. & ELECTRONICS	3661	25	15	40	64,987	3,142	3,827	375,313	960,881
BARRY OF SAN ANGELO	3142	250	100	350	419,960	21,297	27,122	2,483,287	6,034,387
AMERICAN BOX COMPANY	2421	25	19	44	63,234	4,169	14,081	359,226	1,038,163
MODERN MACHINE SHOP, INC.	3325	56	45	95	183,138	9,178	10,338	836,750	2,543,720
TRANTER MANUFACTURING, INC.	3443	56	56	106	218,152	11,462	13,437	1,571,342	3,597,686
DOMORE OFFICE FURNITURE, INC.	2521	76	43	113	149,866	8,624	9,511	987,626	2,548,073

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CIBA-GEIGY CORPORATION	3079	150	153	303	547,854	27,436	35,186	3,105,782	8,665,132
MARTIN-LANE FEEn MILL	2048	40	238	278	468,795	27,298	50,467	2,635,914	9,093,903
KERR-BAN FURNITURE MFG.CO.INC.	2499	22	16	38	48,394	2,826	4,642	359,680	852,396
LORNA DRESS MANUFACTURING CO.	2335	30	13	43	50,548	2,926	5,336	362,778	823,506
SOUTHWEST FIBER GLASS INDUS.I.	2221	4	4	8	12,900	641	956	64,614	180,919
REPUBLIC ALUMINUM COMPANY	3354	100	213	313	762,106	36,314	42,858	5,736,247	11,931,394
** TOTALS: # PLANTS = 186		11,429	20,653	32,082	69,278,475	5,059,491	5,040,279	440,698,040	1,141,971,729

OFFICIAL POLICY OF
TEXAS INDUSTRIAL COMMISSION

Adopted December 17, 1974

Pursuant to Article 5183 through 5190 1/2 and Article 6144e: Revised Civil Statutes of Texas as Amended, and Senate Concurrent Resolution 89 introduced May 26, 1967, the Texas Industrial Commission shall pursue a program to satisfy those provisions of existing statutes and the recently adopted amendments of Section 56, Article XVI of the Constitution of the State of Texas as follows:

SECTION 1. PURPOSE OF THE TEXAS INDUSTRIAL COMMISSION

It shall be the purpose of the Texas Industrial Commission to satisfy the responsibilities assigned to it from time to time by the Legislature on behalf of the citizens of Texas. It shall accept among its responsibilities as mandated by the Legislature, the need to:

a. Investigate, study and undertake ways and means of promoting and encouraging the prosperous development and protection of the legitimate interest and welfare of Texas business, industry, agriculture and commerce within and outside of the State.

b. Plan and develop an effective business information service both for the assistance of business and industry of the State and for the encouragement of business and industry outside the State to use economic facilities within the State.

c. Compile, collect and develop periodicals or otherwise make available information relating to current business conditions.

d. Conduct and encourage research designed to further new and more extensive uses of the natural and other resources of the State, and designed to develop new products and industrial processes.

e. Encourage and develop commerce with other states and foreign countries.

f. Cooperate with interstate commissions, engage in formulating and promoting the adoption of interstate compacts and agreements helpful to business, industry and commerce.

g. Cooperate with other State Departments and with Boards, Commissions and other State Agencies in the preparation and coordination of plans and policies for the development of the State as such development may be appropriately directed or influenced by State Agencies.

h. Promote and encourage the location and development of new business in the State as well as the maintenance and expansion of existing business.

i. Advertise and disseminate information as to natural resources, desirable locations and other advantages for the purpose of attracting business to locate in this State.

j. Aid the various communities in this State in getting business to locate therein.

k. The Commission shall have the power to enter into contracts with a recognized and financially responsible advertising agency, having a minimum of five years of experience in handling accounts of similar scope; and for the contracting of time on broadcasting facilities, space in magazines, papers, and periodicals for the publication of such advertising information, historical facts, statistics and pictures as will be useful and informative to persons, and to corporations outside of the State of Texas, and shall have the power to enter into contracts with motion picture producers and others for the taking of moving pictures or still pictures in the State, and provide for the showing of the films when taken and the Commission may join with other governmental departments of the State in publishing such information or publicity matter.

l. Prepare and administer a statewide rural business development program designed to revitalize the rural economy and create rural job opportunities through business and industrial development.

m. Specifically, administer the Texas Rural Industrial Development Act, as amended and as permitted by law to loan money from the Rural Economic Development fund.

SECTION 2. PROGRAM OF THE TEXAS INDUSTRIAL COMMISSION

The Commission shall plan and implement a program of action designed to fulfill its responsibilities and to generally encourage the economic development of the State. The Commission shall maintain working relationships with other governmental and private groups who are also interested in economic development in order to provide service to business and labor in the most effective manner possible. Whenever possible resources of local communities, both private and public, will be supported, developed and utilized to promote the economic growth of the communities.

SECTION 3. ORGANIZATION OF THE COMMISSION AND COMMISSION MEMBERS

At the direction of the Legislature, there shall be twelve members of the Texas Industrial Commission. The members of the Commission shall be appointed by the Governor with the advice and consent of the Senate, such appointments to be made bi-annually on or before February 15 of odd-numbered years.

a. Membership of the Commission shall be structured so that:

(1) Each member shall be from a different geographical area of the State.

(2) Two members shall be employers of labor.

(3) Two members shall be employees or laborers.

(4) Three members shall be from rural areas; rural meaning from counties which have no city within their boundaries with a population of 50,000 or more.

(5) Five members shall be from the general public.

b. The term of office of each member shall be six years, with appointments made in such a manner that the terms of four members shall expire every two years.

c. As required by law, vacancies in the Commission shall be filled by appointment of the Governor, such appointments being for the unexpired term of the member who previously held the position.

d. Officers of the Commission shall consist of a Chairman, a Vice Chairman and other officers as a majority of the Commissioners may from time to time deem necessary. The Chairman, in addition to his duties specifically assigned, shall act as spokesman for the Commission, shall be Chairman of the Public Affairs Committee, and shall be an ex-officio member of all other committees of the Commission and shall direct the activities of the Commission and its staff to accomplish the goals and objectives set by the Commission. The Vice Chairman shall act in behalf of the Chairman in his absence and, in addition, shall serve as Chairman of the Finance Committee.

e. There shall be four standing committees of the Commission:

(1) The Program Committee shall maintain close and continuing liaison with the program staff of the Commission and with its advertising agency. It shall, at least annually, review program performance and recommend to the full Commission program priorities, program changes and/or new programs. Included in the work of the Program Committee shall be the provision of general guidance and periodic review of all advertising and public relations activities of the Commission. When it has been determined to be in the best interest of the Commission to consider the selection of an advertising agency, the Program Committee shall assist the Commission staff in screening and qualifying advertising agencies prior to their presentation before the full Commission.

(2) The Public Affairs Committee shall represent the Commission and its programs to members of the Texas Legislature, the office of the Governor, the

office of the Lieutenant Governor, and the office of the Speaker. It shall establish and maintain liaison with such other State Agencies and local jurisdictions as the Commission may deem advantageous. It shall also maintain liaison, and close working relationships, with the State's Chambers of Commerce and the various private sector groups interested in the economic welfare of the State.

(3) The Finance Committee shall review operating budgets, actual expenses, loan portfolio and loan applications and audit reports in order to report on the financial status of the Commission, at least annually. Based on program priorities set by the Commission, it shall work with the Commission staff in the preparation of all budget requests, either for State or other funds, and shall present all budget recommendations to the full Commission. The Finance Committee shall work with the Executive Director and shall consider changes in budget allocations when necessary for recommendation to the full Commission.

(4) The Personnel Committee shall develop and maintain personnel policies for all employees of the Commission. The Personnel Committee shall review the performance of the Executive Director each year and with the Executive Director, the performance of the Staff. It shall recommend, with the advice of the Executive Director, salary increases and classification changes. At least annually, the Personnel Committee shall report to the full Commission on the performance of the Executive Director and the Staff.

f. It shall be the responsibility of the Commission to set policy, identify objectives and to approve all programs and activities of the Commission and its staff.

g. The Commission shall employ an Executive Director to serve at the pleasure of the Commission as Chief Administrator of the Texas Industrial Commission.

(1) In addition to his general administrative duties,

the Executive Director shall keep full and accurate minutes of all transactions and proceedings of the Commission. He shall also be the custodian of all files and records of the Commission.

(2) With the consent of the Commission, and in the name of the Texas Industrial Commission, the Executive Director may accept gifts of property or money, grants and other funds which may be made to futher the purposes of the Commission.

(3) It shall be the responsibility of the Executive Director to develop and recommend programs and activities that will accomplish the objectives of the Commission.

(4) The Executive Director shall have full authority to employ any and all personnel necessary to execute the programs and activities within staffing levels approved by the Commission. He shall, however, consult with the Personnel Committee of the Commission on the selection and announcement of the staff member who is designated to act on behalf of the Executive Director in his absence.

SECTION 4. SELECTION OF OFFICERS AND COMMITTEES OF THE COMMISSION

The Commission shall organize itself to accomplish the orderly discharge of its business.

a. In October of each even-numbered year the Chairman shall appoint a nominating committee of four members, one of whom will be designated as the Chairman of the Nominating Committee.

b. The Chairman of the Commission shall structure the Nominating Committee so that (1) one member shall be an employer of labor, (2) one member shall be an employee or laborer (3) one member shall be from a rural area, and (4) one member shall be from the general public. The Nominating Committee shall propose to the full Commission at least one candidate for Chairman and one for Vice Chairman at the following April meeting. All Commissioners, whether newly appointed or not, shall be eligible

for nomination to any office by the Nominating Committee or from the floor at the April meeting.

c. The Commission shall elect its officers at its regular April meeting in each odd-numbered year. The normal elective terms of each officer shall begin immediately, at the same regular April meeting in each odd-numbered year, and shall extend for two years.

d. Should resignation, death or incapacity for any reason create a vacancy in the Chairmanship, the Vice Chairman shall, at the next regular meeting of the Commission, or a specially called meeting, conduct an election for a new Chairman to fill the unexpired portion of the former Chairman's term. Should resignation, death or incapacity for any reason create a vacancy in the Vice Chairmanship, the Chairman shall, at the next regular meeting of the Commission, conduct an election for a new Vice Chairman to fill the unexpired portion of the former Vice Chairman's term.

e. No officer of the Commission may succeed himself for that office more than one time.

f. The Chairman of the Commission shall appoint three or more members of the Commission to each of the Standing Committees; Program, Public Affairs, Finance and Personnel.

(1) In making appointments he shall attempt to utilize fully each Commissioner's professional background and special interests.

(2) The Chairman shall attempt to balance the tenure of Committee members in an attempt to insure maximum continuity of Committee memberships.

(3) Every Commission member shall be appointed to at least one Standing Committee.

(4) Each Standing Committee shall meet, or confer, at least once prior to every annual meeting of the Commission.

g. The Chairman may with Commission consent appoint such additional committees as he may from time to time deem necessary.

h. The Chairman of the Commission shall designate a Chairman for each Committee of the Commission, except that the Chairman shall serve as Chairman of the Public Affairs Committee, and the Vice Chairman shall serve as Chairman of the Finance Committee.

i. Each Standing Committee of the Commission shall meet on the call of its Chairman or the Chairman of the Commission, who shall be an ex-officio member of the Committees.

j. The Executive Director of the Commission or his designee shall be an ex-officio member of each Committee and at the request of the members of each Committee or at the request of the Commission Chairman, shall provide such staff assistance as the Committee from time to time may require.

SECTION 5. MEETINGS OF THE COMMISSION

Meetings of the Commission shall be held quarterly:

a. There shall be four regular meetings of the Commission each calendar year. They shall be held on the third Thursday of January, April, July and October, or as near these days as the Commission may find practicable. The regular April meeting each year will serve as an annual meeting for purposes of reviewing programs and in each odd-numbered year for the election of officers. Notice of regular meetings and preliminary agendas shall be mailed to each member of the Commission at least fourteen (14) days prior to the meeting date.

b. Special meetings of the Commission may be called by the Chairman when he deems necessary, or shall be called by the Chairman within fourteen (14) days of receipt of a written request of a majority of the Commission as then constituted. Notice of any special meeting shall be mailed to Commission members at least ten (10) days in advance, with a statement of the time and place of the special meeting, and information as to the subject or subjects to be considered.

c. For the purposes of conducting all business of the Commission:

(1) A majority of the members of the Commission shall constitute a quorum.

(2) All matters submitted to members of the Commission for their vote, including the election of officers of the Commission, shall be decided by plurality vote.

(3) The Chairman shall preside at all meetings of the Commission. In his absence the Vice Chairman shall preside. If neither the Chairman nor the Vice Chairman are present, the Commission members shall select a Temporary Chairman who shall preside.

d. The place of meetings of the Commission shall be determined by the Commissioners except that unless specifically determined otherwise the annual meeting will be held in the City of Austin.

Senator BENTSEN. We are glad to have you with us.

Now, following the rule of those who appeared here first, Senator Dole, did you have any further questions to ask?

Senator DOLE. I think you have defined what you mean by small business. I was trying to sort of get in the ball park, where we were, what we were talking about. I think I have taken about 10 minutes, so I will wait until the next round.

Senator BENTSEN. Senator Brock?

Senator BROCK. Mr. Chairman, before I start I would like to put in the record the statement by Dr. Martin Schnitzer, professor of business administration, and Dr. Monroe Byrd, professor of marketing, from VPI.

Senator BENTSEN. Without objection, it will be done.

[The material referred to follows:]

Comments and Support for S.959

"To provide for a temporary period a 20-percent investment credit for small business enterprises with respect to property placed in service which increases production or decrease costs of production."

A Statement Submitted by
Dr. Martin C. Schnitzer
Professor of Business Administration

and

Dr. Monroe Murphy Bird
Professor of Marketing

both with
Virginia Polytechnic Institute and State University

to

The Committee on Finance
United States Senate, in
Connection with Hearings on S.959

Dated: June 19, 1975

COMMENTS AND SUPPORT FOR S.959

by: Dr. Martin C. Schnitzer
Dr. Monroe Murphy Bird

The purpose of this paper is to provide comments on and support for S.959, which is designed to provide income tax relief for small businesses. In particular, the paper stresses the need to provide a more positive incentive for small businesses to invest in new machinery and equipment for the purpose of stimulating productivity and output. It is felt that one way in which the problem of inflation can be alleviated is to utilize measures designed to increase production. Recent inflation policy is designed to curb the rate of inflation by contracting the rate of growth in the money supply. This policy has created supply shortages. The end result of this policy has been the virtual collapse of the housing industry, with layoffs affecting not only construction workers, but those in the appliance, wood, stone, clay, and glass industries as well. Public utilities are also having their share of problems, with the cost of borrowing at the highest level in this century. Moreover, the index of industrial production turned downward this year which led to a drift into a deep recession.

Inflation is a world-wide phenomenon. During the period, July 1973-July 1974, prices went up an average of 13.3 percent in the OECD countries, with a low of 6.5 percent for West Germany and a high of 44 percent for Iceland. The U. S. rate of inflation was 12 percent, below average for the OECD countries, but nothing to brag about. Moreover, the growth in inflation was not accompanied by any significant gain in real economic growth. To a major degree this world-wide inflation can be attributed to the following factors: an enormous increase in fuel prices associated with the oil embargo,

currency depreciation, an increase in food prices attributable to crop failures, and an escalation of raw material costs caused by forward buying of inventories throughout the industrial sector. It can be said that inflation, whether it be in the United States or Japan, has been exacerbated by a rash of exogenous factors unrelated to government spending that sent prices up in 1973 and 1974.

There are several standard remedies that can be used to cure inflation. The monetary remedy is to raise interest rates by decreasing the supply of money and credit. The fiscal remedy is to raise taxes, decrease government spending, or do both. Both remedies assume the existence of demand-pull inflation - "too many dollars, chasing too few goods." This is true only in part in our economy. Neither approach can do much with cost-push inflation, which also exists in part. Of course, neither monetary nor fiscal policy can do anything to alleviate the fuel shortage or crop failures. So there is no ready panacea for inflation. However, the tight money approach used over the past year is about as effective as feeding castor oil to a person suffering from diarrhea. High interest rates are forcing industry to curtail investment and production, thus causing shortages of goods and hence more inflation.

Before setting forth certain proposals relative to S.959, it is necessary to point out the fact that there are no easy answers for the cure of inflation. These proposals presented here are based on the premise that it is necessary to increase investment and production in order to increase the supply of goods and services. In the long-run, a partial solution to inflation can be achieved by increasing the efficient output of goods and service. This increase can be accomplished through the use of accelerated depreciation and the investment credit. The merits of each are outlined as follows.

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Accelerated Depreciation

A very common tax incentive device is accelerated depreciation. When a government increases depreciation allowances, it reduces the tax burden on a firm, at least on a short-term basis. One advantage of accelerated depreciation is that it is equivalent to an interest-free loan. That is, since a firm is not required to pay the tax in the immediate period, it has the use of a greater supply of funds - greater cash flow - interest-free, which it would not have had without accelerated depreciation.

It is also true that accelerated depreciation means that the firm will be able to pay off the investment project in a shorter period of time. This means a significant reduction in risk and uncertainty, both of which increase with the life of the asset. This factor serves to stimulate investment by raising the cash flow, by raising present value, and by lowering the discount for uncertainty.

Since accelerated depreciation increases the cash flow that provides funds for investment, small firms that experience difficulty securing funds from the capital market, and other firms that do not care to go to the capital market, are induced to invest if profitable investment opportunities exist.

The effectiveness of accelerated depreciation is also influenced by the present and expected future tax structure. Generally speaking, the higher tax rates, the more a business firm can gain from accelerated depreciation. If, for example, a firm expects tax rates to go down in the future, it would be anxious to have the higher depreciation allowances effective immediately so as to reduce its current, and therefore long-run, tax bill. This would have a stimulating effect on the firm's investment plans. We encourage further liberalization of depreciation rates. However, we believe a major

contribution to a recovery of production and productivity can and should be made through an increase in the investment tax credit as described below.

The Investment Tax Credit

The investment tax credit, a relatively new concept as far as its use in the United States is concerned, has been used with varying degrees of success in other countries in the post-World War II years. The investment tax credit is a credit against the income tax liability of an individual or corporation allowed by the government for amounts invested in particular assets that meet specific requirements. The investment tax credit can be thought of as a negative tax, and ordinarily comes about, as the one now in the United States, through the desire of the government to promote investment in specific assets and, through this promotion of investment, to stimulate economic growth.

The investment tax credit provides a stimulus to investment in that it permits an earlier recovery of investment through reduction of tax cash expenditures, and a decrease in the risk involved in the new investment through a shorter period of capital recovery. In addition, the investment tax credit represents a direct increase in after-tax profits to a business firm investing in new qualifying plant and equipment through the reduction of income taxes. This should help a firm aquire new capital at more favorable rates.

Cash flow is increased for the reason that firms can apply the credit to extinguish up to 50 percent of their income tax bill. Thus, by applying investment tax credits, it is possible for a company to reduce its effective tax rate to as low as 24 percent - half of the 48 percent rate. If the investment credit is flowed through to earnings as reported to the stockholders

during the year in which the asset is purchased, this is reflected in terms of higher earnings per share of stock and a greater return on investment. However, if a firm amortizes the investment credit over the asset life, reported earnings per share would be reduced considerably. However, in either case the after-tax rate of return on equity is obviously increased through a shorter flow-back period.

Recommendations

It is strongly recommended that tax relief be given to small business firms. First of all, strengthening the small business sector of the U. S. economy will provide more competition to large firms. To some extent, this could prevent the cost-push type of inflation where large firms, because of their market power, can simply push increased prices off on to consumers. Moreover, there would be possible support from labor since the tax relieve would increase capital investment, production, and employment. In addition, small business firms would provide more employment opportunities in an economy suffering from unemployment as well as inflation.

Both S.3833 and HR14837 provide for some liberalization of depreciation for small business firms. However, depreciation only allows for recovery of capital overtime. During inflation capital recovery through depreciation means a return of cheaper dollars in years to come from more expensive dollar investments made today. Therefore, there is some doubt as to the stimulation effect of liberalized depreciation during times of high inflation.

S.3833 (Small Business Tax Reform Act of 1974) contains a number of needed tax provisions, but did not contain any direct incentive to spur capital investment. HR14837, on the other hand, did contain such a provision. Section 2 called for an increase from 7 percent to 10 percent in the investment

tax credit for eligible items of capital equipment up to a maximum of $20,000 of investment per year. This provision was considered a direct step toward curbing inflation, but fell far short of being an effective stimulant to capital investment in that it provided a maximum of $600 additional incentive for each small business firm over the present provision of the investment credit ($20,000 x 10 percent - $20,000 x 7 percent). This would not provide sufficient incentive to call forth significant new investment in more efficient capital equipment.

What the U. S. economy needs at this point in time is a large, but temporary, increase in incentives to stimulate small business firms to invest in productive capital equipment. The incentive must be large enough to jolt management into a quick but sound decision to invest. However, the stimulus must be so directed that investments will be made in capital equipment that will increase production and or productivity. Therefore, it is recommended that S.959 be supported by the Committee. In particular the following provisions of S.959 are most noteworthy.

Allow small business firms (as defined by SBA) to claim for a period of 36 months following the enactment of the law a 20 percent tax credit on capital investments which can be reasonably demonstrated to increase production and/or decrease the cost of production (increase productivity). This credit would be allowed up to a maximum of $200,000 worth of investment during any taxable year.

The temporary nature of this incentive provides an impetus to invest and expand production facilities now rather than later. A surge of new production would work to blunt inflation without increasing unemployment (reduce cost-push inflation). In fact the new production would reduce unemployment. Moreover, small business firms are not usually hampered by

internal administrative delays. This means that they would be quicker to react to a stimulus than a large firm thus creating a much needed boost to the economy.

The increase in productivity by the small businesses would provide real competition for the larger firms and thus spur the large firms to find more productive production methods to allow them to stay competitive.

Perhaps the single most compelling reason to support S.959 is that the proposed 20 percent tax credit will give small businesses a much needed increase in their cash flow. Tight money policy has hurt small business much harder than large corporations. As money became tight, sources of supply of short-run capital dried up for small businesses. This is true because small firms have not the expertise to seek out and secure capital as do large firms. Many small firms are being forced out of business because of being "cash broke." This bill will provide the incentive to invest and produce as a measure of gaining short-run capital.

A benefit to the national economy to be gained from the investment credit is a shift from consumption to needed investment. Over the last few years, the U. S. has consumed or given away more than it has produced. Most national efforts have centered on problems of consumption rather than production. Recent fuel and grain shortages have caused the U. S. to realize that its major long-term economic problem is underproduction and shortages. Goods and services in this world are not free. We are not as rich as rich can be. We must increase our ability to produce more with more efficiency.

Unless direct action is taken to stimulate investment, the high cost of money will surely continue to decrease the rate of capital investment. This

will reduce production, cause a decline in productivity, increase unemployment, and contribute to inflation in the short run by decreasing the supply of goods in an already inflated economy.

Martin C. Schnitzer
Professor of Business

M. Murphy Bird
Professor of Business

Senator BROCK. You know, I am most interested in what the first two witnesses referred to. I cannot really argue the point of the investment tax credit, if you go on to talk about the corporate tax itself. But, gentlemen, we do not have that situation. We have got a situation where there is a corporate tax. Living in the real world, I think you would agree that one of the problems we have got in this society is the shortage of capital formation. If you do not, you had better say so now, before we get on that path. I would like to pursue that some more. Dr. Holt?

Mr. HOLT. I would be interested in what leads you to that conclusion. It is often asserted, but I think there are serious questions about the point.

Senator BROCK. Maybe we can turn it around. You said—and I think I am quoting you accurately—that this particular device, the investment tax credit, might soak up capital which would otherwise be available. What do you mean—available from where, for what?

Mr. HOLT. Well, this was in the context of how capital is allocated in the economy, with respect to large business versus small business. Many small businesses are in service areas, and investment tax credit may not do very much good for a small business firm that cannot raise either equity capital or borrow very much money. They simply cannot afford to spend the money to take advantage of that particular tax break. If larger companies are able to, then there is a differential effect of the investment tax credit. I am sure it was not the intention of Congress to try to promote the growth of capital in large business as distinct from small business. It was put in terms that we want to promote capital growth in general.

Senator BROCK. Just to be fair with you, I think we are pretty close together. Let me tell you why. I was the author of the amendment in the tax bill to cut the tax on small business. My first amendment was to cut it measurably more than we ultimately did, and to put it on a progressive basis; and I think both of you mentioned that. So in that respect, we are in agreement.

I also suggested another modification that was not adopted, and I am still somewhat interested in it; that we have, since small business too often are labor-intensive and not capital-intensive, and they could not use a capital credit, that we have an employment tax credit for small business, which would have a double effect, both of giving them additional capital resources, but also of course of affecting employment to a measurable degree. But again, back to the basic problem. We are in a situation in which, with the $70-plus billion deficit projected this year, and the effect that has on the capital markets, if the economy begins to surge, as we hope it will, I think there is a serious prospect of an increase in interest rates, because of the long-term demand for capital, for energy, and for other structural improvements that have to be made in this society.

Now, if you see an inadequacy there that I have not found, maybe you could tell me where it is.

Mr. HOLT. You speak about the problem of rising interest rates, which are controlled by the actions which the Federal Reserve Board takes. If that is what is concerning you, then an investment tax credit is not a very direct way of getting at the issue.

Senator BROCK. What is the alternative? Do you want the Fed to finance the deficit? I mean, can they do that in times of prosperity without an inflationary impact?

Mr. Holt. If you think that the interest rate is rising too high—if the prospect is that the interest rate is going to rise so high that we will cut back on investment and slow down the recovery, then that is equivalent to saying we have got too tight a monetary policy and, so, we need to——

Senator Brock. No, it is not. You are dealing with only one edge of the sword. It is either saying we have too tight a monetary policy or an inappropriate fiscal policy. It could be either.

Mr. Holt. Well, these two obviously interact.

Senator Brock. We have never dealt with them as interacting.

Mr. Holt. But the most direct effect on interest rates, which is what you had focused on, is by monetary policy; the effect of fiscal fiscal policy on it is secondary.

Senator Brock. I am using interest rates as a symptom of the problem. Now, there may be some way of massaging the problem by govermental exercise, an increase in float in the open market operations by the Fed, things of that sort, or a reduction in the level of nonproductive Federal expenditures, or an increase in taxation. All three of those would have the same result in terms of relieving the symptoms.

Mr. Holt. Well, I think what you are concerned with is the path of recovery which is an aggregate demand question, and it is much more a monetary-fiscal policy issue than an investment tax credit one. Now, I think——

Senator Brock. I do not argue that.

Mr. Holt [continuing]. If you can get one kind of economic stimulus through Congress and obtain the President's signature, and you cannot get another one, and we need more stimulus, then I would buy what stimulus we can get, but I think the context in which Professor Eisner and I have been talking are *structural* issues—basically whether we can reform the way the economy operates and make it work better in the long run. These changes cannot be achieved fast, so I think there is a distinction about whether we are talking about short-term issues, where we have to be essentially opportunistic or whether we are really talking about the long-term ones that reflect on growth, efficiency, and equity in the economy.

Senator Brock. Professor Eisner is sitting there itching to get into this. Why do you not go ahead?

Mr. Eisner. Yes, I am delighted at the thrust of the discussion, the thrust of Professor Holt's remarks, with which I largely agree. I would question the evidence that we have a shortage of capital formation. Indeed, I would question the notion, with all due respect, whether it is to Congress or to the economists, to assert over and against the market that there is a shortage of capital formation. What we pride ourselves on in a free ecomomy, is that business concerns and consumers make decisions which meet individual tastes and demands. There might be a shortage of capital formation on two grounds: one, that we have followed an economic policy that has created very substantial recession, unemployment, and excess capacity, and that, I believe, is true. But then the remedy for the lack of capital formation is to restore a full-employment economy. Without that, businesses will not find it profitable to invest. Consumers, individuals, will not have an income out of which to save.

Now, with any particular kind of incentive, I think we all too often lose sight of the ultimate effects. Take for example, the equipment

tax credit, supporting what Professor Holt said earlier, and amplifying what I said, which is encouraging businesses to spend on equipment. It means only on eligible equipment. It means if there are limited funds, if there is a limited amount that people want to save, that those funds, that that investment must be taken from other kinds of investment which are not so favored; for example, investment in plant; for example, investment in residential housing; for example, investment by businesses in research and development. Here, by the way, I think there are good theoretical reasons for arguing that business investment is insufficient because when a business buys a piece of machinery it can own it, get its full benefits, but with investment in research and development and training people as I indicated earlier, there is no way it can hold on to that benefit, so what we do is we encourage one kind of investment that soaks up funds; to the extent it is successful, it causes businesses to go out and borrow. That raises interest rates with that kind of investment and discourages it elsewhere. Indeed, it is a truism in economics that saving equals investment. If you are not taking a measure that causes an increase in total savings then any investment that you stimulate in one direction is going to come from investment somewhere else, and that is part of this no free lunch. There is no escaping it.

Now, I do not quarrel with the businessman that says, gee, if you give me this credit for this, I will invest more. He may be perfectly right. He is not looking at the whole economy, but, unless an economist or you can show some way in which that increase is in saving in the whole economy, then you know, as a matter of arithmetic, that that increase in investment by this guy is going to mean less investment somewhere else, and, indeed, since you have destroyed the free market allocation of resources by encouraging one kind of investment, you are very likely encouraging the kind of investment which is less productive, which will aid growth less than another kind of investment which a businessman might have found more profitable if he had not been pushed out of it by the bias that the tax structure introduced.

Senator Brock. Unfortunately, my time is expired. I find nothing you say that I disagree with, and I would like to pursue it a little bit, maybe a little bit better.

Senator Bentsen. Thank you, Senator Brock. I made the serious mistake on the part of the chairman. I did not ask my own questions, so I am going to intervene at this time and ask a few myself.

First, let me say, Mr. Harwell, one of the very significant themes made in your statement, one of the significant points, is on page 3, when you talk about in the 1973–74 period the analysis made of the 186 new plant locations employing 11,429 people. And then you talk about the interdependence among those plants and the remainder of the economy in Texas, that an additional 20,653 people would be employed by business and industry already located in Texas. In other words, two for every one, and I guess that is one of the significant differences that we see in our public service employment, which we use as an emergency procedure, to try to help the unemployed, but we do not get as much rippling effect as we do with small business, creating new jobs, because, as I understand it, when you get public service jobs, it does not necessarily follow that you end up with two additional employees. Would that be a fair statement?

Mr. HARWELL. Yes, sir. We have gone on the basis, or we operate on the basis, that our No. 1 concern is to generate new income which gives you the spilloff effect, and the only way we are able to do this in our State is one, by either creating a manufacturing job, which gives you the value added by manufacturing, through agriculture, which we have a very large basis, through tools, and where we have a transfer of funds generated someplace else, and we can bring to Texas or through Government spending, and really in all four of these areas we are pretty well balanced. We have a very good return of Federal funds per taxes that we pay in the State of Texas. In fact, I think we are probably a little more blessed than most, but moving around it within the State is part of the thing, but you have got to start someplace with new—you have to generate some amount of new money.

Now, my purpose of being here is to say that with our input-output model, if you come up with some proposals for taxes we would be delighted to run them through our model, and I think we could give you an answer as to what the effect would be. Our State legislature has used the input-output model to determine what effect State taxes would have on the businesses of the State of Texas, and we would be delighted to use this model to at least show you what a proposed new tax, what its effect would be in the State of Texas on both small and large business. We can differentiate.

Senator BENTSEN. Thank you very much, Mr. Harwell, We get some interesting results when we ask the Treasury to run models for us.

Mr. HARWELL. Well, ours is not a model that was made by estimates. It was made by actually going out on personal interviews, so we do not have something that we have just guessed at. We have got an honest-to-goodness model that gives a true reaction.

Senator BENTSEN. I hope that is right. We have had a number of these econometric models give us entirely different results, and I am sure we have very sincere people operating each of them.

Mr. HOLT. Senator Bentsen, I think that that multiplier of 2 would be a general ballpark figure for public employment, as well as private employment.

Senator BENTSEN. You think it follows through on public employment?

Mr. HOLT. Yes. It is the right order of magnitude. It clearly depends somewhat on the particular employment, but, in general, it has to do with the expenditures of the newly hired government worker—somebody has to cut his hair, do his laundry, sell him groceries, and so forth.

Senator BENTSEN. Do you think it follows the same as it does in private business then?

Mr. HOLT. Basically, unless there are subtle, indirect effects. For example, you may stimulate the development of one kind of industry which makes the State more attractive to another kind of industry coming in.

Senator BENTSEN. Dr. Eisner, let me pursue one point with you. I know you oppose the graduated capital gains tax. My concern is a lot of people make what, in effect, are tax decisions and not investment decisions, and I look at a situation where a man starts a company and he has a zero tax base virtually and he has worked at it for many years, and then he reaches an age when he would like to retire and he

does not want to merge into someone else's company and get their stock, but he would like to sell out. He does not have kids who want to carry it on, and he looks at a situation where he would pay a 35-percent tax and then a preference tax would probably run it up to 37½ percent, and then if he is in a State like New York or California, it runs up to 42½ percent, and what does he do? He says no, I am just not going to take that kind of cut in my estate, so he keeps it and you have capital frozen.

I do not think that is good either. I think you ought to have mobility of capital. If you had a graduated capital gains tax, that would give some offset for inflation. Why do you feel it is inequitable or improper to have a graduated capital gains tax? I would like to hear your argument on that.

Mr. EISNER. Certainly, sir. I actually, to begin with, believe in the income tax, and I would try to tax all income equally, including the income which accrues in the form of capital gains. I think you have made an excellent point on the problem of inflation, because our capital gains tax is such that we tax nominal capital gains and, where we have inflation, there may be no real capital gains. The economist's definition of income is that which one can consume while keeping one's capital intact, meaning one's real capital, so that adjustment might well be in order in some instances, but I would argue that the lockin effect, the immobility of capital, can best be answered by something which I fear may be impolitic at this time, but is to me, the clearly called for answer, and that is taxing all capital gains, after adjustment for inflation, as if they were income, but taxing them as they accrue, and you can allow businesses or individuals to declare, as best they can, what they consider the gain to be. They do not have to even pay the year it accrues. They can accrue the liability and pay interest on it, but in that way there would be no lockin.

I think the difficulty with graduating it—and I think you mean graduating it over time——

Senator BENTSEN. Professor, I can not agree with you on that one, I must say.

Mr. EISNER. I would feel that graduating over time would, if anything, increase the lockin. That is, once I have held a security for 6 months, except to the extent I want to hold it to leave to my estate, the only advantage of holding the asset longer is, of course, I delay the payment of the capital gains tax if it has gone up in value, and that is a not insignificant gain. But, if we have a situation where I include, let us say, 50 percent of the gain in taxable income after 6 months, 45 percent after a year, and 40 percent after 2 years, and so forth, then at each point of time, I will say, well, if I held it another year I will reduce the rate to less, so I would think that graduating the capital gains tax over time has every likelihood of increasing the lockin, rather than decreasing it.

I submit it is an empirical question. You have to analyze it, and you may never know until after the facts are in, but I see no reason a priori that that would reduce a lockin.

Mr. HOLT. Senator Bentsen, the biggest lockin effect is the ultimate way of escaping the capital gains—that is to die out from under it and never have to pay.

Senator BENTSEN. But, if you have a graduated capital gains tax, you get away from that problem to a degree.

Mr. HOLT. Well, the biggest lockin effect is that you may never have to pay it. So, if we change the inheritance tax so that a capital gain will automatically be realized at death, then there is no way of escaping the capital gains tax. You pay it sooner or later, and the only issue is when you pay it. That drastically reduced the lockin effect. Then, you can make a choice as to whether it is *desirable* to be locked into this *particular* investment or whether, alternatively, it would be better to *diversify*. I think that is really *not* a serious economic problem. When it is a serious one is giving a person an incentive to hold it for 40 years so that finally he dies and never pays the tax at all.

Senator BENTSEN. Thank you very much, my time has expired.

Senator Nelson, do you have any questions?

Senator NELSON. Since this is Finance Committee room, I assume we are following the committee rules, so I will wait.

Senator BENTSEN. Senator Javits.

Senator JAVITS. Mr. Chairman, I shall be very brief.

I am very interested in one area in reading your statement, but I regret that I was not in time for it since I had a meeting this morning. If you would be good enough to follow me, Professor Eisner, it would save a lot of time. On page 11 where you really lay out a program for small business in lieu of the tax reduction, you, yourself, would put your finger on the ball by pointing out that you have to make profits to pay taxes. If you do not make profits, it is peanuts.

Mr. EISNER. That is correct.

Senator JAVITS. That is true of the equipment tax, it is true of the income tax. But I do not think the income tax is making or breaking small business. So, I am very much in support of amending it and working with my colleague, Senator Nelson, as I have for years.

But I like what you are doing here. Now, let us go over that if I may, briefly. One, a tax advantage for giving the youth or another marginal member of the labor force a job. Now, that is a very important concept. Have you drafted anything on that? I have tried and have been defeated in the Senate on this. Not too decisively, but defeated on a tax for taking on additional workers, always concerned about the criterion of what are additional workers. I like the idea of a tax advantage for youth and marginal workers rather than lowering the minimum wage or the youth exemption or whatever it is called, which is very tough and which I am against. I think most of the prolabor members here are against that, too.

So, question: Have you actually drafted anything on that score, or would you try your hand on it, as a service to us?

Mr. EISNER. I have not drafted a particular proposal for legislation. I have in several writings, which will be put into the record, made the proposal, but hardly in terms that would be direct or useful for legislative purposes. I would be happy to draft a set of options.

Senator JAVITS. Would you do that?

Mr. Chairman, I ask unanimous consent that those would be included as part of Professor Eisner's testimony.

Senator NELSON [presiding]. Yes, we would be glad to receive them. The record will be open for some time.

Senator JAVITS. Say in 10 days, is that all right, or 2 weeks?
Mr. EISNER. Unfortunately, I am about to go out of the country for 2 weeks on Sunday.
Senator JAVITS. How about a month, or 30 days?
Mr. EISNER. That is fine.
Senator NELSON. May I say, Senator, the staff advised me we will not be printing the record for a month anyway. So if you had it in there by 30 days, it could be included. Would that be possible?
Mr. EISNER. Yes, sir.
[The material referred to follows:]

NORTHWESTERN UNIVERSITY
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DEPARTMENT OF ECONOMICS

July 14, 1975

Honorable Jacob K. Javits
United States Senate
Washington, D. C. 20510

Dear Senator Javits:

I am pleased to submit the "Proposal for a Job Development Credit: A Tax Credit for Investment in Human Capital," which you requested when I testified on June 17 before the Select Committee on Small Business and Subcommittee on Financial Markets of the Senate Finance Committee.

I hope this will prove useful. Please let me know if I can be of any further assistance.

Sincerely,

Robert Eisner
William R. Kenan Professor

RE:mf
Enclosure

cc: Mr. Herbert L. Spira
Senate Small Business Committee
Room 424 Old Senate Office Building
Washington, D. C. 20510

7/14/75

Proposal for a Job Development Credit: A Tax Credit for Investment in Human Capital

by Robert Eisner

Introduction

A direct way to increase employment is to reduce taxes on employment. There has been and is much talk of incentives for business investment in general and the purchase of equipment in particular. The equipment tax credit has even been strangely labeled a "job development credit," although among its effects must certainly be some inducement to substitute machinery for labor.

Yet employers and all covered employees are now faced by taxes totalling 11.7 percent of nominal earnings up to $14,100 per year. These direct taxes on employment, however dubbed as employer or employee contributions, are now being paid at a rate of over $100 billion per year and constitute a tax well in excess of corporate income taxes and second only to the individual income tax in payments to the Federal Treasury. Further, these taxes, as a component of marginal or variable costs, are a major element in prices. Their substantial increase in recent years -- they have approximately doubled since 1970 -- must certainly be a significant element in both the inflation in general prices and the loss in purchasing power which contributes to recession.

Unemployment appropriately adjusted is now at its highest proportion of the labor force since the Great Depression of the 1930's. Of the approximately 8 million counted as totally unemployed, almost 2-1/2 million are concentrated in the 16 to 21 year age group. There

is also substantial additional underemployment in that age group. Large if precisely untold numbers of youths do not enter the labor force or withdraw because of the apparent impossibility, for inexperienced new entrants, of locating jobs in a period of deep recession. While exceedingly heavy for whites as well, the unemployment rates are exceptionally high among blacks, running to approximately one-third of the labor force in the Labor Department category of "Negro and other races." Finally, in addition to those fully unemployed or out of the labor force, we must add some three-quarter of a million youths in the 16 to 21 category who are "employed part time for economic reasons," but would presumably prefer full time work, this out of a total of 3.7 million in all age groups "employed part time for economic reasons."

Current unemployment of youths threatens a permanent loss to the economy and to society. It is well known that labor learns by doing. Experienced workers are more valuable than inexperienced workers. Continued large scale unemployment among youths threatens to create a new generation of chronically unemployed and underemployed, frequently doomed to an endless repeating cycle on "welfare" or other forms of public aid and/or surviving in an underworld of crime and illicit activity.

While investment and accumulation of capital are clearly critical to economic growth, massive evidence has been accumulating in recent years that probably the most important component of that capital is human capital, the know-how based upon training and experience, along with habits of productive labor of which we have in so much of our past

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history been justifiably proud. That human capital is acquired by education and training. It is also most importantly acquired by actual job experience and that particularly in the early and formative years of life. A measure to reduce directly the general level of unemployment, and most particularly the level of unemployment among youth, and further to increase employment both by drawing additional potential workers into the labor force and making full time labor available to all those who wish it, is therefore called for most urgently.

Proposal

It is proposed that beginning with the first month after enactment of appropriate legislation, both employers and employees be relieved of contributions for social insurance or further contributions to social insurance for employees under 22 years of age, up to a cumulative maximum for each employee equal to the maximum amount of annual payments required under the law.

Thus currently, an employee eligible for such relief and the employer of such an employee would be excused from social insurance taxes on up to the first $14,100 of the employee's earnings. This may be implemented without affecting social security trust funds by having the equivalent contributions to those funds made by the United States Treasury. The exemption from payment of such taxes would expire for each employee at the time that his cumulative earnings have reached the total annual earnings on which such taxes are levied (currently $14,100) or on the employee's 22nd birthday, whichever comes sooner.

For those under 22 years of age at the time of the enactment of this legislation who have already had some eligible earnings and paid some social insurance taxes, this relief would extend until their cumulative earnings, including those earned before the effective date of this legislation, reach the maximum figure, or until their 22nd birthday, whichever comes sooner.

Under the workings of this proposal, all employers of employees under the ages of 22 whose cumulative lifetime earnings have not yet reached the maximum of annual earnings subject to social insurance taxes will receive an immediate reduction in their labor costs equal to the payroll taxes that they will not have to pay on these employees. In addition, such employees will immediately enjoy an increase in gross earnings after payment of employee contributions for social insurance equal to over 6.2 percent (that is, 5.85 divided by 94.15). The relative increase in their take-home earnings after taxes would of course be greater. The immediate reduction in labor costs would be most beneficial for labor-intensive enterprises. To the extent that small business is a relatively greater employer of labor and of youths in particular, the benefits will be disproportionately greater for small business. There will be further benefits to employers as turnover is likely to be reduced where youthful workers with larger take-home pay find their jobs more desirable.

Of considerably greater importance, however, employers will now find a twofold advantage in hiring youths with little or no experience. In the first place, they will recognize the gain of lower labor costs

due to relief from employer contributions for social insurance, a relief which is likely to last for well over a year for each youthful employee because most young workers would not in one year earn the current maximum of annual earnings subject to social insurance taxes. Secondly, they would find it economical in many cases to offer new youthful employees a take-home pay which would be attractive to such employees without the added cost of a built-in employee tax for social insurance. This would further move some way to meeting the objection that minimum wage laws tend to make it uneconomical to hire young, inexperienced workers who may be less productive until they acquire experience and for whom initial employers would incur a high training cost. Minimum wage legislation would thus be retained without exception while the United States Treasury meets the social costs of offering initial job experience which will eventually make workers sufficiently productive for employers to be willing voluntarily to pay them the minimum wage and above, and all relevant taxes.

Costs and Benefits

Those in the current labor force under 22 years of age number approximately 14 million, and their current contributions for social insurance in 1975 may total about 5.2 billion dollars.[1] Recognizing that some workers will have already reached their maximum cumulative earnings and most will already have had some earnings, we may estimate roughly that the initial annual cost

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[1]A one percent social security sample indicates that contributions for social insurance of those 16 to 21 years of age were $4.476 billion in 1973. Multiplying this by 104.5/89.3, the ratio of total contributions for social insurance in the first quarter of 1975 to those in the first quarter of 1973, yields an initial estimate of $5.238 billion. Similar results are obtained by extrapolating with the ratio of the Wharton Model's projection of 1975 contributions for social insurance to 1973 contributions.

I am indebted to Roy Webb for assistance in locating the underlying data and preparing these calculations.

to the Treasury should be no more than $3 billion. The annual cost to the Treasury would run somewhat higher, however, in future years as there would be fewer employees who reach the cumulative earnings cutoff without enjoying full tax relief, but would remain well under the $5.5 billion for the current labor force, with current wages, current employment and the current annual earnings limit applied in the cumulative earnings cutoff. As wage rates and employment vary, in part due to implementation of this proposal, and as the cutoff is changed, the direct tax effects would of course also change.

Direct benefits are to be found first in a reduction of labor costs of approximately 5.53 percent (that is, 5.85 divided by 105.85) for perhaps 6 million workers under the ages of 22 who would be affected immediately. This should in turn reduce prices or lower the rate of inflation. To the extent that employees are concerned primarily with take-home pay, employers would find that they might realize a further saving in labor costs while offering new employees a lower wage than would be necessary if the net wage were reduced by social insurance taxes. If employers were not driven by competitive pressure to lower the prices of the products to reflect fully the lowered labor costs, they would of course now enjoy higher profits which would result in higher profits taxes, thus reducing tax loss to the Treasury.

Second, and most significant, employers would have an incentive to hire additional teen-agers and those 20 and 21 years of age and to give full-time jobs to many now working only part time. The gains from such increased employment of youths are likely to be lasting. Employers are frequently understandably reluctant to hire young people without experience and training. Risks are considerable and if new employees work out there is no guarantee that they will remain long with the employers who invest in their first job. Yet that first job, before the frustration of idleness has wreaked its toll, may be critical to establishment of life-long skills and the work ethic.

In the short run, increased employment for those under 22 years of age would add to production and income. As youths and their families spend the increases in income further employment will be generated as production of goods and services is increased to meet the increased demand. The initial tax revenues generated from increased employment, production and income are likely to offset a significant portion, if not all, of the initial tax loss. The savings in social costs of idle youth and the ultimate costs of lives ruined by youthful idleness are incalculable.

It may be objected that a special incentive to hire youths will result in less employment for adults. This is hardly likely. While there might be some "substitution effect," in the economist's jargon, the expansion effect of added employment would considerably outweigh it.

It may further be objected that employers would hire youths only until they exhausted their tax-relief potential and then fire them.

This, however, does not make economic sense and seems highly unlikely. For after one to two years of employment most workers have enough experience to increase their prospective value by considerably more than the 5.85 percent in additional labor costs which would be entailed in the employer contributions to social security and indeed by more than the total of 11.7 percent. If it paid employers to hire the youths to begin with it should certainly pay to keep them after they have acquired initial experience.

Possible Extensions

This proposal could obviously be modified to remove the ceiling cutoffs and permit relief from payroll taxes for all employment of those under 22 years of age. The monetary costs would be somewhat greater but so would some of the benefits, although it might be argued that the benefits of increased employment would not grow proportionately with extension of the duration of the relief.

The proposal might also be modified to a lesser extent by removing the inclusion of income already earned before the effective date of the embodying legislation from the cumulative earnings counted toward the cutoff. This would also increase the costs and some of the benefits but, applying to those already employed, would consequently have a lesser effect on increasing employment.

The proposal might also be extended to cover initial employment for those of any age. It might be argued that employers should be encouraged in the social interest to treat kindly any new entrants

into the labor force. This may be particularly important for women who have not had previous work experience. If the age limit were extended beyond 22 years it would entail the inclusion of many young college graduates and of those who have completed graduate or professional training as well. Inclusion of these latter, relatively better qualified entrants into the labor force, would not, however, seem as fruitful in terms of the key objective of increasing employment. In general, it can be argued that the greatest benefit in terms of human capital is derived from investing in those in the youngest age groups. They have the longest number of years in which they and society can profit from investment in initial jobs and training. In the interest of increasing employment generally and lowering prices, however, one might extend the tax relief beyond those under 22 years of age, for example, by applying to the payroll tax the $750 personal exemption in individual income taxes.

Conclusion

This proposal will increase real demand while lowering costs and hence combat inflation while increasing production and employment. It will be focussed directly on employment and increasing the most vital and productive human capital of the nation's youth. If it were desirable to substitute other tax revenues for those lost under the initial operation of this proposal, it might be appropriate to limit, reduce, or eliminate the equipment tax credit, which in its expanded

form will involve a similar or greater magnitude of loss of Treasury value. While the benefits of this proposal would extend to all enterprises, they will be concentrated somewhat more heavily on relatively labor-intensive small business and, of course, these businesses which hire or might hire larger proportions of youthful workers. But by contributing to the reduction of inflation while, most importantly, moving us back toward a target of full employment, adoption of this proposal will contribute to prosperity and economic growth.

Senator JAVITS. Secondly, I think we ought to consider very carefully your idea of eliminating the unemployment compensation taxes for younger workers, again, rather than breaking down the minimum wage structure.

But to proceed to the next point, you than say, credit. Credit is a big problem for small business. And do you agree with the illusion that the SBA is an adequate source of credit—especially as that credit is uncoupled with any technical guidance that a banker gives to his client. And this business that bankers, you know, are just leeches—from my own experience; and I was a big business lawyer long before I was a Senator—is wrong; the banking firms have, on many occasions, given very, very useful and special guidance and advice. They are a very high salaried control which a small business cannot hire.

So, question: Should we go for some concept of a development bank in the United States which, even as conservative or as middle of the road a Senator as Senator Sparkman has shown a very great interest in, because of the need, as is shown in the World Bank for coupling larger source of credit from the SBA with technical assistance in the financial banking field for small business.

Mr. EISNER. I would be sympathetic in principle to such a proposal, because it seems to me that it would fit the general criteria I would have of perfecting markets and improving capital markets in this instance, and also offering the kinds of services which may well be externalities—that is, expertise—which perhaps an individual concern, and particularly a small concern, may not be able to afford, but which would be of greater benefit than the cost.

Senator JAVITS. Now, would you do a little added work for us and let us submit to you—the bill which I have introduced for some years—or Senator Sparkman's bill, which may be even better—a bill for the development bank—and would you give us your critique of that at the same time that we hear from you on this other propositional tax?

Mr. EISNER. I shall endeavor to do so.

I should add that I am not really a specialist in this particular area, but I will offer what opinions I can.

Senator JAVITS. Well, all right.

And last, what about R. & D. for small business? We wrote into the law what practically amounted to an antitrust exemption for small business in respect to research and development. It has had very few takers, which is sad, because it was so well intentioned and so necessary.

Would you have any suggestion as to that? That, collaborative research by small business. What is keeping them out of it, or what to do instead, where they really are behind the eight ball as far as big business is concerned.

Mr. EISNER. I fear here I have only general principles. For one thing, as I indicated in my prepared statement, we discourage R. & D. expenditures by giving tax advantages to other kinds of expenditures; for example, equipment, in this instance. But generally, by its nature, research and development expenditures are frequently unjustifiable in terms of ordinary profitmaking for an enterprise. The smaller the enterprise, the less it is justifiable, because the enterprise cannot maintain for itself a sufficient proportion of the advantages. And the remedy there is to, as you suggested, encourage some kind of coopera-

tive effort or to have the Government in the business as it is for agriculture, as it is largely in the military-space area, providing the research services itself.

Senator JAVITS. Mr. Holt, would you like to contribute to this—we will not have time in questioning—in the way of writing? Especially, I noticed you shaking your head on the R. & D.

Mr. HOLT. I think the model of having nationalized agricultural research is a very good model here. You cannot expect small business firms, say in the dry cleaning industry, to do a lot of research.

Senator JAVITS. Could you give us some finite thoughts on that in writing?

Mr. HOLT. Certainly.

Senator JAVITS. I ask again unanimous consent for 30 days.

[The information referred to follows:]

SUPPLEMENTARY STATEMENT ON RESEARCH ASSISTANCE TO SMALL BUSINESS

by

Charles C. Holt

The federal government should make greater efforts to make laws, regulations, and administrative procedures more responsive to the capabilities of small business. Failure to do so will handicap small business relative to large ones that often are thousands of times bigger.

However, a strong case can be made that government should lend positive assistance to small business in certain areas. The failure rate for small business, particularly in the start-up phase, is so shockingly high that attention needs to be directed at achieving successful firms. For the pain and costs of business failure to be reduced, many ill-stared ventures should never be started and others should be started better.

Better knowledge is needed on how to start and run small businesses. Unfortunately, the small business manager cannot afford to do the research on the technical, financial, marketing, etc., problems that must be solved, if he is to survive and prosper. Even though the benefit/cost ratio of research is prohibitive for the individual small firm, it may be highly advantageous from the social point of view, provided that the resulting knowledge is widely disseminated.

In agriculture these considerations have led to extensive, publicly-funded research, which has contributed importantly to our high agricultural productivity. Lacking such research and the technical assistance to deliver it, small businesses, in the interests of survival, will tend to be forced to rely increasingly on standardized franchise packages. While this is a healthy development in many

ways, it does decrease the rich cultural variety of home-grown businesses, and may lead to a decrease in economic competition.

Given the fact that large business can afford research but small ones can't, unless government research and technical assistance is supplied, our small business sector will be technologically and managerially handicapped, and tend, in the long run, to shrink in relative importance.

For these reasons I would urge that the federal government establish a program of research and technical assistance designed to operate in the industrial areas and on the problems of greatest concern to small business. In drawing legislation to implement this recommendation, consideration should be given to economies of scale in performing and publishing research, on one hand, and to the need for widely dispersed technical assistance in the application of the findings at the regional, state, and firm levels. Profit-motivated consulting firms also should be encouraged to participated in the dissemination process and in the formulation of problems requiring research. The agricultural extension system should be studied as a possible model for this legislation. A federally-coordinated and supported program at land-grant business and engineering schools could supply much of the research, technical assistance, and adult education that are needed by small business. However, the involvement of federal laboratories and agencies also needs to be considered.

Senator JAVITS. Now, anything on this, Mr. Harwell, that you would wish to contribute would be more than welcome, although it is not particularly in your line.

Mr. HARWELL. No, I would like to say just one thing, and maybe get concurrence with something that Senator Brock mentioned, and that is talking about whether a tax incentive or some kind of a tax break will encourage business, versus the cost of money itself.

In the Federal Reserve and its policies—just as an observer, not an economist—but every time the interest rates go up, the number of new jobs created in Texas from a manufacturing standpoint drops drastically. And I can take a look at the number of new plants, the number of new jobs in industry created in the State of Texas, and it is in direct proportion to the lowering of the cost of interest. And I think that one of the things, especially in the small business, the small businessman is going to be much more influenced by whether he grows or does not grow by the cost of money than he is by some kind of a tax credit.

Senator JAVITS. Well, Arthur Burns is always wont to say that the cost of money depends on its supply. That is why I suggested to Professor Eisner development banking.

Mr. HARWELL. There was a statement made about the fact that we have a lot of capital. Now, we have a lot of capital in Texas, but it is all for very short-term notes. I do not know that we have solved the long-range capital problem in this country at all. And in fact, just last year we were all tearing our hair, saying where are we going to come up with the money to finance new powerplants, and all of the rest of it. And we have companies all across the State that are not able to get long-term money.

Senator JAVITS. So that you say that the supply of money at reasonable rates is the critical problem for small business in Texas.

Mr. HARWELL. Absolutely.

Senator JAVITS. Thank you, Mr. Chairman.

Senator NELSON. Senator Packwood.

Senator PACKWOOD. One question, Mr. Holt.

On page 3 of your statement, you are talking about the progressive corporate income tax. You vary it according to size of business, and then you say, "For small corporations in the $25,000 earning bracket losses should produce tax refunds rather than loss carryforwards."

Tax refunds of what?

Mr. HOLT. Well, actually, I talked with a tax attorney since I wrote that, and it is to some extent obviated by the fact that not only do we currently have tax carryforwards, but we have tax carrybacks which allow you, in effect, to get a tax refund. So, in some part, that problem has been taken care of. However, there is a real distinction between the isolation that you get from losses in a corporation as distinct from say a proprietorship or partnership. And some of the points that Professor Eisner made about decreasing the dependence on the corporation income tax, simply passing through *both* earnings and losses directly to personal taxation, has a good deal to recommend it.

The interaction between the corporation income tax and personal income tax gives corporations an incentive *not* to pay out earnings in the form of dividends and to simply reinvest in their own busi-

nesses—that introduces a type of rigidity. It keeps those funds from flowing back into capital markets where they might be more profitably invested in other industries.

Senator PACKWOOD. I want to make sure I understand.

You are not suggesting that if you and I go into business and we form a corporation—just a small business—and the first year we lose $10,000 or $15,000, that we get some kind of a subsidy from the Government for our loss?

Mr. HOLT. If you wanted to *encourage* people to go into new businesses, that is the kind of program you might consider. There was a time when the corporation income tax operated in such a way that when you made money, the Government participated, and when you lost money, the Government closed its eyes—you were given a loss carryforward, but you have no way of recovering taxes that you had paid earlier. That obviously was a very negative incentive for people to undertake risky investments. We have to some extent gotten away from that problem through the loss carryback.

However, if you want to encourage people to go into risky business more could be done. Since the Government now takes about 50 percent of the *profits*, for the Government to take 50 percent of the *losses* essentially puts the Government in partnership with the entrepreneur in terms of risk bearing. You might do that, if you felt that there was a real problem in getting small businesses started.

Senator PACKWOOD. It is intriguing.

Mr. HOLT. I am not strongly advocating it without further study.

Senator PACKWOOD. I have hundreds of friends who I think would take advantage of it.

Mr. HOLT. The idea that you are going to risk losing money simply because Uncle Sam is in there losing with you is not a game that you necessarily would want to play if you look at it closely—that still does not make losing money to be good business.

Senator PACKWOOD. Oh, no; I agree. Nobody wants to lose money. It would make projecting our Federal Government expenditures very difficult from year to year—assuming we were going to pick up 50 percent of all the losses of new businesses for the first 2 or 3 years they were in business.

Mr. HOLT. I am sure that is peanuts in terms of the overall budget.

Senator PACKWOOD. I have no other questions.

Senator NELSON. Senator BYRD.

Senator BYRD. Thank you, Mr. Chairman.

May I ask Mr. Holt and Professor Eisner this: What do you regard as the appropriate income tax rate for corporations?

Mr. EISNER. I am on record—I hope it does not shock you—I am on record in a "Business Week" article of December 14, that I have offered for the record, as suggesting that the appropriate corporate income tax rate is zero, and I mean that seriously. But that would involve having individuals include in their taxable incomes the share of corporate earnings which is represented by their equity or ownership in a corporation. And that would remove a considerable number of the distorting effects of business taxation.

Senator BYRD. You would apply subchapter S to all corporations, is that what you are saying?

Mr. EISNER. I would have to be sure I knew precisely the implications of subchapter S.

Mr. HOLT. That is what it comes to without all of the restrictions associated with subchapter S.

Senator BYRD. May I ask Mr. Holt what he feels would be an appropriate tax structure?

Mr. HOLT. I do not consider myself a tax expert, and I am inclined to agree with the point that Professor Eisner made that there are serious questions in terms of distortion in the corporation income tax. But I have not done as much thinking about it as he has, and I am less ready to firmly urge its abandonment.

Senator BYRD. If you lay out 50 percent now, and leave it out for the smaller corporations, do you feel that is too high or about right or too low?

Mr. HOLT. Well, I am inclined to think, if it is anything, it is too high.

Senator BYRD. May I ask Mr. Harwell his view on it?

Mr. HARWELL. Well, Senator, I am not a tax expert at all, but I would go along with the concept that if you can eliminate any taxes, I am in favor of them.

Senator BYRD. May I ask Professor Eisner this: What do you feel would be the appropriate capital gains tax? 25 percent? 35 percent? More or less?

Mr. EISNER. The appropriate capital gains tax, I would argue, would be the income tax rate, with capital gains taxed as they accrue, with adjustment for inflation. But I would suggest that this would mean a considerably lower income tax rate than we have had. The direction—and I am sure that the members of this committee are aware—that we have followed in this country is generally an increase in rates, either directly or by letting the effects of inflation bring us into a higher tax bracket. And then at the same time, with people more and more miserable with the higher rates, we exclude more and more income from these rates. We ask special preferences in reductions, whether they are on capital gains or equipment credits or municipal bond interest or one thing or another; and of course, that means, then, that the higher rates which become necessary increase the demand for still more exemptions.

If we included all capital gains in taxable income, even if we merely included the realized capital gains—including, as Professor Holt is apt to urge, the taxation of capital gains at death—we would find that we can decrease the rate on all income, including the income from capital gains, to everybody's benefit.

Senator BYRD. What do you regard as the two or three major factors in the inflation which we have been experiencing?

Mr. EISNER. The major factors in the inflation, I would say, are, first, it is an initial pull from the surge of expenditures way back in the Vietnam war from which we have never quite recovered.

Senator BYRD. Federal spending?

Mr. EISNER. Yes, Federal spending at that time. But second, I believe that the major push has come from the increases in petroleum prices and the push from the shortages of the supply in agricultural commodities in the last few years. And this has been aggravated by imperfections in markets, regulatory agency action, and other characteristics of the economy, such that there is hardly any downward flexibility.

I cannot refrain from adding quickly that given this explanation, I think trying to fight the inflation by reducing demand has been a very misguided action which might well have been predicted to bring on the massive recession that we have had. You do not come back from an inflation due very largely to increased costs of supplying goods and services due to a shortage of supply by trying to reduce demand, and certainly not in an economy where it is notorious that there is relatively little downward flexibility of wages and prices.

The particular effect on the economy now has been precisely the huge surge of unemployment we have had.

Senator BYRD. How do you feel?

Mr. HOLT. I totally agree with that, adding simply one point; that there has been a general inflation of world prices—all commodities, not just agricultural commodities and petroleum—and that, although foreign trade is not of dominant importance in the American economy, this has contributed to our inflation problem.

The testimony that I gave to Senator Bentsen's JEC Subcommittee on Growth dealt with some of these aggregate demand issues. And it is also somewhat responsive to the issue that Senator Brock was raising. And if the committee is interested, it might like to include that statement in the record.

[The information referred to follows:]

Statement for the Economic Growth Subcommittee
of the Joint Economic Committee

UNEMPLOYMENT, INFLATION, AND STRUCTURAL REFORM

by

Charles C. Holt

June 3, 1975

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UNEMPLOYMENT, INFLATION, AND STRUCTURAL REFORM

Statement for the Economic Growth Subcommittee
of the Joint Economic Committee

by

Charles C. Holt

Senator Bentsen and members of the JEC Subcommittee on Economic Growth, I want to express my pleasure at being asked to testify before you on Manpower Policies to Restore Full Employment.

Ralph Smith and I are testifying as individuals and not as spokesmen for The Urban Institute or its sponsors. However, we will be drawing freely on the research of our colleagues Richard Toikka, William Scanlon, and Jean Vanski. Our research has been supported by the Department of Labor, the National Science Foundation, and the Ford Foundation. Ralph Smith will talk about near-term unemployment prospects and I will consider the need for structural change and manpower policy.

I. THE ROLE AND LIMITATIONS OF MACRO POLICY

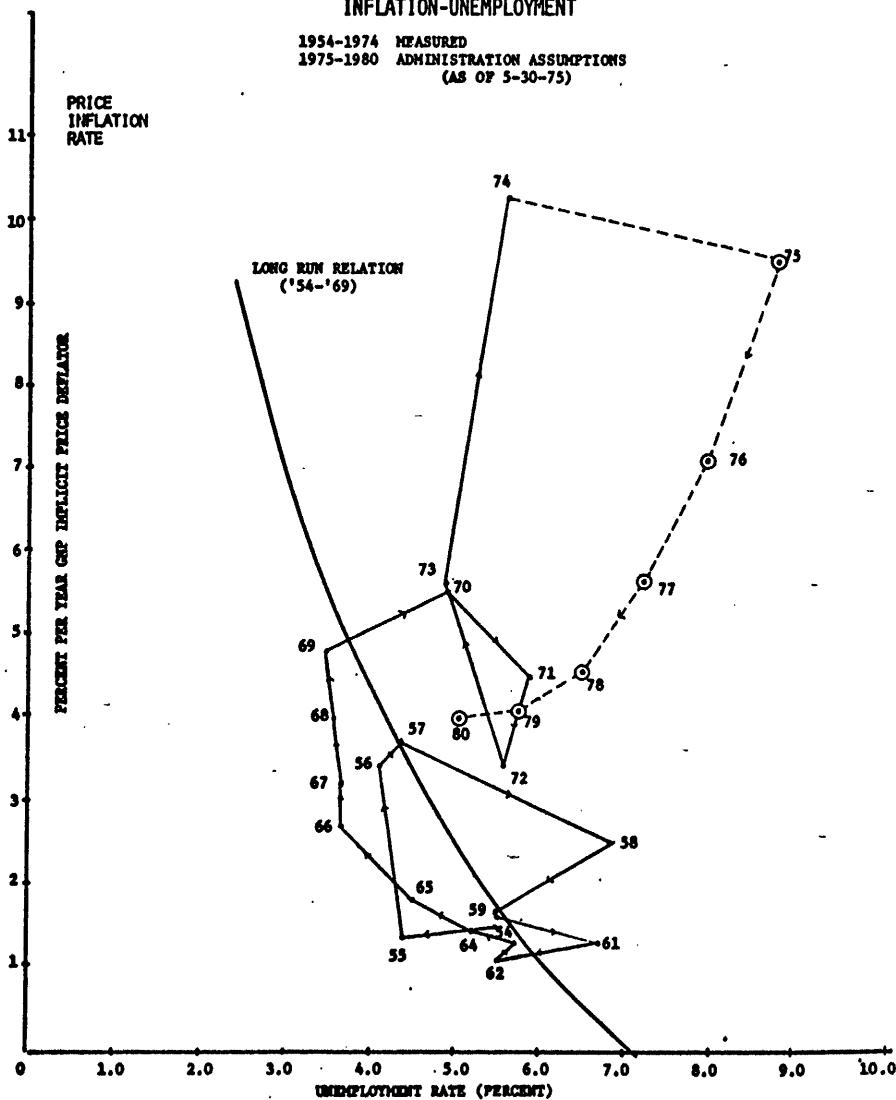
Ralph Smith's presentation, based on our econometric study of the labor market, shows vividly both the severity of current and prospective unemployment and the uneveness of its impacts. It also suggests the existence of severe structural problems in the labor market. I will return to those issues later.

However, doing something about unemployment requires the recognition of its intimate connection with inflation. The Phillips diagram in Figure 1 shows the recent history of unemployment and inflation in this country and a long-run Phillips curve fitted to data from 1954 to 1969. The data from recent years, of course, reflects extraordinary international impacts from wheat, oil, etc., but even before that the increasingly adverse unemployment-inflation tradeoff is evident. We have also plotted the Administration's "extrapolations" to 1980. One might question whether their unemployment and inflation figures are mutually consistent, much less optimal, but they do need to be taken seriously as the best indication of the President's intentions.

Monetary, fiscal, and international exchange policies can certainly reduce the unemployment level, but the governing constraint is the dynamic link to inflation and the choice of the least painful mix of unemployment-inflation outcomes, both currently and in the future. In my view, greater demand stimulus, _if promptly applied_, would lower unemployment without excess risk of inflation. Aggregate demand stimulus including public service employment is urgently needed and further action should be taken now.

Unfortunately, macro demand policies can only deal with less than half of today's unemployment. Macro policies are limited because using them to attain and _hold_ unemployment at much less than five percent is likely to produce inflation that would be unacceptable to the American people. Lower

Figure 1



levels of unemployment have been attained temporarily without undue inflation, especially when the reduction has been made very slowly. However, our recent experience of high rates of inflation has undoubtedly made our economy more vulnerable to inflation because of the increased responsiveness of inflationary expectations.

Hence, we must seek other policies to complement macro stabilization policies.

II. THE NEED FOR STRUCTURAL REFORM

If we are to obtain a better Phillips tradeoff between unemployment and inflation, we must take actions that impinge on:

(1) the processes that determine prices,
(2) the processes that determine wages,
(3) the processes that determine unemployment.

These are not simple supply and demand relations, but are processes that intimately involve the institutions of industry, trade, finance, unions, and government and the economic, social, psychological, and political behavior of people and organizations.

John T. Dunlop, Secretary of Labor, and Professor Hendrik S. Houthakker, formerly on the Council of Economic Advisers, have attempted to spell out specific structural changes that governmental policies should pursue. Many other economists as well have urged structural reforms.

Reducing the structural contributions to inflation and unemployment is a systems problem whose solution will require changes in public and private policies on many parallel fronts. No easy, simple, quick solutions exist. An active process of change is needed that will take many years. In the

face of the severe challenge to national leadership, which this problem poses, it is encouraging to meet with a Congressional Committee that is willing to consider a horizon that extends beyond the next election.

In the short run, little can be done about structural inflation and structural unemployment. Yet there is a critical interaction with macro policies, because structural reform is very difficult, if not impossible, under high levels of cyclical unemployment. But, on the other hand, short-term economic stimulus, taken alone, will be inadequate -- over half of the current unemployment is structural and frictional in nature.

III. DO WE KNOW WHICH STRUCTURAL CHANGES TO MAKE AND HOW TO MAKE THEM?

The short answer is no, and we're not likely to, unless changes are made. Some reasons can be suggested. There are very few micro economists who relate their research to macro problems. Few social psychologists connect work satisfaction with the problem of unemployment. The Departments of Labor and Health, Education and Welfare haven't related their programs to the Council of Economic Advisers' national inflation-unemployment problem. The federal government is fragmented by agency functions and universities are fragmented by discipline. Such specialization is helpful, but vital interactions between national inflation and unemployment, and the structure of industries and the labor market have been largely ignored.

This is partially due to the serious difficulties that are involved in researching complex socioeconomic systems, but it also results from the inept use of research by government in solving practical problems.

Although there are a few notable exceptions, the federal government's socioeconomic research relating to structural issues can be roughly characterized as follows:

(1) A coordinated research strategy is missing for producing the essential basic knowledge and applying it to solve the government's policy, program, and operating problems;
(2) Governmental staff often haven't done research themselves, and, as a result, don't administer outside research well;
(3) Governmental data collection is fragmented, slow, and inadequately tied to research needs;
(4) Much research doesn't get used because administrators are not analytically oriented;
(5) Resources have been inadequate for research support.
(6) Universities and research institutes have not adequately overcome fragmentation among disciplines.

Consequently, the research often is low in quality, fragmented and little used. The resulting deficiencies in our knowledge base affect all the areas requiring structural reform: manpower, antitrust, regulation, etc.

An index of the inadequacy of the government's research effort on inflation and unemployment is the fact that it has had _no_ coordinated research program directed at finding structural solutions. Aside from the knowledge issue, the needed structural changes will be politically and administratively difficult.

The above overview is not intended to discourage the Subcommittee from the structural approach to inflation and unemployment, but rather to supply a realistic assessment of the point of departure and the magnitude of the efforts that will be required. Legislation which is currently being proposed by some members of the Committee should give serious attention to filling our knowledge gap.

Since two out of the three processes mentioned in Section II that account for the Phillips relation occur in the labor market, i.e., those that determine unemployment and those that determine wage changes, we turn to the issue of structural changes through manpower policies.

IV. LABOR MARKET PROGRAMS AND POLICIES FOR FULL EMPLOYMENT

I would like to examine briefly the present status of manpower programs[1] and then consider directions for development. The bulk of manpower programs have been transferred from the federal level to the state and local (SMSA) levels through the CETA legislation. Although this decentralization was not adequately tested for workability in advance of its implementation, it probably was a sound move to build more manpower capability at the state and local levels. However, it has left the federal government with few programs for organizing a national manpower effort in response to national economic conditions. Because of the inclusion of public service employment in CETA and the transfer of funds between its titles, it would be possible through local decisions to have very small support of manpower programs and instead have a revenue-sharing type program which resulted primarily in state and local tax savings.

The Employment Service, which is a more integrated federal-state activity, is under increasing budget pressure and its role is being challenged.

Indeed, it might not be inaccurate to characterize the federal manpower thrust as being almost defeatist with respect to the difficult problems of improving our economic structure. To be sure, actions by the Executive

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1. Public service employment has been much more an aggregate demand measure than a manpower program in terms of developing human capital or dealing with structural problems. In this discussion I do not consider PSE a manpower program although it could and should also be so used.

branch and Congress have restricted manpower funds, but much more could have been done to improve program impacts. The points discussed above about research and its utilization are relevant here.

Let me give a few examples. The Employment Service is under pressure to increase placements and a drive is underway to improve career education. Yet neither DOL, HEW, nor the National Institute of Education have significant research efforts to find out what basic factors account for the success of a person in a job. Effective programs of placement and counseling require this knowledge. The effect of low job vacancies on placements is recognized by the Employment Service, but its potential to affect aggregate demand policies is not.

Improving the quality of work, which has important implications for the quality of life, turnover, and unemployment, has been declared a high priority objective by HEW, DOL, and the Productivity Commission, yet there is little basic research or carefully designed experimentation underway.

Evaluations of training progams have shown widely variable results, ranging from disappointing to spectacular, but little careful work has been done to find out what accounts for the differences.

I do not want to sound overly critical of what has been done, because all of these areas pose extremely difficult problems for both research and administration. But the efforts are utterly inadequate relative to the importance of finding manpower policy approaches to improving the structure of the economy.

While we need better knowledge, we cannot simply wait for the research to be completed. Manpower results achieved in Sweden, Japan, and West Germany suggest what can be done and lend encouragement, but they do not offer solid transferrable knowledge.

Against this background, what manpower policies should we pursue to help achieve full employment? Many people should contribute to the answer. I propose the following recommendations for consideration:

(1) Clear policy targets should be established through legislation directing that manpower programs be developed which would contribute to lowering unemployment and reducing inflation. This means concentrating attention on the one-third of the labor force that have the greatest employment problems and the one-third of the jobs that, at the time, are most difficult to fill, and, hence, contribute to inflationary pressures.

(2) Plan and fund a process of gradually developing, testing, and implementing programs and policies that would be effective in attaining the above objectives.

(3) Build up the imaginative, experimentally-oriented, administrative leadership necessary to get this job done.

(4) Support the administrators with research staff and a program of basic, applied, and experimental research.

(5) Gradually reorganize existing CETA, DOL, and HEW manpower programs and add new ones as needed in order to balance contributions at the federal, state, and local levels, each agency funded and empowered to make its best contribution. The system should be designed for both coordination and competition including the participation of community and commercial organizations. Resources should reward the most effective agencies.

(6) Discriminatory barriers in the labor market should be attacked more forcefully, both through enforcement actions and supportive programs which would absorb some of the costs of change.

In order to be successful, this program would need to be supported with as high a level of aggregate demand as possible consistent with reasonable restraint on inflation. Parallel structural reforms would need to be made in other areas including those designed to reduce disruptions resulting from inflation. Since sound programs and policies

will more than pay for themselves in increased output, they should be implemented and funded as quickly as their effectiveness is reasonable demonstrated. However, unreasonably high standards should not be set in view of the fact that structural problems and the recession which we induced to fight inflation currently are wasting productive resources at the rate of over one hundred billion dollars annually, not to mention the inequity in the distribution of unemployment. Also weight needs to be given to improving the distribution of income as well as improving economic efficiency.

The strategy of structural reform will take years to implement, and improvements will come in undramatic increments, but there is probably no other way to achieve sound and continuing full employment without inflation. The structural problems will be there until we face up to them. Shouldn't we accept the challenge now?

Fortunately, there are some encouraging signs on the horizon, with respect to structural reform. Secretary Dunlop is deeply knowledgeable about and interested in the issues that I have been discussing, and I understand, may be testifying again before this Subcommittee. Also, the National Commission on Manpower Policy, under the leadership of Eli Ginzberg, has expressed keen interest in plans for expanding our manpower capabilities. His testimony today will indicate some directions for that development. Finally, President Ford has strongly urged structural reforms in the area of government regulation. I hope the recession will spur a critical reexamination of policies needed to deal with inflation and unemployment.

Senator BYRD. Has inflation and/or recession had a significant impact on small business different from larger businesses in the percentage of profits retained?

Do you happen to have any information on that, either one of you?

Mr. HOLT. I think that small businesses are very much more vulnerable to economic fluctuations than large businesses. They do not have the economic resources financially, and they are selling in very much narrower segments, so they have less opportunities to compensate losses in one area with increased sales in another. So I would anticipate that you would find a very much more drastic effect on profits and sales of small businesses compared to large.

Obviously, it will depend on the industry as well.

Senator BYRD. Could I ask Professor Eisner, in what way are retained earnings related to the ability to attract equity and debt capital?

Mr. EISNER. Retained earnings are certainly positively related to the ability to attract capital, although I should qualify that by saying that earnings generally will be positively correlated because none of us can forecast the future perfectly. If we see a concern is earning money, we feel it may be somewhat less risky—if we feel it has retained earnings, we may feel it has a certain cushion. On the other hand, paying out some of the earnings may also attract some investors, particularly if they are not too concerned about the tax consequences on the receipt of dividends. But earnings will tend to generate an ability to borrow.

Senator BYRD. Thank you, gentlemen.

Thank you, Mr. Chairman.

Senator NELSON. Thank you.

Thank you, gentlemen, for you very valuable testimony and for taking your time to come here and present it today. We appreciate it very much.

Mr. EISNER. Thank you, sir.

Mr. HOLT. Thank you, sir.

Senator NELSON. The record will be open for 30 days for anything you might wish to submit in addition.

Our final witness today is Mr. John Lewis, executive vice president, National Small Business Association, accompanied by Herbert Liebenson, staff vice president for Government Affairs of NSBA; and John Mendenhall, CPA and attorney.

The committee is pleased to welcome you here this morning, gentlemen.

If you would please identify yourselves for the reporter.

STATEMENT OF JOHN LEWIS, EXECUTIVE VICE PRESIDENT, NATIONAL SMALL BUSINESS ASSOCIATION, ACCOMPANIED BY HERBERT LIEBENSON, VICE PRESIDENT FOR GOVERNMENT AFFAIRS, NATIONAL SMALL BUSINESS ASSOCIATION; AND JOHN MENDENHALL, CPA AND ATTORNEY, A MEMBER OF THE LAW FIRM OF WILLIAMS, CONNOLLY & CALIFANO OF WASHINGTON, D.C.

Mr. LEWIS. Mr. Chairman, my name is John Lewis, and I am executive vice president of National Small Business Association. Our association represents firms doing business in more than 500 categories.

On my left is John Mendenhall, a certified public accountant, attorney at law, a member of the law firm of Williams, Connolly and Califano of Washington, D.C.

On my right is Mr. Herbert Liebenson, vice president of Government Affairs of National Small Business Association.

With your permission, Mr. Chairman, I would like to summarize my statement.

Senator NELSON. Go ahead, your statement will be printed in full in the record, and you may go ahead and summarize it.

If you would please pull up your microphone so that everyone in the room can hear.

Mr. LEWIS. We are very, very grateful, Mr. Chairman, for these joint hearings involving the Senate Small Business Committee and the Senate Finance Committee. In announcing these hearings, you stated that "small and independent business accounts for between 52 percent and 53 percent of the Nation's total private employment, 43 percent of the business product, and about one-third of the gross national product."

There are about 10.5 million small business firms in this country today—about 98 percent of all of the firms. These firms, their employees and their families, dependent on small business employment, total about 80 million people—more than one-third of the total population of the country. And as impressive as these percentages and these figures are, a great problem for small business is that you cannot bank them, you cannot spend them and you cannot borrow on them.

The major problem that small business faces today is that it is losing market share and losing it rapidly.

Now, concentration is not as bad in the distribution industries as it is in manufacturing. However, there are certain exceptions. For example, in the retail food industry, there are 142,000 food retailers—less than one-tenth of 1 percent—in orther words, 142 food chains, retail chains, make 57 percent of all sales. We almost have a similar situation in the drug industry. Approximately 40,000 retailers—one-tenth of 1 percent—that is, 40 retail drug chains—make one-third of the total sales in that industry.

In manufacturing, in 270 out of 413 industries—and that is 65 percent of all——

Senator NELSON. What are those figures again?

Mr. LEWIS. 270 of 413 manufacturing industries. That is, 65 percent of all of the industries for which figures are available the eight largest companies in those 270 industries accounted for 40 percent or more of the value of shipments from their industries.

Let us compare manufacturing profits, manufacturing assets, to determine how small business is faring with regard to profits.

In 1960, small and medium-size business gained 41 percent of the profits; 12 years later, the share of profits for small and medium-size business had dwindled to 28 percent. With respect to assets, small and medium-size business' share of the assets in 1960 was 50 percent; 12 years later, this had shrunk to 30 percent.

Only last week Senator Hart, in introducing his Industrial Reorganization Act, said that 200 manufacturers, 200 corporations, control at least two-thirds of the manufacturing assets of the country.

We are concerned with concentration, just as you are. We are not anti the bigs, we are for small business. This country is now in its Bicentennial—200 years ago, there was only small business. Today, there is not one giant that did not start out as a small business—even General Motors, United States Steel. They are a combination of small businesses.

If there is one important factor about the giants, their greatest growth, with some exceptions, came when the tax bite was the smallest on them. In other words, they got a headstart in plowing back profits for expansion. Now the tax rates have changed. Theoretically, the smallest of the smalls—the Joe's Machine Shops—and General Motors pay the same tax rate; but it does not work out that way. The truth is that there are provisions in the tax code that only certain companies—and generally these are giants—can take full advantage of. And when this happens, there is a discrimination against small business. Averaged out, it is approximately a 15 percent discrimination—15 percent in that the effective tax rate paid by the smalls is 15 percent higher than that paid by the giants. Some day there must be a complete overhaul of the tax code to bring equity for small business and to bring growth for small business. But we are willing to take one step at a time.

Senator Nelson, we applaud the leadership of you and the members of the Senate Small Business Committee and the members of the Finance Committee that worked so diligently and so effectively in winning some benefits in the 1975 Emergency Tax Reduction Act. Unfortunately, these benefits are for only 1 year and they do not go deep enough; and they should be made permanent.

We have certain recommendations that we believe should be incorporated in the new Small Business Tax Reform Act—the new Nelson-Evins Act—which we hope that all members of the Finance and the Senate Small Business Committee will cosponsor with you.

The starting point is what was incorporated in the Bible-Evins bill plus what was almost—and I repeat—almost acted on by the House Ways and Means Committee. This was an excellent start, but there are certain recommendations that we want to make to you today.

With regard to the 1975 Emergency Tax Reduction Act, those who needed help and relief the most, actually got the least. The normal tax was reduced from 22 percent to 20 percent. Now, in truth, we favor a graduated income tax for corporations, just as we have with the individual income tax. But being very practical, we know that that cannot be accomplished in all probability. But to help the small smalls, we would recommend that the normal tax be cut permanently to 10 percent for those companies that meet the SBA's size definition.

Second, we would like to talk to you about adjusting the fixed-dollar amounts in the code. Everytime the debt ceiling, which is the fixed figure, has to be raised, Congress acts. When the cost of living goes up, the social security payments are adjusted; Federal salaries, Federal pensions are adjusted. But the fixed-dollar amounts in the code have been there for decades and are never adjusted.

Our recommendation to you is that, to compensate for the erosion by inflation, these fixed-dollar amounts be adjusted accordingly. And to prevent recurrence of this problem in the future, we recommend these adjustments be tagged to the Council of Economic Advisors' index of "Price Deflators for Gross National Product."

Illustrative of what we are talking about is a surtax exemption for 1 year in the 1975 Emergency Tax Reduction Act; it was increased to $50,000. Actually, it should have been increased to a minimum of $100,000. The surtax exemption was enacted in 1938. It has eroded in value to approximately $7,000. What cost $25,000 to buy in 1938 would require at least $100,000 today. Item after item similar to that should be amended in the code to reflect the ravages of inflation.

Next, we would recommend to you that the code be equalized. Businesses competing with businesses should all be taxed. We think that it is unfair that the co-ops get a special tax break. We think that there is no such thing as a free lunch—as one of the witnesses said this morning. The co-op and the small businessman are competing for the same dollar. Their earnings are the same; but one is taxed and one is not. Not only are the co-ops sheltered by the tax code, but they are also sheltered from antitrust violations by the Capper-Volstead Act. That act, enacted in the early 1920's, provided that for production purposes a co-op was possible; but they have extended that now into marketing, distribution. They are practically in every industry, from aspirin to zippers.

In the dairy industry, a specific example: In 1958, there were 5,828 fluid dairies; 14 years later, 1972, there were only 2,507.

Senator NELSON. You are saying fluid dairies?

Mr. LEWIS. Fluid dairies. The person that is taking the beating is the independent dairyman.

Look about you. In Washington, D.C., where are the independent dairies? Do you remember when the independent dairy used to deliver door to door? They are gone; they are economic tombstones today.

Senator NELSON. Caused by what?

Mr. LEWIS. Caused by, No. 1, the tax break given a co-op; two, its unfair use of its exemptions given by Congress to the co-ops.

The big get bigger. They use their profits for expansion and they drive the small independent dairy out of business.

Senator NELSON. Are you referring to the dairies that used to make home deliveries?

Mr. LEWIS. Yes, sir, that is exactly what I am talking about—independent dairies like that.

Senator NELSON. I do not know anything about the data in this area, but I think, if you are talking about home deliveries, these firms may have gone out of business for other reasons.

Mr. LEWIS. Well, the tax break given the co-op is one of the reasons. Actually, the large co-op uses it profits to acquire the independent dairy.

Senator NELSON. Well, nobody is delivering at home, not even the co-ops. That business seems to be by the board. Co-ops do not make home delivery of milk, and neither does anybody else, to my knowledge.

Mr. LEWIS. Well that is correct, sir, but also it is very, very difficult, practically throughout the country, for an independent dairy to get into many chain store outlets.

Senator NELSON. Well that is maybe another question——

Mr. LEWIS. So their market is vastly limited.

The next point that I wanted to make to you relates to the creation of a source of capital for small business. We are talking specifically here about tax-exempt Federal bonds.

Our recommendation is that Federal tax-exempt bonds be permitted, with the proceeds earmarked for small business. Mr. Liebenson will be testifying in a few minutes regarding the impact of recession on small business.

The facts are that small business today is not attractive to outside investors. The managers of mutual funds, the managers of pension funds would rather put their money in an IBM, a Xerox, a General Motors, rather than in small businesses.

Second, when the money market gets tight, that is exactly the time that the bank participation in SBA guaranteed loans dries up. Whenever money is needed the most, it is unavailable.

Now what we propose, sir, is that these tax-exempt bonds be issued with the proceeds earmarked solely for small business. This has many advantages. A new agency would be unnecessary. There would be no additional Federal employment, no additional redtape, no additional paperwork.

Secondly——

Senator NELSON. You are talking about Federa' bonds?

Mr. LEWIS. Federal, tax-exempt bonds.

Senator NELSON. So that investors could purchase them, then the money would be available for small business. Do you mean through loans?

Mr. LEWIS. That is correct, sir. Through the Small Business Administration. The Treasury would actually operate the program, but the loans would be made by the Small Business Administration using their experience and expertise n this.

In other words, there would be no need for any additional appropriations by Congress for direct loans to be made by the Small Business Administration. The proceeds would be available from the Federal tax-exempt bonds. There is a story in The Washington Post this morning. One of the staff members of the House Small Business Committee said that the OMB is opposing any appropriations for direct loans.

The problem is there that the need for direct loans is great and this is a direct solution to that problem.

Also, we feel that part of the proceeds could be dedicated to the housing industry, and SBIC's for use in stimulating small business and making capital available to it.

Furthermore, because certain areas of the country have extremely high unemployment, preference could be made for loans into those areas.

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For the long pull, our tax code should permit a greater accumulation of liquid assets by small business. This would be a cushion to enable small business to survive wild economic fluctuations. For the short term, this Congress should give small business a challenge and an incentive to pull this country out of its current economic tailspin.

We have three specific recommendations with respect to this. One is that the small business be permitted to retain $250,000 in accumulated earnings. Second, we would recommend that small business be given a 10-year carry forward and carry back, and we are going to file a supplemental statement on this within a matter of days. Third, we recommend that small business be given a one-time job creation credit of 50 percent of the cost involved in hiring one or two new employees. The maximum credit being limited to $20,000.

Now, this bill is being readied for introduction into Congress. There are good indications that this bill will have broad support from both aisles of Congress. Under it, permanent jobs and permanent taxpayers will be created.

There are 9.2 million people unemployed today. This is no time for doles, no time for trickle down remedies. It is a time for direct solutions and we recommend that you give small business both the challenge and the incentive to put people back to work.

[The prepared statement of Mr. Lewis follows:]

STATEMENT OF NATIONAL SMALL BUSINESS ASSOCIATION BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS AND SENATE FINANCE SUBCOMMITTEE ON FINANCIAL MARKETS ON TAX REFORM LEGISLATION TO BE PROPOSED, JUNE 17, 1975

Mr. Chairman and Members of the Joint Committee: my name is John Lewis, and I am Executive Vice President of National Small Business Association (NSB). Our Association represents firms doing business in more than 500 industry categories.

With me is Herbert Liebenson, the Association's Vice President for Government Affairs. Also with us is John Mendenhall, attorney-at-law and certified public accountant, and a member of the law firm of Williams, Connolly and Califano of Washington, D.C. Mr. Mendenhall will testify shortly as will Mr. Liebenson. By chart he will document, based on the government's own figures, that small business is hurt longer and more, as a general rule, than big business in economic downturns. We believe that the current recession will be no different unless help is given quickly by Congress, especially to the very small.

The Chairman of the distinguished Small Business Committee, in announcing these hearings, said that "Small and independent business accounts for between 52% and 53% of the nation's total private employment, 43% of the business product and about one-third of the gross national product."

Small business represents at least 98% of all the business firms of the country. These firms, together with their employees and families dependent on small business employment, constitute at least 80 million of this country's people—more than one-third of our population. But you can't deposit numbers or impressive percentages in a bank. Or spend them. Or borrow on them.

A much more important yardstick is market share. Small business is falling further behind year by year in market share.

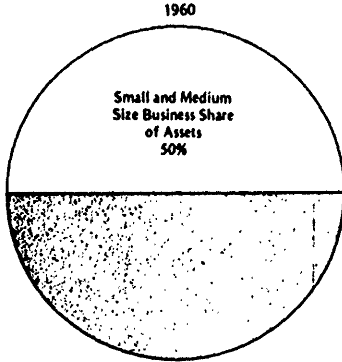
In 270 of 413 manufacturing industries—in 65% of the industries for which figures are available—the eight largest companies account for 40% or more of the value of the shipments from their industry.

In 1960, small and medium-sized corporations in manufacturing had 50% of the assets and were responsible for 41% of the profits. By 1972 this had declined to 30% of the assets and 28% of the profits. Only last week Senator Hart (D-Mich.) stated on the Senate floor that 200 corporations control two-thirds of all manufacturing assets in the country.

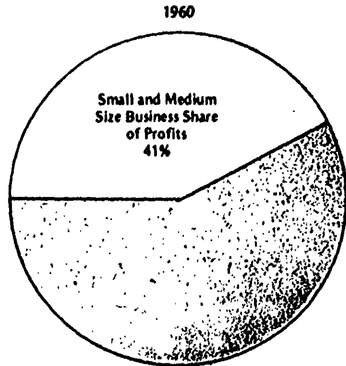
Relatively, small business is doing better in distribution market share than in manufacturing market share. But there are some frightening exceptions. One-

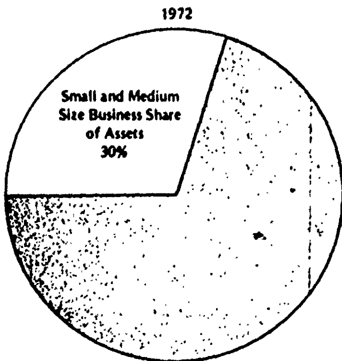
tenth of one percent of 142,000 food retailers—that is 142 retail chains—make 57% of all retail sales. One-tenth of one percent of 40,000 drug-proprietary stores—that is 40 retail chains—make one-third of all retail sales. (Source: Small Business Administration, based on Dun & Bradstreet data.)

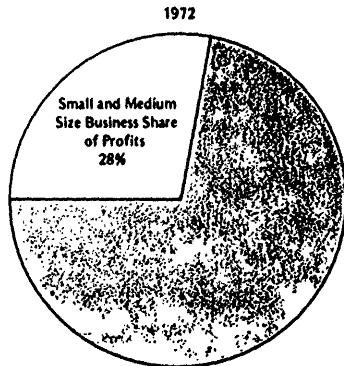
CORPORATE MANUFACTURING ASSETS BY ASSET SIZE, 1960 and 1972



CORPORATE MANUFACTURING PROFITS BY ASSET SIZE, 1960 and 1972







SOURCE U.S Federal Trade Commission, Quarterly Financial Report for Manufacturing Corporations 1972

TAKE THE TILT TOWARD GIANTISM OUT OF THE TAX CODE

Contributing to the tilt toward giantism in our country's economy is the tax code itself. When Congress adopts certain provisions in the tax code that only the giants can take advantage of fully, it discriminates against small business. The result: the effective tax rate for small business is about 15% higher than for giant business.

It is time that the scales of economic justice as symbolized by the tax code be balanced. The investment tax credit, important to all business, is an example. When it is a flat percentage whether utilized by large or small business, it actually helps accelerate the growth of big business. It widens the gap between large business and small business. About 350 companies obtain more than 50% of the investment tax credit dollars. *To enable small business to "catch-up" to big business, the investment tax credit should be doubled as a minimum for small business.*

National Small Business Association applauds this Committee's leadership in revitalizing the Small Business Tax Reform bill. You may depend, as before, on NSB's co-operation in working with your professional staff in drafting the provisions of the 1975 Act.

THE ELEMENTS OF AN EQUITABLE TAX SYSTEM FOR SMALL BUSINESS

National Small Business Association believes that the essential elements of an equitable tax system for small business are clear. The include: (1) The ability of smaller firms to reinvest their earnings for expansion and greater efficiency including the ability to retain top personnel; (2) the attractiveness of small firms for outside investors; (3) simplicity and certainty of tax laws and regulations.

These elements, we believe, should be the foundation of the 1975 Small Business Tax Reform Act.

Some progress has been made. Because of the work of the Small Business Committee and a task force from the small business community which included Mr. Mendenhall, the IRS at least and at last has an Advisory Committee of Small Business to help simplify the requirements imposed on small business.

Further we are most grateful to the members of this Joint Committee for your diligent efforts in winning some salutary benefits for small business in the 1975 Emergency Tax Reduction Act. However, these benefits are largely only for one year. The benefits should go deeper and be a permanent part of the taxcode.

A 10 PERCENT NORMAL TAX FOR SMALL BUSINESS WITH $25,000 OR LESS IN PRE-TAX INCOME

NSB is quite concerned that the sector of the small business community—the small "smalls"—that needed relief the most actually received the least in the 1975 Emergency Tax Reduction Act. NSB recommends that the normal tax be reduced to 10% for companies with (1) $25,000 or less in pre-tax income and (2) meet the SBA size definition of small business.

It is abnormal that the normal tax for Joe's Machine Shop and General Motors be the same. Give the small a chance to grow. Realistically, the only way it will do it is by plowing back profits. Let it retain more so that it can be more competitive.

ADJUST TAX CODE'S FIXED DOLLARS TO COMPENSATE FOR INFLATION

Although Congress moves quickly to adjust Social Security payments, federal salaries and federal pensions to meet the inflationary impact on cost-of-living, it has done nothing to adjust the tax code to reflect increases in the cost-of-doing business. The tax code contains many fixed dollar amounts that were established years, even decades ago. The small business community has been particularly disadvantaged because it is the first few dollars of profit that are vital to growth for a small firm. NSB recommends that the "fixed dollar" amounts in the tax code (1) be adjusted to compensate for the erosions by inflation, and (2) thereafter be tied to the Council of Economic Adviser's index of "Price Deflators for Gross National Product".

Illustrative is the corporate surtax exemption of $25,000 enacted in 1938. This should be increased to $100,000 even if it is necessary to accomplish this in stages to soften the immediate impact on income to Treasury. (The Treasury usually gives an incomplete picture to Congress concerning this and similar proposals. *It does not project the increase in income to Treasury* that comes from the creation of new jobs, purchases of equipment, etc.)

The $25,000 of 1938 has eroded to about $7,000 in 1975 dollars. It would take more than $100,000 today to buy what cost $25,000 in 1938. This increase in surtax exemption would provide about $1.5 billion in stimulus to the small business sector; would help about 150,000 corporations, with 90% of the relief—the maximum $19,500—going to companies with less than $1 million in pre-tax income. NSB prefers that this increase in exemption be limited to small companies as defined by the Small Business Administration.

Estate Taxes are also illustrative. In 1942 Congress provided that $60,000 could be given to one's family without tax liability. Solely to allow for inflation this provision should be increased to a minimum of $200,000.

Estate Taxes presently in force discourage small business. No wonder they sell out to larger business. No wonder small businesses are often dissolved at the death of their founder. Liquidation may be essential to pay the Estate Taxes.

If a closely-held corporation has been formed, there is difficulty in determining the value of the shares of stock for purposes of Estate and Gift Tax.

Not only must a method be established in the tax code to determine an equitable valuation for closely-held stock, there must be a complete overhaul of Estate Taxes because of the disincentives to small business.

REMOVE THE BALL AND CHAIN FROM SMALL BUSINESS BY TAXING THE CO-OPS

It is not fair to permit the co-op to run in the same competitive race with private enterprise, yet require private enterprise to wear leg-irons. NSB recommends that the co-op be placed on the same tax basis as other business enterprise, making them fully taxable on the profits which they earn.

The co-op is competing unfairly with taxpaying business units for the same consumer's dollar. They perform the same commercial function as the taxpaying business unit. But because of their tax loophole, they can afford to cut prices to gain a greater stranglehold on the market. Or use their profits for expansion. Or use their profits to acquire competitors—primarily the smalls. The end result is the same: Less competition. A trend toward monopoly. Potentially a destruction of the economic tax base of the country.

A good illustration is the dairy industry. The co-op which competes with the independent dairy has two shelters: the tax code and the Capper-Volstead Act. Under the Capper-Volstead Act, by way of example, it was the original intent of Congress to shield the co-op from the antitrust laws with respect to production. However, the co-op has extended its operations to marketing and distribution. Neither the Department of Agriculture nor the Department of Justice has callled a halt. The inroads made by the co-ops (together with backward integration by giant chains) have been devastating on the independent dairyman. According to U.S. Census statistics there were 5,828 fluid milk dairies in 1958. In 1972 there were were only 2,507. This is almost a 50% loss!

The expansion of the co-op into food and home supplies, credit, electricity, trucking, petroleum, chemicals, etc., is dismaying.

The government requires taxes to function. When the co-op avoid taxes, the burden shifts to some one else to take up the slack, As long as the co-ops gobble up taxpaying entities and erode the tax base, smalljbusiness and the public must fill the gap by paying higher taxes.

CREATE A SOURCE OF CAPITAL FOR SMALL BUSINESS: TAX-EXEMPT FEDERAL BONDS

It is a fact that the small firm is not too attractive to outside investors, especially to the managers of the giant money market of mutual funds, pensions, etc.

The twenty-year experience of the Small Business Administration makes clear there are only extremely limited funds for direct loans. Further, in times of tight money, *when the need is greatest,* bank participation in SBA-guaranteed loans dries up.

An additional and permanent source of capital for small business is urgently needed. NSB recommends that tax-exempt federal bonds be issued with the proceeds earmarked for small business.

Preliminary guidelines for such a program would include these elements:

Purpose

Establish a sizeable fund for direct loans to existing and formative Small Business.

Market

1. $10,000 and above denominations to institutional investors, mutual funds, foundations, trusts, insurance companies, banks, and businesses.

2. $1,000 and above denominations to general public as well as those noted in No. 1 above.

Management

SBA—from Treasury receipts from sales—because SBA has both the knowledge and machinery for handling loan applications. The funds—unknown quantity—would be the last resort after bank loans (guaranteed or not) and SBA guaranteed loans.

Benefits

A. Totally unnecessary to establish a new agency, increase Federal employment or additional red tape and paper.

B. Provides private funds for increasing the economic health of small business.

C. Negates the need for Congressional appropriations from general revenues for a direct lending program.

D. Assures qualified small business borrowers of a capital source, at least in part.

E. There exists the possibility that a percentage of the funds received could be dedicated to the housing industry and to SBICs for example.

F. Interest rates on these tax exempt bonds could be set as with other bonds, while loan interest rates would fluctuate away from the prime commercial rate. This means no loss to the Government by way of loans made at unrealistically low rates and assures the borrower of a realistic and businesslike interest rate.

G. Interest paid on the bonds would be less than an appropriated amount thus freeing general revenues previously appropriated for other purposes.

H. Purchase of these bonds should have no greater effect on the capital inflow to savings institutions than do present bond sales provided these are marketed as any other high rated tax exempt—or corporate.

I. Preference should be made where loans will create jobs or where areas of high unemployment have been designated.

J. Treasury will handle interest paid on the bonds and redemption of bonds.

GIVE INCENTIVES TO SMALL BUSINESS TO HELP COUNTRY WEATHER RECESSIONS

The data to be presented by Mr. Liebenson will show that the valleys of recessions for the past few decades are particularly damaging to small business. This recession will be no different.

For the long pull, our tax code should permit a greater accumulation of liquid assets by small business. There should be a cushion to enable small business to survive wild economic fluctuations.

For the short term, this Congress should give small business a challenge and an incentive to pull this country out of its curernt economic tail-spin:

NSB recommends that small business be permitted to retain $250,000 in accumulated earnings.

NSB recommends that small business be given a 10-year carryforward and carryback. (A supplemental statement concerning this recommendation will be filed with the Committee by NSB in a few days.)

NSB recommends that small business be given a one-time "job creation" credit of 50% of the cost involved in hiring one or two new employees, the credit being limited to $20,000.

Such "job creation" bill is now being readied for introduction in Congress. Indications are there will be broad support from both aisles of Congress. Under this job credit, permanent jobs and permanent taxpayers will be created. This NSB position already has received strong editorial support throughout the country.

Today unemployment is 9.2 million. Now is not the time for doles. *Or "trickle-down" remedies.* Now is the time *for direct solutions* by giving small business the incentive to put people to work.

Mr. Chairman, we like the aggressive attitude of you, this Committee and your staff in pushing for Small Business Tax Reform. Count National Small Business Association on your team. We thank you.

* * * * * * *

(Mr. Liebenson's Statement Follows)

Some economic indicators suggest the present recession has bottomed out. But not all. Profits for even the larger corporations are still down sharply. New entries in business are few. Continuing inflation is playing havoc with small business. So are the increasing costs of doing business to comply with ever-increasing government regulation.

Most significant: *the first three months of 1975 show the failure rate of businesses running 21% above the corresponding period in 1974.* (Source: Small Business Administration)

A forecast of after-tax profits expressed in percent of sales in February, 1975, using Federal Trade Commission data *for manufacturing corporations,* presents a pessimistic picture for firms with assets under $1 million (the "smalls"). This forecast indicates a 50% drop in the index for the first quarter of 1975, and zero for after-tax profits in percent of sales for the second quarter of 1975. This reduced profit—or no profit—situation in 1975 is identical to the situation facing the small manufacturing corporations in the first quarter of 1958.

For these hearings we have prepared a chart on the "Annual Rates of Profit on Stockholders Equity by Asset Size—Before Taxes". From this chart you will see the reaction to changes in the economy from 1952 to 1974 on small business.

We recognize that the larger a firm is the greater its potential for efficiency in operation. We also recognize that it has greater resources to weather downturns.

However, our objective is to demonstrate graphically the greater impact on the smaller firms in times of a recession.

Before there is an examination of the chart, we state our conclusions:

1. Government economists repeatedly fail to identify a downturn in our economy early enough to implement remedial steps and recommend changes in governmental policy to reduce the impact on small business. (Various studies indicate recession periods have been identified long after the downturn began—ranging from three months to 18 months after the downturn had occurred.)

2. Reactions to the downturn are much more violent as to the smaller firms. Obviously many are driven out of business. Furthermore the recovery period for small business (to restore it to its former competitive position in the economy) is much longer.

3. The range of reaction—from peak to valley—over the period 1952 to 1974 for the smalls under $1 million in manufacturing assets shows a change of 44%.

4. However, the larger the firm is the less drastic are the changes during a recession. Their ability to recover comes at a much faster rate. For the largest companies (assets over $1 billion) the variance—from peak to valley—is only 15% from the highest to the lowest point. (It is significant that the effective tax rate for the larger companies has averaged 15% below those of the smaller firms. The capital available to the larger firms as preferred customers of lending institutions is reflective of the favorable tax rate given the larger firm in actual application of the tax code.)

Mr. Lewis. Mr. Mendenhall will now testify.

Senator Nelson. Mr. Mendenhall?

Mr. Mendenhall. It is very regrettable that more of the tentative decisions of Ways and Means did not see their way into law. It is also regrettable that many of the other provisions of the small business reform bill, which has had great public exposure for some time now, have not been enacted. There are many provisions in there that are accepted by everyone in the world, but somehow they do not get enacted.

On the administrative side, I might take a moment to review some of the situations that cause small business great problems. One of them is the inventory regulations. You may recall that within the last 2 or 3 years there has been quite a great stir about getting the inventory regulations in order, and they have been finalized. These are generally good regulations for large business. They can understand them. They can hire the professional people to see that they comply with them. On the other hand, it is just another example of where just the mere complexity of these regulations means that small business cannot have any kind of a chance of proper compliance with those regulations. And apparently no consideration was given to the administrative problems that would be inflicted upon small business. Likewise, we have the foreign tax regulations, particularly on foreign source income allocation. Despite the merits of these for large business, it is absolutely impossible for a small business to comply with these regulations.

Without extreme, undue professional costs, where we get into the foreign area, we practically have to tell a small company: "If you are interested in going overseas, in the way of a subsidiary or a branch or whatever else, just forget it." You cannot do it unless you are a "big", as Mr. Lewis calls it.

Another example is with the ADR regulations. You will recall, the "Asset Depreciation Range" regulations that were endorsed by Congress a couple of years ago. These regulations again were a good response to the needs of large business. It is a very workable system,

a fine system for large business, but here again it is an advantage that is available to taxpayers generally which, in fact, because of the high administrative costs, just cannot be possibly used in an accurate way by a small business.

It is quite ironic that subchapter S, for small business corporations, and limited partnerships, again for small business ventures, really are the most complex area in law. I had the pleasure this year of teaching at George Washington University Law School the subchapter S and partnership course.

This was known in the tax group down there as the hardest course in the school. Is that not ironic that small business law happens to be probably the most complex law existing?

Why these things are not remedied, I do not know, but there are substantial compliance problems which also exist in rather small things like estimated tax payments. All corporations have to make estimated tax payments. Large corporations can more easily predict (I do not mean it is easy, but larger companies can take steps to predict with their budgeting procedures) what their estimated tax payments would be and make those payments to avoid penalty. Small business does not have the staff and their earnings are so unstable. Nevertheless, they have to file those pieces of paper and incur those penalties. Here again, no exception is made to take into consideration the needs of small business.

Finally, I heard Mr. Singleton Wolfe, who is the Assistant Commissioner-Compliance for the IRS, address a small business group in which he said that the two largest problems with business tax compliance in general, and especially small business, were in two areas. One was inventory. Small business just does not know how they are to keep their inventory and there are no simplified rules. There would be a great prospect for simplification if, for example, a business with receipts, let us say, under $200,000 a year, or $800,000 a year, could just not record its inventory if it chose to, and therefore use the cash method with regard to certain size.

Likewise, Mr. Wolfe mentioned that the second most difficult area of enforcement was with depreciation. If we could say that expenditures of under $10,000 a year, or $25,000 a year, whatever, could be expensed or depreciated as elected by the taxpayer, this would be a great administrative burden off of many small businesses.

In the small business reform bill, that has been exposed, and the Ways and Means tentative decisions that were not enacted, there were many ideas, which could eliminate many of the unfair and complex provisions from the back of small business.

Thank you.

Senator NELSON. Thank you, very much, Mr. Mendenhall. Will you proceed, Mr. Liebenson?

Mr. LIEBENSON. Thank you.

Many of the economic indicators have suggested that the present recession has bottomed out, but not all of them, as indicated by the releases of the past few days. Profits for even the larger corporations are still down sharply, and new entries into business are very few.

Continuing inflation is playing havoc with small business. So are the increasing costs of doing business to comply with ever-increasing Government regulation.

Most significant: the first 3 months of 1975 show the failure rate of businesses running 21 percent above the corresponding period in 1974. And this is according to the Small Business Administration.

A forecast of aftertax profits expressed in percent of sales in February 1975, using Federal Trade Commission data for manufacturing corporations, presents a pessimistic picture for firms with assets under $1 million, which we, for this purpose, are calling the "smalls".

In answer to questions that were asked earlier, in order to demonstrate the relative relationships of the tax code on the "large" and "smalls", we are using "under $1 million in assets" to represent the "smalls."

This forecast indicates a 50-percent drop in the index for the first quarter of 1975, and zero for aftertax profits in percent of sales for the second quarter of 1975. This reduced profit—or no profit—situation in 1975. This reduced profit—or no profit—situation in 1975 is identical to the situation facing the small manufacturing corporations in the first quarter of 1958.

For these hearings we have prepared a chart on the "Annual Rates of Profit on Stockholders Equity by Asset Size—Before Taxes." From this chart you will see the reaction to changes in the economy from 1952 to 1974 on small business.

We recognize that the larger a firm is, the greater its potential for efficiency in operation. We also recognize that it has greater resources to whether downturns.

However, our objective is to demonstrate graphically the greater impact on the smaller firms in times of a recession. Turning to the chart, a moment, this blue line at the very top indicates the recession periods.

You will note that the initial stages of the first recession period in the early 1950's when the recession began at least the indication of the recession—is shown about 3 months after the downturn began.

In the second period, it was about 6 months after the downturn. In the third period, it was a year and a half later that the indicators showed that a recession had begun. And, perhaps, in the third period, the fact that it was an election year might have been a factor in the governmental agencies not coming forth to declare a recession has been occurring.

We go further to show that the reactions to the downturns in our economy has been very violent on small business, as against the larger firms. In effect, the ranges for the smaller firms which, by the way, is in the red, on generally the lower part of the chart, indicates something like 44 percent change over this period of time.

When you get to the larger corporations of over $1 billion they are blue—in the light blue there—you will note that the indicators show that there has been relatively a smaller change running somewhere below, or about 15 percent.

Here we have shown several examples of recession and the effect. In this case, the small business impact was 24 percent. In this case, the larger firms, or those over $1 billion in assets, it was somewhere over 8 percent. The same thing occurs in another recession period, where you have something like 20-percent change in the "smalls," and you would have something like a 10-percent change in the large business operations.

As we said earlier, the larger the firm the less drastic the changes during recession and their ability to recover comes at a much faster rate than do the "smalls"—again, in the red.

The "smalls" go down faster, and it takes a much, much longer period of time for them to come back to a peak. It is significant that the effective tax rate for the larger companies, which we just mentioned, averages 15 percent below those of the smaller firms.

The capital available to the larger firms as preferred customers of lending institutions is reflective of the favorable tax rate given the larger firm in actual application of the tax code.

Thank you.

Senator NELSON. Thank you very much, gentlemen, for your very fine presentations. We appreciate you taking the time to come today. If you have any supplemental material to submit, the record will be open for 30 days.

And, I assume that if some of the members have some questions to ask, based upon your testimony, you would be willing to respond to their questions in writing?

Mr. LEWIS. Most certainly, Mr. Chairman.

Senator NELSON. Thank you very much, gentlemen.

The hearings will open again tomorrow morning at 9:30 a.m. in this room. Thank you very much.

[Whereupon, at 11:52 a.m., the committees recessed, to reconvene at 9:30 a.m., Wednesday, June 18, 1975.]

[The chart referred to follows:]

OVERSIZE FOLDOUT(S) FOUND HERE IN THE PRINTED EDITION OF THIS VOLUME ARE FOUND FOLLOWING THE LAST PAGE OF TEXT IN THIS MICROFICHE EDITION.

SEE FOLDOUT NO 1

SMALL BUSINESS TAX REFORM

WEDNESDAY, JUNE 18, 1975

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
AND THE SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The committees met, pursuant to notice, at 9:37 a.m., in room 2221, Dirksen Senate Office Building, Senators Gaylord Nelson (chairman of the Select Committee on Small Business), and Lloyd Bentsen (chairman of the Subcommittee on Financial Markets of the Committee on Finance) presiding.

Present: Senators Long, Nelson, Bentsen, McIntyre, Hathaway, Clark, and Curtis.

Also present: Herbert L. Spira, tax counsel, Select Committee on Small Business; Richard R. Rivers and Michael Rowny, professional staff, Senate Finance Committee; and David Allen, Office of Senator Bentsen.

Senator BENTSEN [presiding]. These hearings will come to order.

Today we begin the second of a 3-day set of hearings by the Small Business Committee and the Senate Financial Markets Subcommittee, and I am pleased to be cochairing this with Senator Nelson, who had some other commitments but he will be here in a few minutes.

The subject of these hearings is financial problems which presently confront small businessmen.

Yesterday we heard testimony from two economists and a representative of a small business association. These witnesses told a compelling story about the role of small business in our Nation's economy and the need to take special steps to strengthen employment and profitability in small enterprises.

Today we will receive additional testimony concerning small business financial problems and our Nation's tax laws. Small business, in many ways, is the essence of our country's promise. It has always been relatively easy for an American to go into business for himself, to become his own boss. This great diversity of ownership has spurred competion, helping keep prices down, helping to assure a wide variety of goods and services and helping bring strength and resilience to our free enterprise system.

However, the statistics show that from 1948 to 1972 the number of self-employed businessmen in this country has shrunk from 10.7 million to 7.1 million, even though the work force has grown from 60 million to 86 million. In 1960 small- and medium-sized manufacturing corporations held 50 percent of this country's manufacturing assets and 41 percent of the profits. But by 1972 this had declined to 30

percent of the assets and only 28 percent of the profits. Part of the reason for the decline in the number of small businesses is the substantial competitive tax advantage enjoyed by the large corporations. These hearings will take an especially close look at this problem, looking at the incredible maze of regulations faced by the small businessman, the tax complexities, the need for him to have to spend an inordinate amount of money on tax consultants, attorneys, and accountants in proportion to the size of his business.

In 1974 a congressional study of 143 large corporations found an average tax rate of 23.6 percent compared to a tax payment level for all corporations of about 33.4 percent.

So what we are talking about here is a return to the climate of opportunity that has promoted broadbased economic growth in America since our beginning, an economic growth that is stable and viable, an economic growth that is not inflationary.

I am pleased at this time to have my colleague, Senator Clark, make such statements as he desires.

Senator CLARK. Mr. Chairman, we have got a list of distinguished witnesses. I think I will simply ask unanimous consent that my opening statement be made a part of the record at this point.

Senator BENTSEN. Without objection, it will be done.

[The prepared statements of Senator Clark and Senator McIntyre follow:]

STATEMENT OF HON. DICK CLARK, A U.S. SENATOR FROM THE STATE OF IOWA

Mr. Chairman, I would like to commend the committee for initiating this study of how small businesses are affected by the tax laws.

The question of how tax reform can benefit small business has been largely unexplored. For example, the administration's emergency tax legislation of last February totally ignored both small corporations and unincorporated small businesses. The Administration proposed to concentrate three-fourths of the business tax benefits on the five thousand largest corporations. Congress was thus faced with a policy which ignored 97 percent of the thirteen million enterprises in this Nation, a sector which accounts for 53 percent of all jobs and creates 33 percent of our gross national product.

Largely through the initiative of Members of the Select Committee, smaller businesses ultimately did receive a share of the benefits of that emergency legislation, with the enactment of Public Law 94-12 on March 26.

This legislation temporarily increased the investment credit from 7 percent to 10 percent, and cut tax rates for corporations earning less than $50,000 per year. It also permanently increased to $150,000 the earnings which can be accumulated before being subject to the penalty tax provisions.

It is high time that Congress enacted more permanent structural changes in our tax laws to assure that both small and large businesses bear their fair share of the corporate tax burden.

As it stands now, our system of corporate taxation has a discriminatory impact against the small business—too many provisions in the Internal Revenue Code are of use only to the large corporations.

For example, large corporations are more likely to be capital intensive than are small firms, and tax provisions such as the investment credit and accelerated depreciation favor the capital intensive business.

The small firm relies more on labor as a factor of production. Yet there are no tax provisions which encourage businesses to employ people rather than machines to turn out their products.

This pro-equipment bias in our tax system has caused a distorted allocation of our scarce economic resources. By ending the discrimination against small business, we can do much to achieve a neutral tax system which will allow our resources to be employed in the most efficient combinations.

A coherent tax system will move us toward a lasting solution to the serious problem of high unemployment in the unskilled labor force. When a businessman buys

a machine, the labor which that machine replaces is likely to be unskilled. Equitable taxation will increase the number of jobs available to workers with little or no skills—people will go to work in this country.

Other problems include the sheer complexity and burdensome reporting requirements of the Internal Revenue Code. Large corporations can afford to hire expert tax attorneys and CPA's to do their tax planning and file reports.

But small businessmen cannot effectively utilize these professional services. Consequently they often simply don't know what options are available to them to minimize their tax liabilities, and waste valuable time and energy wading through mountains of reports.

Businesses cannot grow and prosper without access to investment capital, and small firms are starving for capital. Large corporations have as sources of capital public offerings of equity or debt, bank loans at the prime rate, and high depreciation charges. None of these sources are of much utility to small businesses. We must make sure that the tax system provides small businesses with equal access to investment capital.

Mr. Chairman, we must have a fair and equitable system of corporate taxation which does not discourage the acceptance of economic risks by the entrepreneur. We must promote, not stifle, the economic growth which will result from the dynamism of free private enterprise.

That is why this examination of our business tax structure and the efforts to formulate legislation providing meaningful reform for the small business taxpayer are so essential.

Statement of Hon. Thomas J. McIntyre, a U.S. Senator From the State of New Hampshire

Mr. Chairman, I wish to commend you and the Chairman of the Small Business Committee, Senator Nelson, for initiating these hearings. I hope they will lead to a significant contribution to the deliberations of both houses on the critical issue of tax reform and its effects on small business.

These issues are as complex and difficult as any we must face in Congress, yet we as legislators must often make decisions of critical importance without adequate data or analysis of problems or the impact of proposed remedies. This has meant in the past that our efforts have been counterproductive and served to hinder the very results we sought to achieve.

The needs of small business, as we have often found, tend to get lost in the shuffle. We legislate without realizing the impact of our actions, and we do not adequately supervise the implementation of the well-intentioned laws we pass.

The tax laws are a good example. Over the years we have created a monster of growing size and complexity, adding increasing burdens of confusion and frustration—not to mention paperwork—for small businessmen who don't have the time or the resources to cope with it. And this complexity guarantees that the only people who can take full advantages of the dark and obscure passages of our tax laws are the already rich and powerful.

This is not what Congress intended, but we have created this monster, and we must now try to cut it down to size, so that the small businessman, the individual with a new idea—can grow and prosper.

Small business, after all, is the great source of this nation's ingenuity, growth, and new employment. It is here that new ideas are born. The Small Business Committee has found that small business in the United States accounts for about 97% of all businesses by number; 52–53% of all private employment; 43% of all the business output in the country, and about one-third of the entire gross national product. At the same time, small businesses bear the heaviest tax load at the very time when they are struggling to survive and expand in new markets or against larger competitors and are more severely affected by the recession than other segments of the economy. This is unjust, and it costs us dearly—because we cannot as a nation afford to stifle this much-needed innovation and new competition.

I am pleased by the openness of these hearings, and that we are not locked into a particular bill at this stage. I think this is an excellent opportunity to take a fresh look at our problems—to escape from the conventional wisdom and ideological habits—and hopefully to develop new insights and alternatives.

Senator Bentsen. Our first witness will be Mr. Bruce Fielding, who is a CPA, and if you would please take the stand, and Dr. Dunkelberg, consultant to the National Federation of Independent Business.

STATEMENT OF JAMES D. MICHAEL McKEVITT, WASHINGTON COUNSEL, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. McKEVITT. Mr. Chairman, my name is James D. "Mike" McKevitt. I serve as Washington counsel for the National Federation of Independent Business.

I serve as Washington counsel for the National Federation of Independent Business here in Washington. At the present time we are conducting our seminar, our national seminar and convention here in Washington, D.C. It is my pleasure to introduce both of these gentlemen this morning, and before I do I would like to point out briefly a bit about the National Federation of Independent Business.

We represent over 420,000 member firms across the country, from small to large companies, and as a result I think that Mr. Fielding and Dr. Dunkelberg today will be able to give you a broad spectrum of ideas as to the concerns that they have.

The first witness who will speak this morning is Mr. Bruce Fielding, who is secretary of the board of the National Federation of Independent Business. He is also a practicing certified public accountant in California and just yesterday he was named to the new paperwork commission by President Ford.

And the other witness is Dr. William Dunkelberg, who serves as associate director of the credit research center at Purdue University. He is also associate professor of economics at Purdue University, and he has been of great assistance along with Dr. Bailey from the University of California in preparing quarterly energy and economic reports for the National Federation of Independent Business over the past several years.

I would like to introduce as our first witness Mr. Bruce Fielding.

Senator BENTSEN. If you would proceed, sir.

STATEMENT OF BRUCE G. FIELDING, CERTIFIED PUBLIC ACCOUNTANT, SECRETARY, BOARD OF DIRECTORS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. FIELDING. Thank you.

The National Federation of Independent Business, which we refer to as NFIB, presently has over 420,000 members, and they are located in all of the 50 States of our country. Our membership contains every conceivable business category and business entity. All of our members are small independent businessmen and women. Our unincorporated members have an average of four employees. Our incorporated members have an average of 27 employees. Eighty-five percent of our members have sales of less than $1 million. However, our total membership employs 5½ million people and our share of the gross national product is approximately $200 billion.

Because of the size and diversification of our membership, we are able to survey and to obtain information from our members on a variety of subjects which in turn produces representative and reliable data. Dr. Dunkelberg will expand upon our survey capabilities in his testimony.

NFIB has agreed to assist both the Senate Select Small Business Committee and the Senate Finance Committee in gathering data to use in their joint study of the tax problems of small business.

Mr. Chairman, the purpose of my appearance here today is to acquaint you with the financial profile and downfall of the typical small independent business.

In my opinion there are three basic ingredients required in starting your own business. They are managerial ability, adequate working capital, and confidence in yourself. Unfortunately, we usually find that the small businessperson is long on ability and confidence and short on working capital.

When I started my own business, I did not hire Stanford Research Institute to do a market survey or to advise me as to how much working capital I needed. If I had, I would be still an employee. I was a typical entrepreneur overconfident and undercapitalized.

Let us be thankful for these overconfident entrepreneurs. They are the backbone of the economy. They and we employ more than 50 percent of our work force and account for more than a third of the GNP. We entrepreneurs are the majority. But unfortunately, we have become the neglected majority.

Our tax laws have neglected to take into consideration that small business must be allowed to accumulate capital in order it insure a healthy and steady growth. The small businessperson if faced with discriminatory tax rates, severe penalties for unreasonable accumulation of surplus, taxation of paper profits, taxation of inflationary inventories, the costly administrative burden of pension and profit-sharing plans and crippling inheritance taxes which can force the sacrifice sale of a healthy small business.

Let us look at an average company which has been moderately successful in its first 6 years of existence. I might say this average company is based upon a financial survey which NFIB conducted in September of 1974 and from financial data of clients at my firm.

As we look at the income statement, this is his income statement for 6 years from the inception of the business. We started out with sales of $149,000 and at the end of our 6 years we were up to $380,000, making a total of $1,504,000 for his 6 years in business.

You will note that our entrepreneur has been able to pay himself an average of about $1,000 a month in those 6 years. This means that he probably made more than his secretary, but less than the lead person on his assembly line. His undistributed profits, $47,000, means that he has equal to only 3 percent of his sales for the entire 6 years, not much of a margin for error.

Now let us look at his balance sheet.

You will note that our average entrepreneur started his business with $15,000 original contributed capital. His undistributed profits have amounted to $47,000, which results in a total capital now of $62,000.

So that his total capital after 6 years of business is $62,000. And we might say, well, not bad for 6 years of effort. He has enhanced his equity by $47,000.

But let us look at the balance sheet realistically.

His working capital, which is the difference between his current assets, which totaled $93,000, less total current liabilities of $64,000, is only $29,000. He has only got $6,000 in the bank. He owes the bank $14,000 in an unsecured note and he owes $16,000 in income taxes. Six years of moderate success. And he knows that his seventh year is going to be the biggest year he has had since he has been in business,

but he is going to need a lot more equipment to meet the demand. How does he survive? How does he get into that seventh year? He has to renew the note at the bank. He is a good salesman, he talks the bank into it. He buys his equipment on time and he gets extensions of time on his income tax returns to postpone their payment.

How did the average company do in the seventh year? Look at his sales—$532,000, an increase of 40 percent. His net profit increased 54 percent, and the owner this year was able to take out $20,000. But his silent partners, the Federal and State governments, took $29,000 out of the profits.

We should be very healthy, we have had our best year. Let us look at our balance sheet.

This is what has happened to our healthy company in its seventh year. He is overdrawn at the bank $7,000. He owes the bank $36,000 for equipment, $14,000 on an unsecured note. A total of $50,000. And this represents more than 50 percent of the company's capital. When you borrow money from the banks, they do not like to see this ratio get above 50 percent. So this probably means no more credit from the bank and no way to meet the next payroll.

Our successful average company, gentlemen, could be out of business, and this is what is happening to the neglected majority. Let us look at what caused this.

Discriminatory tax rates. The owner of the average company in our example ends up in the 60-percent bracket, combined State and Federal tax rates.

Taxation of his paper profits. He has been taxed on $10,000 of paper profits, which represents the increase of his accounts receivable for the year over his accounts payable for the year. Paper profits of $10,000.

Taxation of inflationary inventories—$39,000, the difference between his beginning and ending inventories. $49,000 of paper profits and he ends up in the 60-percent bracket. That is why he is overdrawn at the bank, that is why he may be out of business. The deck is stacked against the small independent businessperson. If this trend is allowed to continue, the small businessperson will be seen during visiting hours at the Smithsonian Institute. Our economic, political, and educational life will be dictated to by a few multinational conglomerates. What can we do about this situation? How can we reverse this trend?

We would like to suggest graduated corporate tax rates ranging from 10 percent to 45 percent, a maximum tax rate of 45 percent on individual's earned income. An individual in business should be treated no differently than a corporation. An individual in business should not pay more tax in a higher bracket than a corporation.

But the most important thing is to tax small business on its ability to pay rather than on paper profits.

Another incentive would be tax credits for retaining profits in your business. Exemption of $500,000 of undistributed profits from the tax on retained earnings, this would bring us in line with Canada.

Senator BENTSEN. With what?

Mr. FIELDING. With Canada.

What would happen to the average company if it was taxed on a cash basis rather than an accrual basis, and that is what we are talking about, Senator, paper profits versus cash profits, the cash basis

versus the accrual basis and it was also allowed a 20-percent annual tax credit for cash profits retained in the business. We have reconstructed our average company by utilizing the cash basis of taxation for our small, average company. We can see that he has now got some cash in the bank. In fact, it has been increased by $16,800. His current liability for income taxes has been decreased by $26,000 and his working capital, which is the basic ingredient that we need to survive, has been increased by $42,800, an 86-percent increase, merely by being taxed on the cash basis as contrasted to the accrual basis.

Our average company is here to stay. If we go one step further and give him an incentive for leaving money in the business, not drawing it all out but trying to accumulate more capital, we still have another advantage to look at.

We can see his position has been enhanced. The cash basis is now—he has $18,000 in the bank, simply by utilizing these credits, for retaining profits in the business. Now he can even reduce his bank loan.

All we are suggesting is that the small business people be allowed to pay their taxes on their ability to pay, and at the same time be encouraged through tax credits to build up their capital. The Government should not, in the long run, lose any revenue. It is merely postponing the time for collection.

[The prepared statement and attachments of Mr. Fielding follow:]

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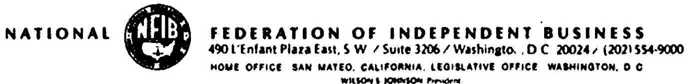

STATEMENT OF BRUCE G. FIELDING

DIRECTOR & SECRETARY - NATIONAL FEDERATION OF INDEPENDENT BUSINESS

PARTNER, BRUCE G. FIELDING AND COMPANY
1043 Stierlin Road
Mountain View, California

Before: Senate Select Committee on Small Business

Subject: Small Business Tax Reform

Date: June 18, 1975

Mr. Chairman, I am a Director and Officer of the National Federation of Independent Business and I am also a partner in a Certified Public Accounting firm.

The National Federation of Independent Business, which we refer to as NFIB, has over 420,000 members and they are located in all of the fifty states. Our membership contains every conceivable business category and type of business entity. All of our members are small independent businessmen and women. Our unincorporated members have an average of four employees and our incorporated members average twenty-seven employees. Eighty-five percent of our members have sales of less than $1,000,000 per year. However, our total membership employs approximately 5 1/2 million people and our share of the gross national product is approximately $200 billion.

Because of the size and diversification of our membership, we are able to obtain information from our members on a variety of subjects which in turn produces representative and reliable data. Dr. Dunkelberg will expand upon our

survey capabilities in his testimony.

NFIB has agreed to assist both the Senate Select Small Business Committee and the Senate Finance Committee in gathering data to use in their joint study of the tax problems of small business.

Mr. Chairman, the purpose of my appearance here today is to acquaint you with the financial profile and downfall of the typical small independent business.

In my opinion there are three basic ingredients required in starting your own business. They are managerial ability, adequate working capital, and confidence in yourself. Unfortunately, we usually find that the small businessperson is long on ability and confidence and short on working capital.

When I started my own business, I did not hire Stanford Research Institute to do a market survey or to advise me as to how much working capital I needed. If I had, I might never have started my own business. I was a typical entrepeneur over-confident and under-capitalized.

Let us be thankful for these over-confident entrepeneurs. They are the "backbone" of our economy. They employ more than fifty percent of our workforce and account for more than a third of our GNP. We entrepeneurs are the majority. But unfortunately we have become the "Neglected Majority".

Our tax laws have neglected to take into consideration that small business must be allowed to accumulate capital in order to insure a healthy and steady growth. The small businessperson is faced with discriminatory tax rates, severe penalties for unreasonable accumulation of surplus, taxation of paper profits, taxation of inflationary inventories, the costly administrative burden of pension and profit-sharing plans and crippling inheritance taxes which can force the sacrifice sale of a healthy business.

Let us look at an average company which has been moderately successful in its first six years of existence. (See Exhibit A, attached hereto.)

This average company is based upon a financial survey which NFIB conducted in September, 1974, and from financial data of clients of my firm.

As we can see our entrepeneur has been able to pay himself an average wage of $1,000 per month. This means that he probably makes more than his secretary but less than the "lead" person on his assembly line. His undistributed profits have been equal to only three percent of sales--not much of a margin for error.

Now, let us look at the Average Company's Balance Sheet, (See Exhibit B, attached hereto.)

Our entrepeneur started this business with $15,000 (original capital contribution) which when added to his Undistributed Profits of $47,000, now results in Total Capital of $62,000. Not bad for six years of effort.

But let us look at the balance sheet realistically. The working capital is only $29,000 (Total Current Assets, $93,000, less Total Current Liabilities, $64,000). There is $6,000 in the checking account, $14,000 due to the bank on an unsecured note and $16,000 due on Income Taxes and his seventh year in business is going to be the biggest year and will require a substantial increase in equipment.

How does the Average Company survive? Renew the note at the bank, buy the needed equipment on time, and get extensions of time on the income tax returns.

How did the Average Company do in its seventh year? (See Exhibit C, attached hereto). Sales increased 40% and the net profit increased 54%. The owner increased his wages to $20,000, but his silent partners, the Federal and state governments, took $20,000 of the profits.

What does the balance sheet look like? (See Exhibit D, attached hereto.) The Average Company is overdrawn $7,000. It owes the bank $14,000, unsecured, and $36,000 for equipment -- a total of $50,000 -- and more than 50% of the company's total capital. This probably means no more credit from the bank and no way to meet the next payroll.

Our successful Average Company could be out of business.

This is what is happening to the "Neglected Majority":

1. Discriminatory tax rates -- the owner of the Average Company ends up in the 60% tax bracket (combined Federal and state effective tax rates).
2. Taxation of paper profits -- $10,000 (the increase in accounts receivable for the year over the increase in accounts payable for the year).
3. Taxation of inflationary inventories -- $39,000 (the difference between ending and beginning inventories).

The "deck"is stacked against the small independent business person. If this trend is allowed to continue, the small business person will be seen during visiting hours at the Smithsonian Institute and our economic, political and educational lifes will be dictated to by a few multinational conglomerates.

How can this trend be reversed?

1. Graduated corporate tax rates ranging from 10% to 45%.
2. Maximum tax rate of 45% on an individual's earned income.
3. Taxing small business on its ability to pay rather than on "paper profits".
4. Tax credits for retaining profits in the business.
5. Exemption of $500,000 of Undistributed Profits from the tax on Retained Earnings.

What would happen to the Average Company if it was taxed on a "cash basis" rather than an "accrual basis," and it was allowed a 20% annual tax credit for cash profits retained in the business? (See Exhibits E and F, attached hereto.)

By utilizing the "cash basis", cash in the bank would have been increased by $16,800 and the current liability for Income Taxes would have been decreased by $26,000 and Working Capital would have been increased by $42,800, 86%. The Average Company is here to stay.

If the Average Company was also allowed an additional annual 20% tax credit for cash profits retained in the business, this would bring the cash in the bank up to $18,000. Now, even the bank loan could be reduced.

All we are suggesting is that the small business people be allowed to pay their taxes based on their ability to pay and at the same time be encouraged, through tax credits, to build up their capital. The government should not, in the long run, lose any revenue. It is merely postponing the time for collection.

Let us take the "Neglect" out of the "Neglected Majority."

EXHIBIT A

THE AVERAGE COMPANY
INCOME STATEMENT
COVERING A SIX-YEAR PERIOD

TOTAL SALES (Ranging from $149,000 to $380,000)	$1,504,000		
COST OF SALES	(1,041,000		
GROSS PROFIT		$463,000	
EXPENSES		(307,000)	
NET PROFIT		$156,000	
OWNER'S WITHDRAWALS (Wages)		(70,900)	
TAXES ON INCOME		(38,100)	
PROFIT RETAINED IN BUSINESS (3% of Total Sales)			$47,000

EXHIBIT B

THE AVERAGE COMPANY

BALANCE SHEET

	ACCRUAL BASIS TAX RETURN END OF 6TH YEAR
ASSETS	
CURRENT ASSETS:	
Cash In Bank	$ 6,000
Accounts Receivable, Trade	40,000
Inventory (Cost or Market)	47,000
TOTAL CURRENT ASSETS	$ 93,000
PLANT & EQUIPMENT:	
Original Cost	$ 73,000
Accumulated Depreciation	(32,000)
BOOK VALUE OF PLANT & EQUIPMENT	$ 41,000
TOTAL ASSETS	$134,000
LIABILITIES & CAPITAL	
CURRENT LIABILITIES:	
Note Payable, Bank	$ 14,000
Accounts Payable, Trade	28,000
Equipment Contracts Payable (Current Portion)	6,000
Accrued Taxes on Income	16,000
TOTAL CURRENT LIABILITIES	$ 64,000
LONG-TERM LIABILITIES:	
Accrued Taxes on Income (Accrual Basis)	$ 0
Equipment Contracts Payable	8,000
TOTAL LONG-TERM LIABILITIES	$ 8,000
TOTAL LIABILITIES	$ 72,000
CAPITAL:	
Original Capital Contribution	$ 15,000
Undistributed Profits	47,000
TOTAL CAPITAL	$ 62,000
TOTAL LIABILITIES & CAPITAL	$134,000

EXHIBIT C

THE AVERAGE COMPANY
INCOME STATEMENT
SEVENTH YEAR

SALES	$532,000		
COST OF SALES	338,000		
GROSS PROFIT		$194,000	
EXPENSES		(117,000)	
NET PROFIT		$ 77,000	
OWNER'S WITHDRAWALS (Wages)		(20,000)	
TAXES ON INCOME		(29,000)	
PROFIT RETAINED IN BUSINESS			$28,000

EXHIBIT D

THE AVERAGE COMPANY

BALANCE SHEET

	ACCRUAL BASIS TAX RETURN END OF 6TH YEAR	ACCRUAL BASIS TAX RETURN END OF 7TH YEAR
ASSETS		
CURRENT ASSETS:		
Cash In Bank	$ 6,000	$ (7,000)
Accounts Receivable, Trade	40,000	74,000
Inventory (Cost or Market)	47,000	86,000
TOTAL CURRENT ASSETS	$ 93,000	$153,000
PLANT & EQUIPMENT:		
Original Cost	$ 73,000	$110,000
Accumulated Depreciation	(32,000)	(42,000)
BOOK VALUE OF PLANT & EQUIPMENT	$ 41,000	$ 68,000
TOTAL ASSETS	$134,000	$221,000
LIABILITIES & CAPITAL		
CURRENT LIABILITIES:		
Note Payable, Bank	$ 14,000	$ 14,000
Accounts Payable, Trade	28,000	52,000
Equipment Contracts Payable (Current Portion)	6,000	8,000
Accrued Taxes on Income	16,000	29,000
TOTAL CURRENT LIABILITIES	$ 64,000	$103,000
LONG-TERM LIABILITIES:		
Accrued Taxes on Income (Accrual Basis)	$ 0	$ 0
Equipment Contracts Payable	8,000	28,000
TOTAL LONG-TERM LIABILITIES	$ 8,000	$ 28,000
TOTAL LIABILITIES	$ 72,000	$131,000
CAPITAL:		
Original Capital Contribution	$ 15,000	$ 15,000
Undistributed Profits	47,000	75,000
TOTAL CAPITAL	$ 62,000	$ 90,000
TOTAL LIABILITIES & CAPITAL	$134,000	$221,000

EXHIBIT E

THE AVERAGE COMPANY

BALANCE SHEET

	ACCRUAL BASIS TAX RETURN END OF 6TH YEAR	ACCRUAL BASIS TAX RETURN END OF 7TH YEAR	CASH BASIS TAX RETURN 7TH YEAR
ASSETS			
CURRENT ASSETS:			
Cash In Bank	$ 6,000	$ (7,000)	$ 9,800
Accounts Receivable, Trade	40,000	74,000	74,000
Inventory (Cost or Market)	47,000	86,000	86,000
TOTAL CURRENT ASSETS	$ 93,000	$153,000	$169,800
PLANT & EQUIPMENT:			
Original Cost	$ 73,000	$110,000	$110,000
Accumulated Depreciation	(32,000)	(42,000)	(42,000)
BOOK VALUE OF PLANT & EQUIPMENT	$ 41,000	$ 68,000	$ 68,000
TOTAL ASSETS	$134,000	$221,000	$237,800
LIABILITIES & CAPITAL			
CURRENT LIABILITIES:			
Note Payable, Bank	$ 14,000	$ 14,000	$ 14,000
Accounts Payable, Trade	28,000	52,000	52,000
Equipment Contracts Payable (Current Portion)	6,000	8,000	8,000
Accrued Taxes on Income	16,000	29,000	3,000
TOTAL CURRENT LIABILITIES	$ 64,000	$103,000	$ 77,000
LONG-TERM LIABILITIES:			
Accrued Taxes on Income (Accrual Basis)	$ 0	$ 0	$ 42,800
Equipment Contracts Payable	8,000	28,000	28,000
TOTAL LONG-TERM LIABILITIES	$ 8,000	$ 28,000	$ 70,800
TOTAL LIABILITIES	$ 72,000	$131,000	$147,800
CAPITAL:			
Original Capital Contribution	$ 15,000	$ 15,000	$ 15,000
Undistributed Profits	47,000	75,000	75,000
TOTAL CAPITAL	$ 62,000	$ 90,000	$ 90,000
TOTAL LIABILITIES & CAPITAL	$134,000	$221,000	$237,800

EXHIBIT F

THE AVERAGE COMPANY

BALANCE SHEET

	ACCRUAL BASIS TAX RETURN END OF 6TH YEAR	ACCRUAL BASIS TAX RETURN END OF 7TH YEAR	CASH BASIS TAX RETURN 7TH YEAR	CASH BASIS CREDIT FOR RETAINED INCOME 7TH YEAR
ASSETS				
CURRENT ASSETS:				
Cash In Bank	$ 6,000	$ (7,000)	$ 9,800	$ 18,000
Accounts Receivable, Trade	40,000	74,000	74,000	74,000
Inventory (Cost or Market)	47,000	86,000	86,000	86,000
TOTAL CURRENT ASSETS	$ 93,000	$153,000	$169,800	$178,000
PLANT & EQUIPMENT:				
Original Cost	$ 73,000	$110,000	$110,000	$110,000
Accumulated Depreciation	(32,000)	(42,000)	(42,000)	(42,000)
BOOK VALUE OF PLANT & EQUIPMENT	$ 41,000	$ 68,000	$ 68,000	$ 68,000
TOTAL ASSETS	$134,000	$221,000	$237,800	$246,000
LIABILITIES & CAPITAL				
CURRENT LIABILITIES:				
Note Payable, Bank	$ 14,000	$ 14,000	$ 14,000	$ 14,000
Accounts Payable, Trade	28,000	52,000	52,000	52,000
Equipment Contracts Payable (Current Portion)	6,000	8,000	8,000	8,000
Accrued Taxes on Income	16,000	29,000	3,000	1,400
TOTAL CURRENT LIABILITIES	$ 64,000	$103,000	$ 77,000	$ 75,400
LONG-TERM LIABILITIES:				
Accrued Taxes on Income (Accrual Basis)	$ 0	$ 0	$ 42,800	$ 42,800
Equipment Contracts Payable	8,000	28,000	28,000	28,000
TOTAL LONG-TERM LIABILITIES	$ 8,000	$ 28,000	$ 70,800	$ 70,800
TOTAL LIABILITIES	$ 72,000	$131,000	$147,800	$146,200
CAPITAL:				
Original Capital Contribution	$ 15,000	$ 15,000	$ 15,000	$ 15,000
Undistributed Profits	47,000	75,000	75,000	84,800
TOTAL CAPITAL	$ 62,000	$ 90,000	$ 90,000	$ 99,800
TOTAL LIABILITIES & CAPITAL	$134,000	$221,000	$237,800	$246,000

NATIONAL FEDERATION OF INDEPENDENT BUSINESS, INC.

The largest individual membership of any business organization in the United States.

(HOME OFFICE) SAN MATEO, CALIF. • WASHINGTON, D.C.

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FOR RELEASE: WEDNESDAY, JUNE 18
AFTER 9:00 A.M.

Washington, D.C.....

Employment in the mass production industries can only be stabilized if the nation's estimated 3,000,000 small and independent firms in the distributive trades feel confident they can maintain inventories without being penalized by taxes on paper profits.

This was the thrust of an innovative new tax proposal presented to a joint meeting of the Senate Small Business Committee and a Subcommittee of the Senate Finance Committee today in the Senate Finance Committee room by Bruce Fielding, a Director of the National Federation of Independent Business, which is sponsoring the small business conference being held at the Washington Hilton.

Basically, the proposal would give independent wholesalers and retailers the option of computing inventories of up to $200,000 for tax purposes on a cash instead of an accrual basis.

Surveys conducted for NFIB by Faculty Associates, Inc. show that independents are continuing to slash inventories, and buying on a "hand to mouth" basis. In as much as this segment accounts for 70% of all wholesale and retail trade, the mass production industries are handicapped in setting up production schedules needed to call people back to work.

The smaller distributors after the experience of 1974 are gun shy, it is claimed, as they were assessed heavy taxes on fictitious inventory values created by inflation, and not by increased sales volume. Many of the big corporate merchandisers took advantage of an accounting method known as LIFO, or last in,

(MORE)

Note: Unless otherwise indicated, all facts, opinions herein are based on the majority result of individually voted ballots, with documentary support on file and open to inspection at headquarters. The Federation is composed entirely of independent business proprietors. At this time, the membership is

first out, to prevent taxes from confiscating working capital. Senator William Proxmire has stated he estimates big corporate merchandisers saved $8 billion in taxes by employing the LIFO method which is not useable by smaller operations.

The problem of the small distributor surviving in an inflationary cycle has long been recognized by some Congressmen who are knowledgeable about the practical aspects of business operation.

Both former Congressmen Charles Chamberlain of Michigan and Emmanuel Cellar of New York, apparently understanding that as inflation increased, factory employment would be endangered by lack of orders, introduced bills which would have to some degree offset the ravages of inflation in working capital.

However, the Treasury Department in the Nixon Administration opposed these remedial measures, although approving the LIFO system for the big corporate merchandisers.

The plan presented this morning by Fielding is a different approach, and more compatible for survival as well as factory employment in an era of double digit inflation. This is the first time this approach to the problem has been advanced.

Fielding, besides being a Director of NFIB, is a partner in a medium-sized CPA firm located in the heart of California's Santa Clara Valley where there are many smaller firms that have grown up around the electronic and space industries. He is also a lecturer at the University of California, and is a member of the Advisory Council on Small Business of the Internal Revenue Service and has been widely featured on tax theories on radio and television.

A number of small business people, attending the NFIB conference, were present to support the Fielding position.

BACKGROUND ON THE TAX REFORM POSITION OF THE
NATIONAL FEDERATION OF INDEPENDENT BUSINESS PRESENTED
BY BRUCE FIELDING, CPA, NFIB DIRECTOR

The Problem:

All business enterprises, whose operations depend on inventories of goods or raw materials, must pay income tax on the increased value of these inventories during the tax year. This is known as the accrual system. This applied to both unincorporated and incorporated enterprises, and while many lines are included, it is principally the wholesaler and retailer who are involved.

How This Works:

Every business that depends on maintaining an inventory to operate must set apart a portion of its working capital to maintain the inventory. In fact, this is normally the chief use of working capital. In normal economic times, using a hypothetical example, if a business carries an inventory of $100,000 covering a certain number of units, it can replace those units for the $100,000. If in a normal time it is decided to divert some earnings to increasing the number of units in that inventory so that at the end of the taxable year the dollar value is $120,000, this additional $20,000, of course, is considered taxable profit.

The Erosion of Inflation:

But this only works fairly when the economy is normal. In 1974, for example, when the rate of inflation was 14 per cent, if the hypothetical business used as illustration above maintained the same number of units in the inventory, the year end inventory would have been at least

$114,000. In other words, if this hypothetical business stood still during the year, it would still pay higher taxes.

From a practical standpoint, even using the 14 per cent inflation rate to illustrate this point is fallacious as the rate of inflation is not even. Some goods and raw materials jumped in value in 1974 40 per cent or more while sitting on warehouse floors, or retail shelves. This results in extra tax dollars being paid that do not come out of profit but the basic working capital of the enterprise.

Is This Fact Recognized?

Yes, it is. That is why the tax authorities have approved a system of accounting known as LIFO, or "last in-first out." This permits a business to offset "paper" inventory profits created by inflation by using the costs of that inventory at the beginning of the taxable year, instead of the end of the year.

Senator William Proxmire has claimed that a few big corporate merchandisers were able to save an estimated $8 billion in taxes in 1974.

In That Case, What is the Problem?

The problem is that only big corporate merchandisers are able to take advantage of LIFO. Smaller operations lack the facilities, the personnel and other expertise necessary to employ LIFO.

LIFO Then Discriminates Against Small Business?

That is true, but more importantly, there is discrimination against people who depend on steady jobs.

Government figures show that 70 per cent of the wholesale and retail function in the country is through small and independent operations. Unless they can maintain or even expand, their unit count of merchandise, factories either shut down completely, or operate on a spasmodic

basis, resulting in idle weeks for the workers, or short work weeks. This, in turn, depresses the consumer market as workers who are uncertain as to how much wages they will earn shy away from assuming long term obligations to buy.

Mass production cannot produce efficiently when distributors who do 70 per cent of the volume order on a "hand to mouth" basis.

Yet, small and independent businesses in the distributive trades are reducing inventories and are buying on this basis in order to avoid paying taxes on fictitious profits, as no one can foretell the course of the present inflationary trend.

It is significant that except for the building industry, which presents a different problem, the big employment slump is in the so-called mass production industries such as autos, textiles, steels, etc. Until such time as these smaller distributive operations, totalling somewhere around 3,000,000 enterprises, start buying with confidence that taxation on inflation will not wipe out their working capital, the mass production industries and their employees will continue to be in trouble.

Can This Be A Bonanza For Big Business?

No. The Fielding - NFIB plan places limits. Only a business ending a taxable year with an inventory of less than $200,000 could elect to compute taxable income on a cash rather than an accrual basis.

Under the Fielding - NFIB plan, smaller businesses would pay taxes only on the actual cash profits, and not on "paper" profits created by further inflation of goods or merchandise.

The estimated loss to the Treasury in the first year would be $3 billion dollars. However, this is a hypothetical loss, as this money would be employed to buy inventory, thus creating more factory income, and income to factory workers.

Senator BENTSEN. Thank you very much.

Rather than interrupt with questions now, I think we will proceed with the next witness and have his testimony, unless my cochairman has a statement to make at this time.

Senator NELSON. No; I will submit a brief statement for the record.

[The prepared statement of Senator Nelson follows:]

STATEMENT OF HON. GAYLORD NELSON, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Today will be the second day of joint hearings of the Select Committee on Small Business and the Subcommittee on Financial Markets of the Senate Finance Committee. The approach to small business tax reform we have chose is on in-depth study of the business tax structure and how it affects small business.

We appreciate the use of the Finance Committee room and facilities for these sessions. We should announce at this time that, because of a Finance Committee hearing on the debt ceiling tomorrow, our joint hearings will be in Room 1114 of this same building.

This morning we are fortunate in having before the Committee the largest small business organization in the country, The National Federation of Independent Business, as well as the four major regional small business organizations, and the Director of the Entrepreneurial Center of the Wharton School of Finance.

We welcome you gentlemen as participants in our study.

STATEMENT OF DR. WILLIAM C. DUNKELBERG, CONSULTANT, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Dr. DUNKELBERG. Thank you, Mr. Chairman and members. I appreciate the opportunity to be here today and talk about these issues. I think you can see from the example that Mr. Fielding constructed that they really are quite important. I think we can probably all agree that tax reform will be one of the major keys to future developments in our economy. We all agree, and the opening statements have reinforced this, that profits are the driving force of a competitive economy and they are the major determinant of a firm's ability to invest. This example, I think, made that quite clear. Profits in themselves provide investment reserves and they also influence a firm's ability to raise equity capital, if it is big enough to be doing that in the markets, and to issue debt or to borrow from lending institutions. Investment firms undertake with the funds they raise, either through getting new capital through borrowing or through retaining profits, provide keys to changes in productivity and potential production in future periods and those are of major concern in this economy today. These have important implications for GNP growth over time and also very important implications for the prices at which the products that are produced by firms in this economy will be sold.

Now to speak in slightly more general terms, the concerns for tax reform, I think, fall into four or five major categories. I think one of the clearer things illustrated by Mr. Fielding's example is that we really need to do something to protect firms real earnings from the adverse effects of inflation. Mr. Fielding kept referring to paper profits and gave a very good demonstration of those. In addition, there are some other interesting problems that we will talk about related to how one measures cost, depreciation costs, for example, in an inflationary period. As an example, assume a firm is depreciating a building over 5 or 10 years. A $10,000 building would at 10 percent a year inflation cost

about $25,000 to replace, and yet the firm may well only be expensing $1,000 a year. Clearly, this will not generate enough reserves to replace that building at the end of 10 years, and the firm will be caught short. We have to do something to protect the firm's earnings from inflation, and the recent experience has certainly made that very clear to us.

I think related to this issue, regulations should make it easier for firms to adopt accounting procedures that make sense in an inflationary environment.

In addition to the effect on real profits, firms need accounting data and procedures that provide accurate and meaningful information for making business decisions. I think we can all agree that just about everybody was fooled during the last few years and did not really know what position they were in, how weak their real earnings were, how weak real income was, and we found out, of course, the hard way, when things got pretty severe. Even the Government underpredicted the inflationary tax revenue bonus that it was going to receive last year, and though I am sure the budget people were pleasantly surprised, a lot of consumers and businesses were not.

The differential tax treatment, the third point I think we need to worry about, for incorporated-unincorporated business operations seems to place an unfair burden of taxes on the smaller business. About two-thirds of the small businesses are unincorporated and from the evidence that we have they pay much higher tax rates than their incorporated counterparts. This becomes a worse problem, a more severe problem, in times of inflation because the unincorporated businesses paying taxes in the same ways consumers do find themselves pushed into higher marginal tax brackets as inflation drives up their profits in current dollars, and of course that increases the tax liability.

Senator BENTSEN. Let's talk about the tax rate of a small business, unincorporated. Give some figures. What are the maximums? Let us get it in the record.

Dr. DUNKELBERG. For the corporate tax rate?

Senator BENTSEN. No, unincorporated.

Dr. DUNKELBERG. Well, maybe we should ask Mr. Fielding for the details on it.

Mr. FIELDING. Seventy percent.

Senator BENTSEN. Let's get that in the record because I want to make that point.

Dr. DUNKELBERG. The unincorporated business pays taxes just as an individual on what is supposed to be a progressive scale.

Senator BENTSEN. Not just as an individual. Just as an individual if it was his specific earnings and salary it would be 50 percent, would it not?

Mr. FIELDING. Yes, that is correct.

Senator BENTSEN. But if you are talking about from his investment, then you are talking about 70 percent.

Dr. DUNKELBERG. That is right.

Senator BENTSEN. Operating as a business.

Mr. FIELDING. Yes. If capital is not an income-producing factor, if it is a service business, the 50-percent limitation would apply.

Senator BENTSEN. If what?

Dr. DUNKELBERG. If it is a service business.

Mr. FIELDING. If it were merely a service business in which capital was not an income-producing factor. That, we think, is not correct either.

Dr. DUNKELBERG. Now the fourth point I think we have to worry about has to do with the costs associated with complying with the multiplicity of tax-related regulations and reports that are required. This is very expensive for small business, for any firm, for that matter, and requires an investment in resources on their part just to get taxes paid, and of course it also requires a fair investment of resources on the part of the tax-collecting agencies to process all of this.

I think we can all agree that if we could streamline the tax system even if total revenues did not change, the resources saved could be much better utilized in productive activities. So we should have as an objective the streamlining of the tax system which would force businesses as well as government to use as little of their time and money as possible to pay taxes. That money and time can certainly be used in a more productive way.

I think the fifth general point we have to worry about is one that deals with our longer run situation in the economy. The current tax structure requires businesses to generate as much as $2, when we include State taxes, as much as $2 in gross profit in order to earn a dollar. In terms of sales required to generate that gross profit, the amount would be much larger and will vary depending on the industry the firm is in. Clearly, this discourages the undertaking of many investments that under a less burdensome tax system would probably be made.

In addition, we all know that earnings paid out by those firms that are incorporated will be double taxed because the dividends are also taxed for private individuals.

With shortages posing a serious threat for future growth and development, the tax structure should be examined to see how it might be altered to stimulate new innovation and encourage businesses to take advantage of new technologies through increased investment. If businesses are encouraged to do this, we may well be in a position to make many more important gains in terms of productivity and output and potential output, and of course this has important implications for prices as well. Productivity is one of the keys.

Now the National Federation is extensively engaged in a data collection project to try to find out, what is happening to the small business, and the example that Mr. Fielding presented is based on some of that information. The data presented in the testimony that I am giving also comes from these surveys of the 400,000-plus members of the National Federation. These quarterly surveys are conducted dealing both with general economic problems and conditions within the small business community, and also with energy policy.

In addition, we have done special studies dealing with minimum wage legislation and with the financial condition of the small business firms. The basic findings of these quarterly surveys were reviewed for the Senate Select Committee on Small Business in testimony presented before that committee by Dr. Bailey earlier this year; you may recall it. The Federation is continually engaged in this process of information collection and we would be delighted to cooperate with this committee in any way possible to provide the kind of information needed in its deliberations on the issue of tax reform.

BEST COPY AVAILABLE

Now let me speak for a few minutes in a little more detail about some of these problems.

In considering tax reform I think that this committee is already now aware, and certainly the testimony suggested, that small business, relative to, say, the Fortune 500, or similar large firms, is quite different. I have several different statistics to present which may even highlight these differences in a better way. The median sales for these firms is slightly under $200,000. That means half of those firms is slightly under $200,000. That means half of those firms have gross sales of less than $200,000. The mean number of employees is about six. About a third of the firms are incorporated. We already mentioned that. And two-thirds are either sole proprietorships of partnerships. A large majority of these firms deal directly with consumers as the distributors of goods and services that are produced. That is, they are at the end of the production line, interfacing with the public in the provision of services and the distribution of goods.

Small businesses, I think, and we have noted this from those attending the program here in Washington these past few days, feel relatively isolated from the decisions that are made in Washington, even though they are heavily affected by those decisions. About 10 percent feel that Government regulations and redtape imposed by the various agencies and laws that have been passed are the most important problem that faces small business today. I think that is a surprising choice among the alternatives which included recession, unemployment, inflation, labor costs, and energy problems. Few of these firms are large enough to support the kinds of specialists and staffs that are needed to comply with the regulations, to interpret them and figure out what they imply for the business in terms of what it should do, what it should file in terms of forms, and so on.

Now speaking for a minute again about the effects of inflation, of course inflation is nothing new in the economy. We have had inflation in the sense that, in general, prices have risen for the past 20 years or so, but I think little happened during that period to prepare any of us, including small businesses, for what we experienced in the late 1960's and 1970's.

As we saw in this example, and it probably can be seen in other examples, inflation did some strange things to the balance sheets of firms. Methods of cost assessment based on historical costs really inadequately reflected business costs in current dollars, and I gave an example of that earlier in my testimony. In the meantime, the prices of goods and services sold rose with inflation so we had costs not rising as much as they should. We had revenues rising at a considerably higher rate.

The net result of this was an overstatement of profits. Mr. Fielding called these paper profits. Half of these or more, depending on the position of the firm, were taxed away. Indeed, what we find for 1974 is that a great number of firms, for all practical purposes, in real terms had their capital base taxed away. That is they ended up in real terms with less capital than they started with because of the overstatement of profits. Then when firms had to replace the inventories, the buildings and so on that they needed for operation, they found that their depreciation reserves were inadequate. Their working capital had been impaired. The working capital they had on hand would not

support as many inventories at the higher prices. The $10,000 building was a $25,000 building and could not be replaced with the $10,000 in reserves.

This forced the firms into the capital market and we found among the small businesses that there was about a 20 percent increase in the need to go outside of the firm for financing during 1974.

During that same period, among the borrowers, the number of people who said that it was harder to get funds and that the rates were higher doubled. So we had more people being forced into the debt markets to get the working capital they needed because of these problems and they found it harder and tougher and more expensive to get those funds.

Although firms will adjust to some of the effects of inflation on their own, most of the costs of inflation that we have documented here are imposed by the rigidity of the tax structures and associated filing regulations that go along with that system. I think a tax system designed to deal with inflation would certainly work perfectly well if we had little inflation, which we all hope will happen. But it is clear that the current system does not deal equitably with any business, and small business in particular, in an inflationary period; and I think that is where we have to look. We have to look very carefully at that problem.

When we are talking about reform, the longrun costs of not doing so in terms of capital accumulation on investment productivity could be very high. Regarding regulations and redtape, a lot has been said about that, and I think that instead of reviewing most of my written testimony on that, I will let it stand in the record. We have heard also about the problems, the amount of resources devoted by small businesses to filling out forms and trying to figure out where they are at. I would like to point out again that, in terms of the fixed tax schedules, if $25,000 was a sensible break for the incorporated profit tax in 1937, that number cannot make any sense today. It would have to be between $80,000 and $100,000, depending on which price index we decide to use, to see where we are at. What we ought to keep in mind in looking at the situation of the small firm—or any firm, for that matter—is to try to see what is happening in real terms. What we have seen over time is that smaller and smaller businesses, in real terms—that is, in terms of the actual number volume of goods going out the door—smaller and smaller firms have been pushed into higher and higher tax brackets, because of the problems that we have had. Smaller and smaller firms have had to pay larger and larger fractions of their total sales out of cost to comply, to find out what their status is; to hire outside accountants, lawyers, and so on. This, as we point out, is certainly not conducive to capital formation.

The longrun implications of all of this, I have alluded to. I would just point out again that if we are going to solve the problem of inflation and employment in this economy, I feel—and many economists feel—that productivity and capacity are key variables. We have got to increase our capacity to absorb the people who do not have jobs, and who will be coming on. We have got to have increases of productivity to keep inflation at a minimum. Tax reform is the key to this; that the small business community, as important as it is in the economy in terms of employment and output, we certainly cannot overlook that sector when tax reform is undertaken. Thank you.

[The prepared statement of Dr. Dunkelberg follows:]

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Statement of

DR. WILLIAM C. DUNKELBERG

Associate Professor of Business Economics
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Economic Consultant to
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San Mateo, California

Before: Senate Select Committee on Small Business

Subject: Small Business Tax Reform

Date: June 18, 1975

Tax reform will be one of the major keys to future developments in our economy. Profits are the driving force of a competitive economy and the major determinant of a firm's ability to invest. Profits provide retained earnings and also influence a firm's ability to raise equity capital and to issue debt. The investment firms undertake with the funds they raise provide the key to productivity gains in the future. This has important implications for GNP growth and also for the prices at which goods and services produced will be sold.

Our concerns for tax reform fall into four major categories:

(1) Something must be done to protect firms real earnings from the adverse effects of inflation. Recent experience shows us that the drain on real profits has been so large in the last few years that, in some periods, real retained earnings were negative.

(2) Related to this issue, regulations should make it easier for firms to adopt accounting procedures that make sense in an inflationary environment. In addition to the effect on real profits, firms need accounting data and procedures that provide accurate and meaningful information for decision-making. Even the government under-predicted the inflationary tax revenue bonus that it would receive at the expense of taxpayers last year.

(3) The differential treatment for incorporated and unincorporated business operations in terms of tax treatment and regulations needs to be carefully examined to assess the impact on resource allocation and the distribution of profits.

(4) Complying with the multiplicity of tax related regulations and reporting is very expensive for the small firm and discourages some types of activities such as the establishment of pension funds. The resources required to collect taxes should be kept to a minimum, consistent with the equity judgments of Congress. Time and money spent _paying_ taxes is of little value to anyone. We have better uses for resources in our economy.

(5) The current tax structure requires most corporations to generate two dollars of gross profit in order to earn a dollar. In terms of sales, the required amount would be much larger. Clearly, this discourages the undertaking of many investments that, under less burdensome taxes, would be made. In addition, earnings paid out in the form of dividends are taxed again as personal income. With shortages posing a serious threat to future growth and development, the tax structure should be examined to see how it might be altered to stimulate new innovation and encourage businesses to take advantage of newer technologies through increased investment.

The data presented in this testimony relating to small businesses were taken from sample surveys of the Federation's 400,000-plus members. Quarterly surveys are conducted dealing with general economic conditions and with energy policy and problems. In addition, special studies such as one dealing with the impact of minimum wage legislation have also been prepared. The basic findings of the Quarterly Economic Survey were reviewed for the Senate Select Committee on Small Business in testimony presented before that Committee on February 4, 1975.

The Relative Position of Small Business

In considering tax reform, the nature of small business relative to firms such as those in the Fortune 500 or similar large firms should be kept in mind. Our surveys show that the median sales are under $200,000. The mean number of employees is about six. About a third of the firms are incorporated, and half are sole proprietorships. A large majority deal directly with the consumer as distributors of goods and services.

Small businesses feel relatively isolated from the decisions made in Washington even though they are heavily affected by those decisions. Ten percent feel that government regulations and red tape are the most important problems facing small business today, a surprising choice among alternatives that include recession, unemployment, labor costs, inflation and energy problems. [NFIB Quarterly Economic Report for Small Business, #7, page 3.] Few of these firms are large enough to support the specialists required to handle required paperwork and regulations and are not sophisticated enough to compile and analyze the information needed to operate in the current economic environment.

The Effects of Inflation

Although the economy has been subject to a moderate amount of inflation for the past 20 years, little had happened to prepare businessmen for the events

of the late 60's and early 70's. Several basic problems occurred:

(1) Methods of cost assessment based on historical prices inadequately reflected business costs in current dollars.[1]

(2) Prices of goods sold rose with inflation, although price increases for goods and services sold by small businesses may have lagged price increases in the general economy.

(3) The net result of this was an overstatement of profits (especially firms selling goods rather than services), half of which were taxed away for corporations. Those earning higher profits were forced into higher tax brackets, increasing their tax liability even though, _in real terms_, business was at best unchanged and, in most cases, worse. In October of 1974, 25 percent reported that sales were lower. In April of 1975, that figure stood at 39 percent of all firms. In terms of real goods and services sold, the figures would be even worse.

(4) When firms had to replace inventory and buildings and equipment, they found that depreciation reserves were inadequate and that existing working capital financed fewer inventories than at old prices. New capital was required, but stock markets were depressed and interest rates at historical highs with funds going only to the best firms.[2] This effectively eliminated most small businesses from the capital markets. Through 1974, the proportion of small busin .ses needing borrowed capital rose nearly 20 percent. At the samo time, the proportion of firms reporting eliminated most small businesses needing borrower capital rose nearly 20 percent. At the same time, the proportion of firms reporting

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1/ For example, a building bought for $10,000 would cost $24,000 to replace 10 years later if the cost of construction rose at 10 percent per year. Straight line depreciation would deduct as a cost of business each year $1,000. But, the cost of the building "used up" each year was higher in terms of current dollars (as the sale of the building in the open market would have shown).

2/ Continuing the example in footnote 1, when the building had to be replaced, $10,000 would have been accumulated as depreciation reserves. But, the same building ten years later would cost about $24,000. The additional funds had to be raised either by selling new equity (in a depressed stock market) or by borrowing in a market where interest rates were very high. Viewed another way, equity was taxed away because costs were understated.

that required financing would be more difficult almost doubled, rising from 19 percent to 34 percent of borrowing firms.[3/]

Although firms will adjust to some of the effects of inflation on their own, most of the costs of inflation are imposed by the rigidity of the tax structure and related regulations. A tax system designed to deal with inflation would work perfectly well if little inflation occurred. But, our current system does not deal equitably with inflation, and the costs of this in terms of productivity and potential GNP could be substantial as productive investment is impaired.

Regulations, Red Tape and Fixed Tax Schedules

If it made sense in 1937 to distinguish between corporated and unincorporated businesses, or to have a break point in the tax structure at $25,000 corporations, the current structure surely must be reconsidered now. Of major concern now are:

(1) The fact that, in terms of real business volume, $25,000 in corporate profit in 1937 dollars would be roughly equivalent to about $85,000 today (based on the Consumer Price Index). The fact that the break point has not been changed means that smaller and smaller firms, in real terms, have been brought under the 48% tax rate.

(2) For firms not organized as corporations, a fixed tax structure has meant paying higher and higher tax revenues for the same real volume of business, as nominal (current dollar) profits rose, moving the firm into higher marginal tax categories.

(3) Compounding these problems are the amount of paperwork and the complicated regulations that accompany tax procedures and decisions to

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3/ NFIB Quarterly Economic Report for Small Business, #7. The proportion of firms requiring fairly frequent outside financing rose from 47% to 56%, an increase of about 20%. [Table 33] The proportion of borrowing firms reporting that they expected financing to become more difficult rose from 19% (9% from Table 35 divided by 47%) to 34% (19% from Table 35 divided by 56%).

incorporate if there appear to be tax advantages (in addition, in an inflationary environment, it is harder to assess the relative benefits of changing forms of business organization). Business decisions should not be based on tax benefits to be gained from an ill-suited system of tax assessment.

The costs imposed on businesses by the complicated procedures associated with tax payments must be paid for by consumers, either through higher prices, or lower income for the owners of businesses. Streamlining the tax system could save many costs, even without a revenue reduction.

Longer Run Implications: Investment, Capacity and Productivity

The costs associated with tax payment procedures and the revenues lost by businesses from the effects of inflation on costs and revenues impair businesses' ability to invest in productive capacity. This, in turn, reduces potential output in future periods and impairs productivity gains. These developments are central to our ability to deal with inflation in future years.[4/]

Keeping in mind that consumers pay all taxes (either through higher prices or through lower profits to owners of businesses), the desirability of a heavy tax on business profits should be carefully re-thought. In the short tun, it may be easier to raise taxes for business than for consumers, but in the longer run effects on capacity may cost the consumer a great deal in lost potential output.

Profits are the return to capital invested in productive capacity. Firms must provide a competitive return or they will not be able to attract new capital:

4/ In addition, substantial amounts of investment funds are tied up in compliance with energy conservation, pollution, OSHA and other regulations. Although of benefit to society, these do not measurably add to capacity or productivity.

(1) Larger firms will not be able to raise equity capital by issuing stocks.

(2) Firms cannot as easily attract funds in the debt markets, and must pay higher interest costs.

(3) New firms will not enter the business sector. Entrepreneurial talent will not find small business an attractive way to utilize their resources.

Thus it would seem that tax reform will be an essential ingredient not only to recovery in this recession, but also to longer run growth and development.[5] To delay reform is to delay the positive benefits to be achieved from the capital accumulation and the spending that will result. This we cannot afford to do.

5/ Tax reform raises many issues on the revenue side not dealt with here. If reform occurs but revenues are unchanged, the tax burden is redistributed from one group of consumers to another. Less sophisticated and specialized, the burden falls disproportionately on small businesses and their customers. If total tax revenues decline (or grow) with reform, then decisions about government spending must also be made. Small business generally feels that this is a desirable outcome.

Senator BENTSEN. Thank you very much, Dr. Dunkelberg; and following the usual procedure set forth by our distinguished chairman, we will limit the questions to 10 minutes each to members, and follow the order in which they appeared here.

Let me comment first on a speech you gentlemen had before your convention yesterday. I believe the President made the speech before your convention when he was talking about small business. It was an interesting thing that spokesmen for the administration told the congressional committee wrestling with the problems of small business earlier this year that small business was relatively well off.

The other interesting thing is that the Senate Finance Committee made some tax changes for small business. We raised the surtax exemption. We brought it up this year from $25,000 to $50,000. And yet, we had the administration testifying against it before this committee.

We also found that businessmen in general were spending $18 billion a year on forms; filling out Government forms. The Government itself was spending $15 billion a year. Congress established a commission to try to do something about it, and the President, who yesterday spoke of his great concern for small business, took 6 months to appoint the first member of that commission, and appointed them the day before his speech. You gentlemen should have had your convention 6 months ago, and maybe you would have gotten those commission members appointed.

It is awfully easy to make these political promises in speeches. But some of the members of this committee have been working on this problem, trying to do something about it.

Now, let me get to your point, Mr. Fielding. When you were talking about an unincorporated business having to pay up to 70 percent——

Mr. FIELDING. Yes, that is correct.

Senator BENTSEN [continuing]. Where it is capital-intensive, or has capital.

Mr. FIELDING. Yes.

Senator BENTSEN. So what we are talking about is a penalty on savings in this country; and already, this country is saving less of its disposable income than any major nation in the world. So we are discouraging savings in this country, and we are also saying that if you are a great rock performer or a pop singer who can make $1 million a year, that you have a maximum of a 50-percent tax bracket. Is that not right?

Mr. FIELDING. That is absolutely correct.

Senator BENTSEN. Is that not correct?

Mr. FIELDING. Yes.

Senator BENTSEN. But if you save, and then try to earn off of those savings, you can go to a 70-percent tax bracket. Is that correct?

Mr. FIELDING. That is correct.

Senator BENTSEN. Now, one of the big problems in this country is going to be generating sufficient capital for the expansion of business and manufacturing capacity, and modernizing it so we can be competitive in these world markets. And we are going to have to have incentives for savings to accumulate that capital. Every time that we have one new job in manufacturing, it costs $25,000 at least in investment

capital in this country. So it is important, I think, that we bring about some of these things that you are talking about.

I look at small business today, trying to float a new issue in the stock market—no way. You go back to 1970, 1969, and look at the new issue market. Look at it today; no one is buying it. I think there will be IBM's of tomorrow if they have the chance to get the venture capital. But you are almost precluded from it these days, unless you are going to be a subsidiary of some major company, and then they are going to own you. They are going to dictate to you.[1]

Mr. Chairman, I ask my cochairman if he has some questions, or would you like to comment?

Mr. McKEVITT. Mr. Chairman, as a former Member of Congress and a member of the House Small Business Committee, may I state I also have seen the systems of legislation, and I in particular would like to commend Chairman Nelson for the great assistance he has been giving small business. We have seen it firsthand, and I want to express that note of appreciation to him and the staffs of both of your committees.

Senator BENTSEN. Thank you very much. With that, I think, Senator Nelson might be called on to speak.

Senator NELSON. I want to also thank Senator Bentsen and Senator Long, who is chairman of the Finance Committee, for being agreeable in endorsing and supporting these joint hearings; because, after all, it will be the Finance Committee under Senator Long's chairmanship that will be responsible for any changes that may be made in taxes affecting all businesses, including small business.

It seemed to us it would be fruitful to conduct these hearings jointly, since the Small Business Committee has a particular special interest respecting small business; and the Finance Committee, of course, has the total responsibility for taxes affecting all interests. And thus far, I think these have been very constructive and useful hearings.

I have just one question for the time being. In your testimony, you made reference to paperwork, and that a certain percentage of your members consider paperwork the most serious problem. What was that percentage?

Dr. DUNKELBERG. 10 percent of the membership said that regulations and related paperwork was the most important problem facing small business.

Senator NELSON. I would hope we can do something about that ultimately. As Senator Bentsen mentioned, the commission to study it has been created, and if they do not get lost in their own paperwork, conceivably they might come out with some useful answers. Thank you.

Senator BENTSEN. I would like to say that Senator McIntyre played very much a lead role in that paperwork study, and in bringing forth that commission. Mr. Chairman, do you have any questions?

Senator LONG. All I want to say is that those members of the Small Business Committee who also serve on the Senate Finance Committee really teamed up on us to put, I think, more amendments favorable to small business on that last big tax cut bill than we have ever had

[1] See charts on capital invested per employee, Appendix IV.

at any time in the history of the country. I do not think that ever happened before. Some of us did not know that they were teaming up on us. They were holding meetings before the Committee meeting, and planning their next move to add first one and next another amendment on that bill. When one considers the good things in that bill, insofar as small business is concerned—and there are several of them—it would be interesting to look and see how many of those had a favorable administration recommendation. I do not believe any of them did. Perhaps there might have been about four good features in that bill which small business very much thought would help their problem. And those were really generated by the Small Business Committee, particularly on the chairman of that committee, Mr. Nelson, and those members of the Small Business Committee who also serve on the Finance Committee. They looked upon that as a chance to move along some ideas they had been thinking about for some time, and they did.

As a conferee, I was pleased to fight for them, and see that what they put on the bill in the Senate survived the conference. I think the credit should go to those who initiated those suggestions and fought for them, because they did some very fine work; and also Senator Bentsen, chairman of this Financial Markets Subcommittee, has been very active in that area.

Now, I suppose any administration has the right to take credit for something which occurred while it was in office, even though they recommended against it. I recall what happened to Pogo one time. Albert the alligator thought he ought to be the leader of the gang, and they decided that Albert could be the leader for a while. And he said, you see there, I have only been leader for 5 minutes, and already it has stopped raining. So one of the animals said, you are not going to claim credit for that, are you? And he said, why not? It happened during my administration, did it not? And Pogo said, well, that has got to be fair. That is exactly right, it happened during his administration, so I suppose we have to give him credit.

He signed the bill, even though he did complain bitterly about the fact that there were a lot of things in that bill he did not recommend, which he thought were irrelevant to the initial purposes of the bill. We definitely should consider some of the suggestions you have here in connection with a tax reform bill, which we are led to believe we will be looking at later on this year. Thank you very much, Mr. Chairman.

Senator BENTSEN. Senator McIntyre?

Senator MCINTYRE. Thank you, Mr. Chairman.

I have a statement, Mr. Chairman. I would like to insert a statement in the record, hopefully at the beginning of your hearing this morning. I did not realize it was at 9:30 a.m.

One of the most healthy things I have seen in a long time is the presence of the chairman of the Finance Committee, and distinguished members of the Finance Committee, here at the Select Committee on Small Business. This wedding bodes very well, and as the chairman of the Finance Committee just stated, you ganged up on him. I think there are four members of this Select Committee on Small Business in Finance. It was not planned; it just happened, did it not?

Senator NELSON. Six.

Senator MCINTYRE. Six? So this is probably the best sign of future assistance to this muddled-up tax situation that Small Business has ever had.

Senator LONG. Well, I am an alumnus of the Small Business Committee myself.

Senator MCINTYRE. Dr. Dunkelberg, I am a little confused, now. You said that 10 percent of the responses indicated that Federal forms—strangulation in triplicate, we call it—was right at the top of the list of problems of small business?

Dr. DUNKELBERG. Maybe I should give you some idea of how the question was asked.

Senator MCINTYRE. You do not mean to tell me that out across the great expanse of small business in this country, that Federal form pollution is the No. 1 problem.

Dr. DUNKELBERG. Well, for 10 percent of them, they pick it as the No. 1 problem. We asked the question of the membership, which goes roughly like this: What is the most important problem facing small business today? And, of course, there are a whole set of possible alternatives, which include inflation, recession, declining sales, energy problems—the whole works, including this choice. And 10 percent of the firms out of that list picked that the forms problem, the regulation, as No. 1 problem.

Senator MCINTYRE, Where was inflation? I am trying to get a perspective as to where——

Dr. DUNKELBERG. We did not ask each firm to rank more than one, We said, pick the most important.

Senator MCINTYRE. Was 10 percent the greatest number?

Dr. DUNKELBERG. Of the respondents 28 percent chose inflation, 18 percent chose taxes, and then 10 percent chose—I think that was roughly in third position—10 percent chose paperwork as the most important problem. But it is interesting, given that they could choose inflation, which has been a clear problem for small businesses, they still decided to pick that as the No. 1 problem instead of choosing inflation. Four quarters ago, of course, energy problems ranked No. 1, tied for No. 1 with inflation. They have slipped out of sight, and paperwork and regulations are running strong.

Mr. FIELDING. Senator McIntyre, may I insert a thought here? We did not have a great deal of notice, of course, of this meeting, and with the short notice that we had, we mailed out a questionnaire to our members who were going to attend the conference. We have some 600 members attending the conference. They had about 3 days to reply. We got over 100 replies, which I think was very good in that short period of time, and the second most reoccurring problem was paperwork burden.

Senator. MCINTYRE. Well, yesterday, the President announced the public members of the Commission that he has appointed. Senator Brock of Tennessee and myself will be on that Commission as well as Congressman Horton and Congressman Steed. Now, in undertaking this job I tell you I do not see any rosy future. It is just the biggest monolithic terror that you have ever come up against. It is just a monster, and we, the Congressmen and the Senators, are responsible. We are the real perpetrators of this, because we pass these laws, and

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we do not sometimes realize the amount of confusion we are causing across the country. But we are going to undertake it, and we will have a sizable budget, and we can get a good staff. Hopefully, we can begin to do some good work, and then, we can set up a proper policeman. We have never had one, despite a law passed in 1942, the Federal Reports Act—we have never had a proper policeman that watches the paperwork burden. The monitors, what we are doing over here, and calls it to our attention.

Last year I made an attempt to get a little bill passed, and it met with tremendous resistance from the chiefs of the staff of the various committees of the Senate. Every time we report and send to the floor a piece of legislation, it is accompanied by a report which briefly outlines—or outlines in considerable detail—the purpose and an analysis of the bill. We wanted to put a paragraph in there so that each Congressman and Senator would know that when he voted aye on a bill that he was creating 36 new forms.

Well, the committees had a good answer to that. They said, how can we tell at this stage how many forms, if we do not know what final action will be taken by the Senate and the House and the conference? But it met with a disastrous result. It is a very difficult problem, and I promise you here that we are going to give it a very good try.

Thank you very much, Mr. Chairman.

Senator BENTSEN. Senator Hathaway?

Senator HATHAWAY. Thank you, Mr. Chairman. Thank you, gentlemen, for your testimony.

I wonder if you could give us some specific provisions of the code which you think should be amended, and how they should be amended to help small businesses in the areas of capital accumulation, in particular.

Dr. DUNKELBERG. I would like to respond first to that question, because I think I can be finished very quickly, since the letter I got suggested I should not be prepared to do that, but rather talk about general problem areas. I thought I would identify general problem areas, and offer our help. But I would like to make one specific observation regarding the capital accumulation problem that I overlooked, and that is the tremendous amount of capital now, by law, is funneled into what we call nonproductive investment. You are familiar with what those things are; they are associated with OSHA and so on, which are nonproductive in the sense that they do not raise output per man-hour although certainly not nonproductive from society's point of view if they do reduce pollution and so on. But this does compound the problem for the firm. Now if he gets an extra dollar of capital, if we help it out through the tax formula, and he gets a dollar, a still larger piece of that than before is going to have to go into OSHA compliance and pollution compliance, and so on.

So, this makes the problem much worse for the firm than before. For each additional dollar he does get there is still less of it left. Even after reform, there will still be less left for what we call productive investment in capacity and productivity.

Senator HATHAWAY. Does not investment in OSHA increase the productivity of the workers, in that they are not as apt to be injured and/or killed, and therefore you get more work out of them?

Dr. DUNKELBERG. I have a quick answer to that: in theory, yes; in practice, it is not clear at this point. I think we need a lot of evidence

on that. A lot of people feel that we did not do a very good cost-benefit job on OSHA, and it got out too fast. And the training is not very good, and we are spending too much time moving fire extinguishers. And you know the old story about the OSHA inspector who says, that banister should be on the left-hand side and 6 inches lower. So you move it, and all of your employees fall down the stairs, because they are used to it on the right.

Well, we do have some problems with that. In principle, it is correct. But we do know it is taking a tremendous amount of investment capital. Pollution control, of course, is the same thing, and all I am saying is, it is going to make it tougher for the firm in the future, regardless of how much capital it can accumulate. So, compounding the problems of inflation and taxes, we have got this problem, too.

As far as specific recommendations, I did not prepare any.

Mr. FIELDING. Well, we have some, Senator Hathaway. I do not know whether we have the time to go into them. I would be glad to list some of the suggestions that we have, if time permits.

Senator HATHAWAY. Why do you not start listing some of them, and then you can submit some to us that we could incorporate in the record?

Mr. FIELDING. One of our suggestions is the graduated corporate income tax rate with a maximum of 45 percent; and then also, this would apply to individuals. The maximum tax rate on individuals from earned income would be 45 percent. The 30-percent requirement would be thrown out; the 30-percent penalty would be thrown out. Graduated investment credit, so that the individual who buys a small amount of goods gets a greater percentage of the credit. Increase the first-year depreciation, so that the small buyer gets a greater share of the increased first-year depreciation—optional cash basis for all taxpayers of any inventories of less than $200,000 a year—credits for undistributable tax on unincorporated business. We would like to see the Small Business Committee investigate indexing the tax structure. We think the payroll tax requirements, tax deposits, are very discriminatory against the small businessman. These should be changed. He does not have enough time to make his deposits, and he is always being penalized.

We think there should be a committee for tax simplification for small business. We think the subchapter S quagmire could be very easily solved if we could just treat subchapter S as a partnership. We have got plenty of regulations dealing with partnerships. There is no reason why we cannot treat them the same.

Another thing we run into are the effective dates of our laws. We have an effective date in the code, and I think the Pension Reform Act is a very good example of this. We have had effective dates; we have had regulations that have not come out; we do not know what the effective dates mean. We feel that the effective date should be 1 year after the regulations come out, so we can understand what we are doing.

Retirement income credit should be increased. The individuals who previously were subject to retirement income credit no longer get it because their social security credits go up so high. Net operating loss carryovers—no reason why a company has to be restricted to 5 years in the future. It should be an indefinite time.

Those are some of the suggestions we have, Senator.

Senator HATHAWAY. Fine. Thank you very much. Thank you, Mr. Chairman.

Senator BENTSEN. Do you have any idea, any estimates, of what that would mean in loss of tax revenue? That is the first thing Treasury hits us with when we talk about something like that.

Mr. FIELDING. Yes, we do. We would be glad to submit that.

Senator BENTSEN. I would like those estimates.

[The material referred to follows:]

NATIONAL FEDERATION OF INDEPENDENT BUSINESS 1975 TAX REFORM PROPOSALS

FIRST PRIORITY

I. Graduated Corporate Income Tax Rates
II. Graduated Investment Credit
III. Increased First Year Depreciation
IV. Optional Cash Basis
V. Undistributed Taxable Income of Unincorporated Businesses
VI. Indexing the Tax Strucuture

SECOND PRIORITY

VII. Payroll Tax Deposits
VIII. Committee on Tax Simplification for Small Business
IX. Sub-Chapter S Corporation
X. Effective Dates

THIRD PRIORITY

XI. Retirement Income Credit
XII. Net Operating Loss Carry-overs
XIII. Maximum Tax Rates
XIV. Amortization of Organization Expenses of Partnerships

I. GRADUATED CORPORATE INCOME TAX RATES

A. Present structure

1. 22 percent of the first $25,000 of taxable income and 48 percent on all income in excess of $25,000.
2. For 1975 the rates were temporarily reduced.

B. Proposed structure

1. Taxable Income and Rate:
   $0 to $9,999—10 percent.
   $10,000 to $19,999—$1,000 plus 15 percent of excess over $10,000.
   $20,000 to $29,999—$2,500 plus 20 percent of excess over $20,000.
   $30,000 to $39,999—$4,500 plus 25 percent of excess over $30,000.
   $40,000 to $49,999—$7,000 plus 30 percent of excess over $40,000.
   $50,000 to $59,999—$10,000 plus 35 percent of excess over $50,000.
   $60,000 to $69,999—$13,500 plus 40 percent of excess over $60,000.
   $70,900 to $79,999—$17,500 plus 45 percent of excess over $70,000.
2. Proposed rates would apply for 1976 and subsequent years.

C. Supporting arguments

1. The income which a small coporation retains (income less taxes on income) is vital to its continued existence. Increasing this retained income through realistic tax relief will enable these corporations to have sufficient working capital to remain in business and acquire more capital goods to insure a healthy existence. Based on the 1970 income statistics, the comparative schedule disclosed the fact that 600,000 (82 percent) of the corporations paying income taxes that year had taxable income of less than $30,000. In todays economy the present two-tiered tax structure is inequitable when it is applied to the small corporation.

2. A graduated corporate income tax would bring corporate taxation more into accordance with the principle of the ability to pay, which has long been in effect for individual income taxes.

D. Estimated revenue loss

1. Based on 1970 corporate income statistics, the estimated revenue loss would be approximately 3 billion dollars. (See attached comparative schedule).

COMPARISONS OF ESTIMATED DIFFERENCE BETWEEN EXISTING CORPORATE INCOME TAX RATES AND A GRADUATED CORPORATE INCOME TAX RATE AS PROPOSED BY THE NFIB (BASED ON 1970 INCOME)

Taxable income	NFIB proposed rates (percent)	Number of Corps (thousands)	Existing rates (percent)	Average taxable income (thousands)	Average annual tax		Average annual savings (e—f)	Government gain (loss) (millions) (g×b)	Percent reduction of annual tax liabilities (g÷e)
					Existing	Proposed			
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
0 to $9,999	10	393.0	22	$3	$660	$300	$360	($141)	54.5
$10,000 to $19,999	15	121.0	22	14	3,080	1,600	1,480	(179)	48.1
$20,000 to $29,999	20	86.0	22–48	25	5,500	3,500	2,000	(172)	36.4
$30,000 to $39,999	25	30.0	48	34	9,820	5,500	4,320	(130)	44.0
$40,000 to $49,999	30	18.0	48	45	15,100	8,500	6,600	(119)	43.7
$50,000 to $59,999	35	13.0	48	56	20,380	12,100	8,280	(108)	40.6
$60,000 to $69,999	40	9.5	48	64	24,220	15,100	9,120	(87)	37.7
$70,000 to $79,999	45	7.3	48	74	29,020	19,300	9,720	(71)	33.5
$80,000 to $89,999	45	6.0	48	85	34,300	24,250	10,050	(60)	29.3
$90,000 to $99,999	45	4.6	48	95	39,100	28,750	10,350	(48)	26.5
$100,000 to $149,999	45	15.0	48	119	50,620	39,550	11,070	(166)	21.9
$150,000 to $199,999	45	7.6	48	172	76,060	63,400	12,660	(96)	16.6
$200,000 to $249,999	45	4.4	48	224	101,020	86,800	14,220	(62)	14.1
$250,000 to $499,999	45	9.2	48	348	160,540	142,600	17,940	(165)	11.2
$500,000 to $999,999	45	4.6	48	687	323,260	295,150	28,110	(129)	8.7
Over $1,000,000	45	4.8	48	10,338	4,956,000	4,638,100	317,900	(1,526)	6.4
Total		734.0						(3,259)	

II. GRADUATED INVESTMENT TAX CREDIT

A. Present Structure

1. A percentage of the cost of acquisition of capital business goods and manufacturing facilities is allowed as a credit against the purchasers tax liability:

(*a*) Property with a useful life of:

(1) less than 3 years—0.0 percent.
(2) 3 years but less than 5 years—2⅓ percent.
(3) 5 years but less than 7 years—4⅔ percent.
(4) 7 years and over—7 percent.

2. This credit applies to all entities whether it is sole proprietor, partnership, sub-chapter S corporation, or a regular corporation.

3. The credit is limited with respect to the purchase of used equipment to the first $50,000 of used equipment purchased in a year.

4. The credit, in a given year, cannot exceed the taxpayer's total income tax liability for that year. Any excess may be carried back and/or forward to other taxable years.

5. If the taxpayer disposes of the item for which there has been an allowable tax credit before the end of its useful life, the government recaptures all or a portion of that investment credit.

6. The investment credit for 1975 and 1976 was temporarily increased by the 1975 Tax Reduction Act.

B. Proposed structure

1. Percentage of the cost:

(*a*) Property with a useful life of less than 3 years, the credit would be 0.0 percent.

(*b*) Property with a useful life of at least 3 years—

(1) 20 percent of the cost ranging from $0 to $4,999.
(2) 15 percent of the cost ranging from $5,000 to $9,999.
(3)(i) 10 percent of the cost ranging in excess of $9,999 if the property has a useful life of 7 years or more.
(3)(ii) 7 percent of the cost in excess of $9,999 if the property has a useful life of less than 7 years but 5 years or more.
(3)(iii) 4 percent of the cost in excess of $9,999 if the property has a useful life of less than 5 years but at least 3 years.

2. There would be no limitation with respect to used equipment.

3. If the credit exceeded the taxpayer's income tax liability, the difference would be refunded.

4. If the taxpayer disposes of the property before it has been held for at least 3 years, the government would recapture all of the previously allowed credit. Any recapture of credit previously allowed on the costs in excess of $9,999, would be treated the same as it is under the present law.

C. Supporting arguments

1. Graduated rates with emphasis on purchases under $5,000 would help small businesses overcome the problem of raising working capital and accelerate their decision to purchase capital goods.

2. Allowing a full credit on all equipment purchases totalling less than $10,000, and having a useful life of at least three years, will encourage the more current replacement of equipment. Accordingly, if equipment is to be replaced over a shorter life-span, then there should not be a limitation on the investment credit applicable to used equipment. Trade-ins are a vital element of the capital goods industry and used property is purchased more often by small businesses than large corporations.

D. Estimated revenue loss

1. Based on a 1974 NFIB survey which developed a financial profile of its members and assuming that there are approximately 10,000,000 tax-paying businesses in the United States, the following revenue loss statistics can be developed:

(*a*) 56 percent made no purchases in 1973 equals 5.6 million businesses-no revenue loss.

(*b*) 25 percent purchased less than $10,000 equals 2.5 million businesses-estimated revenue loss $767 per business equals 1.9 billion dollars.

(*c*) 8 percent purchased more than $10,000 and less than $25,000 equals 800,000 businesses-estimated revenue loss $1,275 per business equals 1.0 billion dollars.

(*d*) 4 percent purchased more than $25,000 and less than $50,000 equals 400,000 businesses-estimated revenue loss $1,875 per business equals .75 billion dollars.

(*e*) 4 percent purchased more than $50,000 and less than $100,000 equals 400,000 businesses-estimated revenue loss $3,000 per business equals 1.2 billion.

(*f*) 3 percent purchased more than $100,000 equals 300,000 businesses-estimated revenue loss (assuming average purchase of $250,000) $8,250 per business equals 2.5 billion dollars.

(*g*) Total estimated revenue loss 7.35 billion dollars.

III. INCREASE FIRST YEAR DEPRECIATION

A. Present structure

1. An additional amount of depreciation is allowed in the year of purchase on all depreciable property having a useful life of at least six years. The additional depreciation is limited to 20 percent of the cost of the first $10,000 of property purchased during the year. This limitation applied to all business entities. However, individuals filing a joint return are allowed a $20,000 limitation. The remaining cost of the assets are reduced by the additional first year depreciation before calculating the normal depreciation for the year.

B. Proposed structure

1. Additional first year depreciation on—

(*a*) 30 percent of the cost of first $5,000 of depreciable property

(*b*) 25 percent of the cost of second $5,000 of depreciable property, and

(*c*) 20 percent of the third $5,000 of depreciable property. (In the case of a joint return the 20 percent would apply to the next $10,000 instead of $5,000)

2. No requirement that the depreciable assets have useful lives of at least six years.

3. No adjustment to depreciable basis of assets for the additional first year depreciation for purposes of computing annual depreciation.

C. Supporting arguments

1. An increase in the first year depreciation allowance would help small businesses to overcome the problem of raising working capital and accelerate their decision to purchase capital goods.

D. Estimated revenue loss

1. Based on the assumption that 4.4 million business taxpayers will each purchase depreciable property in excess of $5,000, the estimated revenue loss is 1.7 billion dollars.

2. Included in the 1.7 billion revenue loss, is an estimated loss of $262,000,000 attributable to the calculation of annual depreciation without a reduction in basis for the first year depreciation.

IV. OPTIONAL CASH BASIS

A. Present structure

If inventories are an income determining factor, a business must determine its taxable income on the "accrual" basis. Accounts receivable are included in income, accounts payable are treated as expenses, and the increase in inventory during the year is excluded from cost of sales.

B. Proposed structure

1. Grant every business with an ending inventory of less than $200,000, the option to determine its taxable income on a "cash" basis. Accounts receivable would not be included in income, accounts payable would not be treated as expenses, and the increase in inventory would be included in the Cost of Sales.

2. For a presently existing business using the accrual basis, the conversion would produce a loss, which would be amortized in equal amounts over a 10 year period.

3. The maximum ending inventory of $200,000 would be indexed to the cost-of-living.

4. A taxpayer would lose this "cash" option when its ending inventory exceeded the maximum for two consecutive taxable years.

5. If a taxpayer voluntarily converts or is required to convert to an "accrual" basis, any income created by the conversion would be amortized over a ten-year period. If there exists any unamortized loss, from a previous conversion to a cash basis, the taxpayer would continue its amortization of such a loss.

6. Any taxpayer, who takes this "cash" option, and later converts to an accrual basis, would not be permitted to reconvert to the "cash" basis until its inventory was less than the maximum for two consecutive years.

C. Supporting arguments

There are two basic ingredients which are necessary for the success of all small businesses. They are good management and sufficient working capital. A small business cannot survive without both of these. The government can enhance the working capital of small business by not taxing its "paper profits". By allowing businesses with inventories of less than $200,000 to be taxed on a "cash" basis, an average of $3 billion dollars per year will be retained. This will enable small businesses to enjoy a more stable growth pattern until they reach the point where they will be able to obtain their necessary working capital in the stock market.

D. Estimated revenue loss first year (assuming all eligible taxpayers convert)

	Billion
1. Excluding Accounts Receivable from Income	$102. 2
2. Including Ending Inventory in Cost of Sales	61. 2
3. Excluding Accounts Payable from Expense	(61. 3)
4. Net Decline in Taxable Income-First Year	102. 1
5. Amortization (one-tenth)	10. 21
6. Estimated loss (30 percent × $10.21 billion)	3. 06

V. UNDISTRIBUTED TAXABLE INCOME OF UNINCORPORATED BUSINESSES

A. Present structure

1. Corporations are taxed on the income retained in the business in 1975 at 20 percent on the first $25,000, 22 percent on the next $25,000, and 48 percent on the remainder.

2. The income retained in the business by a sole-proprietor or partnership is added to the income withdrawn and taxed at more than 20 percent in most cases. A married individual pays more than 20 percent on taxable income in excess of $8,000 and an unmarried individual pays more than 20 percent on taxable income in excess of $4,000.

B. Proposed structure

1. Unincorporated businesses should be allowed a tax credit based on their undistributed taxable income.

2. The tax credit could be 20 percent of undistributed taxable income, with a maximum credit of $10,000 per year.

3. When the undistributed taxable income is later distributed, the tax credit would be recaptured.

C. Supporting arguments

1. The relatively low corporate tax brackets, and other tax advantages enjoyed only by corporations, encourage many businesses to incorporate even though from a practical operational viewpoint they can be conducted more effectively without incorporation.

2. The proposed tax credit on the undistributed taxable income of unincorporated businesses would help businesses to finance the ever increasing cost of inventories and other assets.

D. Estimated revenue loss

The proposed tax credit would be completely recaptured when the income is distributed. The government's revenues would therefore be unchanged over the long-term.

VI. INDEXING THE TAX STRUCTURE

A. Present structure

Tax brackets, standard deductions, low income allowances, individual exemptions, corporate surtax exemptions and other fixed amounts remain unchanged until revised by Congress.

B. Proposed structure

1. Tax brackets and other amounts mentioned above should be indexed to the cost of living.

2. Indexing would be done no more than once each year.

3. No change would be made until the cost of living index had increased by more than 10 percent since the date of the last change.

C. Supporting arguments

Indexing would prevent taxpayers from having to pay an ever increasing proportion of their income in taxes due to inflation automatically pushing them into higher tax brackets each year even though their real income remains unchanged.

VII. PAYROLL TAX DEPOSITS

A. Present structure

1. Payroll taxes of $200 or more, but less than $2,000, per month must be deposited within 15 days after the end of the month.

2. Payroll taxes of $2,000 or more in any quarter-monthly period must be deposited within 3 days after the end of the quarter-monthly period.

B. Proposed structure

1. The limit for monthly deposits should be raised from $200 to $600.

2. The limit for quarter-monthly deposits should be raised from $2,000 to $6,000.

C. Supporting arguments

1. Present depository requirements are unrealistic in view of accelerating payroll taxes. When the requirements for the present monthly deposits ($200 and $2,000) was initiated in 1972 the payroll taxes were considerably less than they are today. Social security taxes have increased 76 percent from 10.4 percent of $9,000 of wages in 1972 to 11.7 percent of $14,100 of wages in 1975. Social security taxes are now three times what they were in 1966 when the depository limits were $150 and $4,000.

2. Requiring less frequent deposits will ease the heavy paperwork burden on the small business with limited clerical staff.

3. It is the small employer, whose payroll tax deposits are subject to different limits each month, that are penalized for failure to make timely deposits.

D. Estimated revenue loss

There would be no revenue loss to the government.

VIII. COMMITTEE ON TAX SIMPLIFICATION FOR SMALL BUSINESS

A. Present structure

1. Tax laws are often written with the medium and large business in mind. The point of views of small businesses and their compliance problems resulting from their limited administrative staffs may be overlooked.

2. Changes in circumstances over a period of years result in many sections of the tax laws becoming inapplicable.

3. Tax laws and the interpretations issued by the Treasury Department are not reviewed to determine whether their application is within the intent of Congress.

B. Proposed structure

1. A permanent standing committee of the Federal Government should be established for the purpose of devoting continued attention to the simplification of the tax laws, regulations, and other publications relating to the taxation of small businesses.

2. The committee should appoint a small business tax analyst with the responsibility for looking at tax problems primarily from tne viewpoint of small businesses rather than the Government's interest in raising revenue.

C. Supporting arguments

1. The committee would provide a forum for regular contact between the various Federal agencies concerned, the businesses affected, and the Congress.

2. The development of tax laws and regulations, their revision in accordacne with changing circumstances, and the review of their application, would not overlook the viewpoint of the small businesses.

IX. SUBCHAPTER S CORPORATIONS

A. Present structure

1. A corporation with 10 or fewer stockholders and complying with a number of other eligibility requirements may elect to be taxed under subchapter S.

2. Under subchapter S, a corporation is taxed in a manner which bears some similarity to the method of taxing partnerships.

B. Proposed structure

1. All corporations with 10 or fewer stockholders should be allowed to elect to be taxed exactly like a partnership.

2. The only requirement for this election should be a statement filed by the corporation with its tax return for the year of election and signed by an officer of the corporation to the effect that there are 10 or fewer stockholders and that the stockholders at a duly constituted meeting decided to be taxed as a partnership.

3. After a corporation has made this election, it should not be allowed to revoke it for 5 years without the permission of the Treasury Department.

C. Supporting arguments

1. The extremely detailed procedures for complying with subchapter S and the many tax pitfalls which may be encountered by a subchapter S corporation, make an election to be taxed under these provisions rather dangerous for the average small business.

2. Eliminating subchapter S and allowing small corporations to be taxed exactly like partnerships would be a substantial simplification of the tax law.

D. Estimated revenue loss

The tax revenues would be unchanged.

X. EFFECTIVE DATES

A. Present structure

The effective dates of changes in the tax laws are fixed when the laws are passed by Congress.

B. Proposed structure

1. The effective dates of changes in those tax laws, which impose different operating or reporting requirements, should not be earlier than 1 year after the final regu ations are issued by the Treasury Department.

2. The effective dates of such changes as a reduction in the tax rates, could be effective immediately, or even retro-actively.

C. Supporting arguments

Taxpayers have great difficulty in complying with changes in tax laws imposing different operating or reporting requirements before detailed regulations are finalized.

XI. RETIREMENT INCOME CREDIT

A. Present structure

1. The retirement income credit allows a tax credit on up to $1,524 of an individual's retirement income at a rate of 15 percent. The maximum credit is $228. A husband and wife who file a joint tax return can elect to take a credit based on their combined retirement income. The election excludes, in effect, $2,286 of retirement income and the maximum tax credit is $342.

2. If a taxpayer receives any Social Security benefits, the above amounts of $1,524 and $2,286 are reduced by the benefits received.

B. Proposed structure

The above amounts of $1,524 and $2,286 should be increased to $4,572 and $6,858, so that more taxpayers who receive Social Security benefits will be eligible for a retirement income credit.

C. Supporting arguments

1. Taxpayers with Social Security benefits of $1,524 if single, on $2,286 if filing jointly, do not qualify for any retirement income credit. The recent increases in Social Security benefits have results in many taxpayers having benefits in excess of these limitations and therefore becoming ineligible for the retirement income credit.

2. An increase in the amounts of $1,524 and $2,286 would be an incentive for taxpayers, who have not yet retired, to save and provide funds for their retirement instead of being totally dependent upon the Social Security system.

3. Social security taxes are now three times what they were in 1962 when the $1,524 and $2,286 figures were established.

D. Estimated revenue loss

Information to estimate the effect on the government's revenue is not readily available.

XII. NET OPERATING LOSS CARRYOVERS

A. Present structure

1. The carry-overs of net operating losses by a corporation are applied directly against income whereas an individual loses the benefit of his personal itemized deductions and exemptions.

2. A net operating loss may be carried back to each of the 3 preceding years, and carried over to each of the 5 following years.

B. Proposed structure

1. The requirement that personal exemptions and nonbusiness deductions be added to taxable income in computing the net operating loss of an individual should be eliminated.

2. An individual or corporation should be allowed to carryback a net operating loss to each of the 3 preceding years, and then carry-over to the following years without time limitation.

C. Supporting arguments

1. The present method of applying net operating losses favors corporations over individuals and is one of the reasons why businesses decide to incorporate even though it is more efficient from an operational viewpoint to remain unincorporated.

2. Operating losses incurred in the early years of a business enterprise may be so large, and later profits so small, that they cannot be recovered in the limited carry forward period now permitted.

D. Estimated revenue loss

This proposal would result in some loss of revenue but the amount is unlikely to be significant.

XIII. MAXIMUM TAX RATES

A. Present structure

1. The top tax rate applicable to an individual's earned income is limited to 50 percent.

2. A taxpayer engaged in a business where both services and capital are material income-producing factors may treat a reasonable amount (not more than 30 percent of his share of the net profits) as earned income.

B. Proposed structure

1. The top tax rate applicable to an individual's earned income should be limited to 45 percent.

2. A taxpayer engaged in a business where both services and capital are material income-producing factors should be able to treat all of his share of the net profits as earned income.

C. Supporting arguments

1. The top tax rate applicable to a corporation's income is 48 percent now and in Section I above it is proposed that the maximum be reduced to 45 percent.

2. None of a corporation's income is taxed at more than 48 percent, even if capital is a material income-producing factor.

3. Taxing an individual's income at higher rates than a corporation's income is inequitable and results in many businesses deciding to incorporate even though they could be conducted more efficiently unincorporated.

D. Estimated revenue loss

These changes would not result in a substantial revenue loss.

XIV. AMORTIZATION OF ORGANIZATION EXPENSES OF PARTNERSHIPS

A. Present structure

Partnerships are not allowed to amortize their organization expenses although the amortization of a corporation's organization expenses is permitted.

B. Proposed structure

The option to amortize organization expense should be extended to partnerships.

C. Supporting arguments

Permitting corporations to amortize their organization expenses while prohibiting it for partnerships discriminates against the unincorptorated business. This is one of the reasons why businesses decide to incorporate even though it is more efficient from an operational viewpoint to remain unincorporated.

D. Estimated revenue loss

The government's revenue would be delayed but unchanged. Under the present law, the unamortized organizational expenses may be deducted upon liquidation of of the partnership.

Senator BENTSEN. Let me ask you: When you go to a cash basis instead of an accrual basis, that gives the small businessman a much greater opportunity to change his tax load from year to year and gives it much more flexibility, does it not?

Mr. FIELDING. Yes, it does.

Senator BENTSEN. Do you think he should have?

Mr. FIELDING. Yes, definitely. However, I do not think that the small businessman should have the option of jumping back and forth.

Senator BENTSEN. Once he goes on a cash basis, he would have to stay on a cash basis?

Mr. FIELDING. Absolutely.

Senator BENTSEN. Well, that is obvious, I think; because he obviously would be able to escape a lot of taxes if he were able to do that.

Mr. FIELDING. He is not escaping. He is postponing.

Senator BENTSEN. All right, OK.

Mr. MCKEVITT. That question is asked of us quire a bit, Mr. Chairman. That is why he wanted to respond to it, because there have been some assertions that there would be an opportunity to do that. We do not request that.

Senator BENTSEN. Now, how did you use the term "indexing"? I did not quite understand this. The variables to indexing——

Mr. FIELDING. Indexing the tax rate to the cost of living.

Senator BENTSEN. To the cost of living?

Mr. FIELDING. Yes, and this is another innovative measure that they have adopted in Canada.

Senator BENTSEN. Yes. I am familiar with the Canadian system. What are the arguments against treating a subchapter S as a partnership, as a straight partnership with the same limitations?

Mr. FIELDING. I cannot see any arguments against it, Senator Bentsen. It would simplify the subchapter S quagmire tremendously, and in essence this is what we are trying to accomplish. We want to tax the corporation as though it were a partnership, and yet we have all of these complicated elections, pitfalls that an individual gets into when they change shareholders. They do not know that they have to reaffirm the election, and all of a sudden they have lost it.

Senator BENTSEN. Where the trust is considered as a partner, and all of that?

Mr. FIELDING. Yes, exactly.

Senator BENTSEN. I have been is some of those. Thank you very much, gentlemen. We appreciate it.

Mr. MCKEVITT. Mr. Chairman, a final point if I could, please.

Senator BENTSEN. Yes.

Mr. MCKEVITT. First of all, we are extremely appreciative with the limited jurisdiction of Small Business that Senate Finance has been so gracious as to work to hold joint hearings, and our membership is quite aware of that as well. And No. 2, on a final point, which might ease your concern a bit, Senator Humphrey will have the last word this afternoon in a closing session at 3:45.

Senator BENTSEN. Senator Humphrey usually does.

[General laughter.]

Senator BENTSEN. Thank you very much.

Mr. McKEVITT. Thank you, sir.

Senator BENTSEN. May we now have Dr. Edward Shils and Dr. William Zucker come up, please.

STATEMENT OF DR. EDWARD B. SHILS, CHAIRMAN, DEPARTMENT OF MANAGEMENT AND THE WHARTON ENTREPRENEURIAL CENTER, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, ACCOMPANIED BY DR. WILLIAM ZUCKER, ADMINISTRATIVE DIRECTOR, WHARTON ENTREPRENEURIAL CENTER

Dr. SHILS. Mr. Chairman, Senator Hathaway, I am Edward B. Shils, the chairman of the department of management at the Wharton School of Finance at the University of Pennsylvania, and also chairman of the Wharton School Entrepreneurial Center. My colleague is Dr. William Zucker, who is the administrative director of the Wharton Entrepreneurial Center, and adjunct professor of management.

I would leave, Mr. Chairman, to speak informally. Would you grant me permission, please, to put my formal statement on the record. I think copies have already been distributed.

Senator BENTSEN. Dr. Shils, that would be helpful. We have a number of witnesses yet to be heard this morning, and the Senate is in session, so we could be called away from here. So, if you would give us your complete statement for the record, if both of you gentlemen would, and then if you would summarize, we will open it up to questions.

Dr. SHILS. All right.

[The prepared statement of Dr. Shils follows:]

Statement Before

SELECT COMMITTEE ON SMALL BUSINESS

United States Senate - Hearings on Taxation

June 18, 1975

Dr. Edward B. Shils, Chairman
Department of Management and
the Wharton Entrepreneurial Center
The Wharton School
University of Pennsylvania
Philadelphia, Pennsylvania 19174

We recognize and appreciate the work of the Select Committee and its concern for the future role of small business in the economy of this country. Over the years the foundation of our economy has been based on the strength and maintenance of small businesses - those who have been willing to risk all and perform mightily, those who have added to the technological know-how of the country, those who have given large amounts of employment, and those who have given strength and credibility to our free enterprise system.

It is not necessary for me to recite to this Committee since it already has the factual data on the high rate of failure in the ranks of small businesses. Part of this is due to the lack of managerial skill and the other to the inability to obtain capital and retain capital in the maintenance and expansion of these businesses.

In the area of capital, taxation becomes a key factor, namely, whether alternative strategies are available for the investment of capital into new businesses and

whether capital can be retained once it has been earned by the entrepreneur. This is a most appropriate time for the Congress under this Committee's leadership to examine into the areas that should be revised with reference to taxation as they apply to small business.

The economy of the country appears to be bottoming out although from all indications as set forth by the Wharton Econometric Unit the bottoming out process may take longer than many anticipate. Wharton's econometricians foresee almost no growth through 1975. Moreover, the Wharton experts expect a sub-par performance right into 1976.

While inflation seems to have been slowed and employment and unemployment are increasing, the economy still generates inflationary forces of its own. 1974 productivity in the private sector was 2% less than a year ago. Compensation per man hour was up 8.5%. Unit labor costs were up 10.8%. This trend will continue unless the economy is allowed to grow. Fortunately, the high interest rates which afflicted the economy during the latter part of 1974 have dropped appreciably and the high mortgage interest rates have diminished somewhat so that the housing industry appears to show some small increases. However, there are still indications in capital spending in areas where expansion and cost cutting investment are badly needed.

In the past, American industry has been able to outproduce its competitors. Those days appear to be fading because other countries have made more aggressive policies to promote capital investment.

The record of capital investment in the United States since the 1960's has been the worst of any major industrial nation in the world. On the average, between 1960 and 1973, the U.S. has put about 14% of its gross national product into new plant and equipment, while Japan was investing 29% and France and Germany about 18-20%.

As a result, we have an overaged and obsolescent industrial machine. Only 30% of Japanese metal-working equipment is over ten years old. In Germany it's 35%. Here in the U.S., 67% of our metal-working equipment is more than ten years old.

With such antique machinery and such a low rate of modernization and expansion, is it any wonder that productivity in these competitor countries is increasing two or three times as fast as it is in the United States?

A study completed a year ago by the New York Stock Exchange determined that U.S. investment capital requirements from 1974 through 1984 were 4.7 trillion dollars allowing for real growth in the Gross National Product at the annual rate of 3.6% and a 5% rate of inflation. In constant 1973 dollars, the sum required for capital formation would be roughly 160% of the amount spent in the preceding period of 12 years. On this basis, the report found that there will be a deficit of 650 billion dollars. That does not take into account the results of the deterioration in the capital market.

Banks themselves in many instances may be hard put to raise equity capital for their own use; those that can't - just like other businesses - may be forced to merge, retrench, or disappear. Economic power may increasingly be concentrated - as it is

in Europe and Japan - in a decreasing number of big, money center banks. And if the security industries distribution system is so enfeebled that it can no longer raise capital efficiently for major corporations, or capital raising for emerging businesses, the big banks may again become, as they were before the Glass-Steagall Act, the major underwriters of corporate securities.

The market's weakness is due primarily to the soaring rise in interest rates. The enormous yield available on debt instruments make it extraordinarily difficult for equities to catch the investor's eye.

While the short term rates have come down significantly, an almost equally impressive majority of analysts think long term rates will stay within close range of the highs which were so distressing last year. The reasons are quite simple. Inflation continues to provide a base on top of which the interest rate structure is built. As long as inflation stays above 5%, there is precious little prospect of rates on good quality debt instruments dropping much below 9%. It should also be remembered that when we talk today of the prime rate at somewhere under 7% that this is the rate charged to the bank's best corporate customers. The small businessman, when he goes to the bank, must pay three, four, or even five points above the prime rate to get short term debt.

With this severe capital shortage, what are some of the feasible courses to follow? For the government, there is one, if it is genuinely interested in curbing inflation. There will have to be a reordering of our national priorities. Inflation cannot be nickeled and dimed to death.

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Actually, the choice may not be one of eliminating inflation but curbing it and learning to live with a high rate of inflation (even with the needed establishment of a national budget priority) or a financial crisis, followed by a deep depression if the cash drought is not eased. For the national administration to await developments before determining its policy on money supply until after the fact is not to delay the inevitable, but to invite it. Economics, like nature, abhors a vacuum and fills it quickly.

For the small businessman one of the areas should be the reordering of tax legislation, not on a piecemeal basis, but on a scale which will have an impact on the operation of the business and the investment in more capital goods to increase productivity and profits. It is necessary to give the private investor an incentive to return to the market. Such an incentive might be a restructuring of the capital gains tax. Another way would be to increase the deductibility of capital losses and to reduce the liability on capital gains which are truly long term. Another area for tax reform might be the institution of ways by which it would be attractive for corporations to provide venture capital to new ventures. Additional incentives for capital improvement and depreciation allowances should be reviewed.

But in all these areas it is necessary to understand the impact of tax legislation on the national economy and the national revenue needs. To approach taxation on a piecemeal basis is not to be totally effective or to respond in a meaningful fashion to the needs of small business or the country as a whole.

We strongly urge that the Senate institute a long range tax study to determine how it might be possible to utilize the tax laws and to understand the impact of tax legislation not only upon national revenues, but upon the operations of the small business

in such a way as to make certain that having made an imput at one end, reforms are not self-defeating at another.

The Wharton Entrepreneurial Center, which is part of the Wharton School of the University of Pennsylvania, is concerned and was established to assist in developing greater productivity and greater profitability for small business and all business in the United States. If we can be of assistance in this regard, we hope that the Committee will utilize our services.

Dr. SHILS. I might say it is a privilege to be here. We know the important work that your committee and your subcommittees are doing. It is not the first time that I individually have been involved with the Senate Small Business Committee. In the middle 1950's, the Senate committee asked me to make a study of State development credit corporations which were then emerging under the New England model and to compare what their services, requirements, and regulations were vis-a-vis the Small Business Administration.

As a result of my report to the then-Senate committee, a great many changes in the way the SBA related to ultimately SBIC's and working with the State development corporations. Our entrepreneurial center at the Wharton School is very much involved with stimulating the development of small business and aiding small business. We have an interdisciplinary staff of faculty, most of whom, like me and Dr. Zucker, have had experience on the outside with small business. For example, for the last 25 years I have served continuously as the Secretary of the Knitted Outerwear Manufacturers Association in Pennsylvania, a group of 60 knitting mills; also as the Secretary of the Dental Manufacturers of America, a group of 40 small firms manufacturing dental products; and also the Dental Dealers of America, a group of 100 dental supply houses.

Dr. Zucker, before he came to the university, was the president of the Southeastern Pennsylvania Economic Development Corp., a type of quasi-public organization which lent money to small business and helped generate many of the payrolls today in Philadelphia in the apparel and metalwork industries, which have helped keep Philadelphia going despite the flight of manufacturing from our city. So, I might say, we are very practical in our role. For example, both our graduate students and our faculty are working with minority businesses in the Philadelphia area and eastern Pennsylvania, and have taken on a role of training clients for the Small Business Administration.

We are likewise acting as an outpatient clinic for many of the small and medium-sized businesses in America, and yet we also recognize that large business is important too, because we are concerned with what we might call productivity problems in America, inflation, rising unit costs, and the difficulty to compete with other nations of the world.

Now, the emphasis on productivity and costs was borne out in my mind just recently. I interrupted a stay in Cincinnati, where I was a member of an international symposium on entrepreneurship and enterprise development, which began Sunday night in Cincinnati, and will go on until the end of the week. Now, we had 330 delegates interested in small business coming from 46 nations of the world, so that actually I was sitting next to delegates from Sweden, Iran, West Africa, Switzerland, the Philippines, Nicaragua, West Australia, many western nations, but many, many small nations and nations of the so-called third world. All of them are interested in just what we are interested in and have the same problems of capital allocation productivity, inefficiency, and concern on the part of their governments and their chambers of commerce.

One of the things that I think you will be interested in was something that came to me at a session yesterday, which is not in my

written paper, but which I would like to add to my testimony. That is the fact that we are now beginning to look at the impact of small business on employment, on payroll, and on the health of society from a regional point of view, and we find, based upon the record, that those regional areas which have benefited the most by capital stimulation have been those to which there have been a heterogeneous type of industry developed. Many small businesses coming in have been much more effective in stabilizing communities than a so-called large company, one-industry community.

We really need to stimulate individuals. We not only need the financial incentives, which were very well pointed out here, but we also need the psychological incentives and the motivations which come with seeing the credibility of success. It is a lot easier for us to generate payroll by seeing a small business that becomes successful through the help of the community and the help of our National Government, and through good training and availability of capital; because this is replicated many times in the community. The feeling is if they can do it, we can do it. But, that is not so true when one large business comes into a community.

So, more and more talk is for us to really create balance, and I think this was probably commented on yesterday in your testimony when you heard from the Texas Industrial Commission; that this idea of balance is recognized by delegates throughout the world. If we are going to have communities that are healthy economically and socially, we have got to have a lot of small business. Furthermore, small business, for every dollar investment, generates a lot more in the way of payroll and employment than large business, primarily because small business starts out in its early stages as being more highly labor intensive.

Let me say this, gentlemen, that public officials, whether they be local, State, or Federal, find by the examples of credibility that once they have two or three successes in the community in small business, that everyone believes they are showing real concern for the future of our communities and of our Nation.

Now, as was pointed out earlier, and which you in your own comprehensive remarks noted, Senator Bentsen, you talked about the fact that one of our great problems in this country is the fact that there seems to be some indication that we are falling behind other nations of the world in terms of obsolescence, relative obsolescence of machinery and equipment. I do not mind saying that this is happening in great part because of the fact that we do not have the ability for small business to retain earnings; we do not have the ability to provide availability of capital; and, as you indicated, we also have the problems of today which is limited in raising funds through securities, and so forth.

Now, I have some data which I would like to put on the record in which I think you would be interested, and the members of your committee. For example, I can state, and later we can give you the authority, if you wish, that America's equipment is becoming more obsolescent, and it is particularly true in those industries which have high labor intensity, and which are characterized by small business. One of them, the metal working industry, for example, in the United States, metal fabrication—for example, in the United States, 67 per-

cent of our metal working equipment is more than 10 years old. That is 67 percent. In Germany it is only 35 percent, and in Japan only 30 percent, which certainly puts us at a real disadvantage.

Now, you can see why the fact is that in our private sector that our productivity has declined, I think, 2 percent in the last year. I think we do not have the kind of productivity record that we had in years bygone.

Now, in a study that was made a year ago by the New York Stock Exchange, in looking ahead at our capital needs for the Nation as a whole—I might say my remarks are more macroeconomic—we have worked with businesses, we understand their problems, we agreed with some of the statements that were made before. But, I think on the record, we must look at the macropicture. For example, in the next decade, we would need $4.7 trillion in order to meet the U.S. capital requirements.

Building a model which would allow a real growth in GNP of 3.6 percent a year, and at a hopefully contained inflation rate of 5 percent, and looking at this in constant 1973 dollars, we would require 160 percent of the amount that we spent in the last 12 years; namely, 1962 to 1974. The best estimates that we can get—and I might also say that we have talked to our own Wharton School econometric forecast group about these figures—is that if the capital markets do not deteriorate further, there is going to be a deficit of $650 billion in the next decade in reaching this capital fulfillment, or about $6.5 billion a year.

This is a rather serious thing to all of our business in America, but it is catastrophic to small business. Now, can the small business people go to the banks. The banks have shown that they do not even have the ability to raise equity capital for themselves, and that too many of them today are beginning to merge and retrench and disappear. Ultimately, what we see is the evolution of big money-centered banks, which are certainly going to be centers of concentration and not particularly responsive to the needs of our friends in small business.

The stock market, as you said very well, Mr. Chairman, is enfeebled. They cannot even raise capital efficiency for large corporations as well as for emerging business, and unless we amend the Glass-Stiegle Act, we are certainly going to find that there will never be anything in the nature of underwriters of corporate securities.

Now, we know what has happened with the short-term interest market. It is becoming reasonable; but nevertheless, our best estimates are that long-term rates are going to remain high. And, as long as inflation stays above 5 percent, we are going to find money finding debt instruments which pay 9 percent yields, rather than to provide the kind of equity capital for financing inventories and working capital for financing the kind of capital needs that we need.

Despite the fact that the interest market and the prime rate has fallen to about 7 percent, we know from our clients that small business has to pay 4 and 5 points more than 7 percent if they go to the bank for money; that is, if they are lucky enough to get a loan at all because there is a tremendous amount of selectivity. Many banks do not want any more new business of this sort.

What can we do? Congress is doing its best, I know, to consider problems of reordering national priorities to curb inflation. That will

certainly be a help to small business. We no longer can nickel and dime it to death; and if we cannot curb it altogether, however, we have to learn to live with it.

In a cash drought, which at present we find in our recession, living with it is pretty tough. Economics, of course, like nature, abhors a vacuum, so something has to be done. It seems to me that some of the comments that have been made by the Senators here today make me feel that something will be done.

In general, our feeling is that tax legislation ought to be reordered for small businessmen. But, it ought to be done in a total fabric, not by constant amendments of small pieces of business; for it to be done on a scale that will have impact on the operations of our small businesses it should be done in such a way that there will be investment in more capital goods and with the opportunity to not only generate profits, but to retain it.

We also need to get the private investor somehow, to give him incentive to return to the market. This, of course, could lead to such a result, by perhaps a possible restructuring of the capital gains tax.

Also, we might bring up the thought that there could be an increased deductibility in terms of capital losses, and perhaps on capital gains which are truly long-term, there perhaps ought to be a reduced liability. We have to make it attractive; institute ways and means to make corporations with capital to provide venture capital for new businesses; because, the truth of the matter is that the only money that is available today in many cases is in those large corporations that have been able to fund their operations.

Now, my own caveat is this. Again, let us not approach it on a piecemeal basis. We have to have the entire fabric of the impact of a program on small business and on operations, and actually we would urge you to institute a long-range tax study to determine how it is possible to use the tax laws to understand not only the impact of tax legislation on national revenues, but also on the operations of small business, and so that these reforms will have a continuous input at one end and are not self-defeating at the other end.

We at the Wharton School at the present time, perhaps, are only helpful in identifying some of the questions; but we do stand ready and available to do the kinds of helpful research which perhaps we could do if you were interested in calling on our university.

I would like to introduce Dr. Zucker and ask him if he has any comments.

Senator BENTSEN. Dr. Zucker?

Dr. ZUCKER. Senators, I want to maintain this material at the macrolevel, as Dr. Shils has. We have talked with a number of businessmen in the area and from our own analysis of the problems we would not want to come here with a series of recommendations, but merely to outline some of the major areas that we think are rather endemic to the situation.

Dr. Shils has pointed out some of them. I would merely like to highlight some others with respect to financing to high capital costs, and then in the retailing field which, by the way, has not been mentioned, since this also is a very important area in the whole field of small business.

Just briefly, our group would like to suggest that in a period of tight economic activity, the ability of small businesses to obtain financing is indeed very limited. Now, there has been some suggestion that there ought to be some sort of a dual level for prime rates—one for small business, and one for large business. Quite frankly, we are not sure that this would indeed be an efficient use of our money market. It might indeed interfere with the operation of the money supply. However, it ought to be looked into and to find out what the economic effect would be. We feel, for example, as Dr. Shils has pointed out, that since the banks are not in a position or willing to make loans to small and therefore sometimes more risky ventures, that some of these institutions are unwilling to do so because they feel that their bad debt ratios would be increased considerably.

Therefore, it might well be something this committee might look into, to find out whether there should be some kind of provision for increasing the bad debt allowance for lending institutions; perhaps also for longer carrybacks and carryforwards, so as to provide additional incentive for lending institutions to make these kinds of loans.

In terms of the small business itself, I think that there should be, because small businesses are so affected by the economic yo-yo effect, they are in troughs and peaks, that there should be some better way of the loss carrybacks and the carryforwards. There should be a more comprehensive analysis given to the depreciation provisions which this committee and the chairman has looked into, and also perhaps greater incentives for the investment tax credit than even now has been given by this Congress and by the Administration.

When we come to the problem of high capital costs, the question is whether it is possible to have some sort of subsidy to be given for capital by the Federal Government to provide additional capital for both working and for investment by small business. We are not sure whether this would even be a desirable thing in the long run; but certainly in the short run it would be of great advantage to the small business.

There should be, we believe, some change in the tax structure which would enable the firms to hold on to their capital because at the rates they are being taxed now, there is no chance for a small business to retain that capital and to generate that kind of capital from within their own firms.

There are a number of other possibilities which will be presented to your committee; but last, I would merely like to mention the problem of the retailer. He is one who is also one of the major backbones of small business, and some effort or study should be given to the possibility of averaging incomes in some fashion in order to provide again for the peaks and valleys which are there. The whole problem of LIFO and the effect of that upon the retention of their capital is indeed another item which is important.

With these brief comments, I would like to conclude.

Senator BENTSEN. Thank you very much, gentleman.

Let me ask this question; I know we have had some help from the Wharton School on a number of economic problems but what specifically is the university doing on studies that would be of assistance to the Congress in writing small business provisions for inclusion in the forthcoming tax legislation?

Dr. SHILS. Well, I can think of one which we are involved with today in which an interdisciplinary faculty of the Wharton School and the Architecture School and city planning were working on a project of writing about six position papers for the Urban Land Institute on the general subject of community development in the United States.

And you know that community development in the United States which has to do with industrial development, commercial development, housing, and whatnot; the byproduct is an awful lot of employment on the part of construction workers throughout the United States.

We have a serious problem today of having many small builders who have gone by the boards because of the high cost of capital and because of other relative problems. But in our position papers, for example, we are studying the impact of energy, regulation, demand, labor, and these position papers, about a month ago we presented them before several hundred delegates to the Urban Land Institute meetings in Chicago. They represent mostly, I would say, small business people from every part of the country. And they were encouraged by the fact that out of this particular piece of research we may come up with a program that identifies the problems in terms of hopefully securing a balance between private enterprise, and community development, and public confidence, and support.

And if we look ahead, for example, to the next decade and see how many houses that we are short and where the employment has been over the years in the construction industries and the stabilizing of communities and the philosophy of what kind of community we should have, we see that here, in effect, is a study of small business that has fantastic impact on the health of our entire United States.

So that this is a typical kind of study that we are doing right now and hopefully this will lead to recommendations to Congress vis-a-vis the role of the private entrepreneur in development and the Government.

Now, there are others that we are doing but I thought this might be a typical kind of thing. In fact, when we leave here we are continuing over to the Urban Land Institute to talk about our progress on this report.

Incidentally, Mr. Chairman, I thought you might like to have a copy of this program where the 46 nations attended at Cincinnati and the subjects that they are interested in and cognizant of, just in line with what you are doing. I am going to leave it with you, if I may.

Senator BENTSEN. I would be delighted, Dr. Shils, and I appreciate that.

I certainly agree with you that we ought not to just piecemeal this tax legislation. We ought to look at it more in total and try to develop something which would bring about savings, incentive on savings, and not a penalty on savings as I think we have in the present tax structure.

Senator Curtis?

Senator CURTIS. Thank you, Mr. Chairman.

I was interested in what you said about two rates of interest, one for larger concerns and one for smaller ones. Would you elaborate on that, as to how you would bring it about?

Dr. ZUCKER. Well, there have been a number of suggestions, some suggestions have been that there be a subsidy of the prime rate so that the prime rate, which as you know is that rate which is charged the

bank's best customers, is at one level and as Dr. Shils has pointed out for small businesses it is anywhere from three to five points higher. Now that three or five points higher might be subsidized or it has been suggested that it be subsidized by the Federal Government in some way.

And what I am saying, and what we are saying is that we are not even sure that that is even a good thing because that puts into the structure of our capital needs a disfunction which very well might be a long-range effect and then, from then on, you have this strange dichotomy between what a small business pays and what a large business pays rather than allowing the capital market to operate as it is.

Perhaps a better way would be to have some sort of a reinstitution of the Reconstruction Finance Corporation which might, we say, give more help to the small businesses where the RFC at that time was more interested in the large businesses.

Senator CURTIS. Now, if you use an RFC vehicle they would have to make all of the loans to the small business in order to make the proposal effective, would they not?

Dr. ZUCKER. That is right, sir.

Senator CURTIS. And if you followed the subsidy route you would have to pay a subsidy to all lenders?

Dr. ZUCKER. That is right and that is why we are saying that we are not even sure, but this has been suggested by a number of economists. It has been suggested by people both in and out of Government.

Senator CURTIS. Do not those people realize if you pay subsidy out of a general fund it increases the deficit, makes it that much more impossible to get any tax revision? We need tax reform primarily to relieve injustice and primarily to spark our economy. So any worthwhile tax reform means a lessening of the revenue.

Now, if you go on with proposals to increase the expenditures and increase the debt, you are just throwing more roadblocks into any effort for tax reform. Frankly, I am very much disturbed about tax reform because of the abuse of the term. I turned on my television during the last presidential campaign before the nominating conventions and I heard audiences told, we need tax reform, there are great numbers of people that are not paying anything. The Congress has created so many loopholes that they are not paying anything, you are paying too much, we need tax reform.

Well now, that notion that you can find money someplace else from someone that is not paying anything and lower everybody's taxes and still have money to run on is a very false doctrine. The last few so-called tax reform bills that we have had have not done anything for business. They have taken the load off of individuals of several billions of dollars and put it on business.

Now, I am for genuine tax reform, but I think there has to be an understanding of what it is. You have got to grant some relief to have genuine tax reform and the last two or three so-called tax reform bills we have had in here have left private enterprise and small business worse off than before the bills were enacted.

I would like to ask you, in reference to attracting venture capital, if we could do something to eliminate the double taxation of dividends? Would this be an incentive, in your opinion, for attracting equity capital?

Dr. SHILS. Very much so, Senator Curtis.
Senator CURTIS. Do you have any idea as to how the best way is to make a start on that?
Dr. SHILS. No, I do not think I could answer that here today. I am not really prepared to speak to this type of specific, but I agree with you, I do in general, but it certainly is worthy of real consideration.
Senator CURTIS. I think it is of utmost importance but I think that it is very doubtful for the moment, disregarding the deficit, I think it is very doubtful if you can get any such proposal through the House and the Senate at this time.
The economic thinking is of a different philosophy. But it would be my hope that if we could not afford to exclude all double taxation that at least we could do something in that direction and make it progressive.
Here is another question I would like to ask. If the larger companies were able to raise equity capital in an easier manner would this take some of the pressure off of smaller firms in the debt market?
Dr. SHILS. The answer is yes.
Senator CURTIS. Keeping in mind that any real relief means lessening of revenue, what would you put down as the most practical and the best and easiest way of assisting small business in the tax field? What would you start with?
Dr. SHILS. Without getting into a specific measure, I would say that the purpose of whatever you would do would be to create the opportunity for retained earnings. In other words, when I look at small business and I look at a continuum in which maybe it is going on a second, third, fourth, fifth stage of enlargement and expansion and it is in the early stages that they can somehow hold onto the money that they have raised themselves and use it and save it and cherish it. I think that is the important thing.
Senator CURTIS. To be able to reinvest the funds on their own?
Dr. SHILS. That is right.
Senator CURTIS. In the long run, that should increase their revenue?
Dr. SHILS. It will. It is going to generate companies that would be more successful and more perpetual and provide the kind of—well, I think you are really interested not only in the survival of the business itself into perpetuity but what it can do for social stability in the community represented by the business.
Senator CURTIS. Now, at the present time, individuals do have a method that they can average their income for tax purposes. Is it not true that that is available to individuals who are owners of a corporation that avails itself of subchapter S treatment?
Dr. SHILS. I am not familiar with that particular revenue law.
Senator CURTIS. I think it is.
Dr. ZUCKER. That is true but subchapter S has certain disadvantages with respect to size and with respect to the kinds of industries in which they can be involved.
Senator CURTIS. Yes, and we very definitely need some simplification; it is sort of a trap that people think that they have certain benefits, and they find that they have not made it by a certain election, by a certain time, and Congress must do something with that.
But when you suggested averaging the income, you meant for small corporations?
Dr. ZUCKER. Exactly, sir.

Senator CURTIS. In other words, do something for them like is being done for an individual now?

Dr. ZUCKER. Exactly, sir. Now please understand, Senator Curtis, I hope that you would also, in the coming weeks and months, give some special attention to the estate tax. The estate tax has not been revised for many, many years.

Small businesses and farms, it is very true in the farm and ranch country, the burden of the estate tax is so great that the business or the farm has to be sold and too often there are no individuals to buy it. It is purchased by a larger concern.

I happen to think we need large businesses as well as small businesses, but I do not think the Government should follow a policy to deliberately encourage the ending of small businesses and sale to larger concerns, because that moves in the wrong direction. It moves toward monopoly and less competition.

Have you any recommendations in reference to the estate tax?

Dr. SHILS. I agree with your general thought and I would like to support a study that would indicate what the impact would be.

Senator CURTIS. Well, I think if we had the votes we do not need a study because it is quite evident that there are people all around us and even small communities where widows and everybody else are having to sell out in order to pay the estate tax.

Dr. SHILS. Senator, we just completed a study for the Young Presidents Organization of 20 companies that were small companies that were acquired by larger companies and we are trying to find out what the reasons were for wanting to sell.

And then, of course, we examined what their postacquisition satisfactions were vis-a-vis their expectancies. And many of the firms, because of the inability to survive that estate tax situation, were actually acquired and sold in our study. We actually did find them firm by firm.

Senator CURTIS. In reference to a different problem, do you think that the first few years of a new business are the toughest ones for it usually?

Dr. SHILS. Well, it is a different kind of toughness. In the first few years you have the problem of survival which in part is entrepreneurial, in other words, it is the ability to preserve cash and get cash. But the next few years, you have the problems of management where the entrepreneur must actually organize his program and delegate as he begins to find his growth requiring it all.

But it is the first few years, when you are just about ready to move from stage one to stage two where you really need the capital to do what you want, it is either that or go down.

Senator CURTIS. Well, we have many witnesses to hear. Just one more brief question, I hope you can make your answer brief. It has been suggested that for the first, say, 3 years in the operation of a company, they be given an unlimited carry forward of net operating loss in order for them to have a greater chance to recoup that expense that it takes to initiate a new business and to acquaint the public with the products and to have the shakedown run on their processes and so on. Do you favor such a thing?

Dr. SHILS. I would favor that. That would help tremendously provided it was part of a total picture situation rather than just a piece of this and a piece of that. That should be part of the total picture.

Senator CURTIS. I disagree with you a little bit. I think if we wait for a massive tax reform bill that it will be a heyday for everybody and that business will come out worse. I think we should take some of these items and drive them through.

Dr. SHILS. Well a little good is helpful and needed.

Senator CURTIS. Thank you very much.

Senator BENTSEN. Thank you, gentlemen, thank you for your testimony.

For our next witnesses we have a panel of presidents of the four major regional small business organizations, Mr. Oliver Ward, Mr. John Hannon, Mr. Edward Richard, Mr. Bruno Mauer, if you gentlemen would come forward, please.

Gentlemen, I understand we have changes in some of the names of the witnesses. If you would each identify yourself for the record, please.

Mr. MAUER. Bruno Mauer, president of the Independent Business Association of Wisconsin.

Mr. McDONALD. I am Charles McDonald. I am chairman of the Federal Legislative Committee of COSE and I am sitting in for Ed Richard, who will present his testimony tomorrow.

Mr. MURRAY. I am Ralph Murray. I am the vice president of the Smaller Manufacturers Council, and I am sitting in for Jack Hannon.

Mr. PENDERGAST. I am Edward Pendergast, a CPA and a tax specialist, and I am past president of the Smaller Business Association of New England.

Senator BENTSEN. Where are you from, sir?

Mr. PENDERGAST. Boston.

Mr. WARD. I am Oliver Ward, president of the Smaller Business Association of New England.

Senator BENTSEN. If you would proceed, Mr. Mauer.

And, gentlemen, if you would summarize your statements, please.

Mr. WARD. We are going to start on this end.

Mr. MAUER. If we may, Mr. Chairman; he is going to introduce the subject material, if that would be all right with you.

Senator BENTSEN. That is all right.

STATEMENT OF OLIVER O. WARD, PRESIDENT, SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND

Mr. WARD. I am Oliver Ward, president of the Smaller Business Association of New England.

First, we would like to express our appreciation for everything that you have done, in terms of the Tax Reduction Act of 1975. We strongly believe that we would not have seen that in the form that it was if it had not been for you refforts. The administration originally proposed a program that would have given 75 percent of the tax relief to the 5,000 largest corporations in America, and after it succeeded in coming through Congress, those benefits were spread over all profitable corporations in the country, and for this we are exceedingly grateful.

We are here testifying as a panel from four regional associations, SBA, the Independent Business Association of Wisconsin, the Council of Smaller Enterprises in Cleveland, and the Smaller Manufacturers Council of Pittsburgh. What do we have in common? We are highly participative organizations. We are dedicated to helping the small

businessman be a better businessman. For example, at SBANE during the course of the last year we brought twelve 1-day seminars on programs as diverse as cashflow, financial principles for the nonfinancial executive, the art of professional selling, in addition to which we run two 3-day live-in seminars, one at the Harvard Business School, one at the Business School at Dartmouth.

We are a grassroots political movement. We seek recognition, and we are working together in an effort to educate the Congress as to the needs of small business. We represent small- and medium-sized business. I think, all too often, that it is not recognized that there is a medium-sized business. That is more often recognized in the countries in Europe, particularly in France, Belgium, and Germany, that there is this sector of the economy.

Medium-sized business is typically from 20 to several hundred employees, and to a large extent this is the economic backbone of the country. This is the area where competition is the greatest. This is where lower prices are brought forward, higher quality.

We are concerned about the declining share of small business in America, not so much from a personal point of view, for those of us who are in it, but from the point of view of those who are not in it yet, the new business formations. In 1961, one out of every four people in this country worked for either the Government or big business. That number is now raised to one out of three. We do not think this is healthy for the country. The economics of scale are overrrated, and the opportunities for abuse are manifest.

In Senator Church's Committee on Multinational Corporations, we are seeing activities that are truly frightening being carried on by some of the larger corporations.

Independent and small business, due to its nature of being small, fragmented, and diverse, does not accumulate such power. This is an advantage for the country in man instances. Unfortunately, these same characteristics are disadvantageous politically for small business.

We are concerned today with the topic of capital formation. As Assistant Secretary Frederic Hickman, as he testified before this committee several months ago, pointed out, what we are concerned about is the difference of whether a man will go to Jamaica or invest his money in American business. With the Government in the next year pulling out the enormous amount of money that it will be to finance the deficit, it does not leave very much to go around. There will be tremendous competition for that remaining money in the money market.

Small business typically has an enormous difficulty in raising money through debt. Last year, we saw most small businesses paying prime plus three or four points, which meant in effect, a 15- to 16-percent interest rate. It is virtually impossible today to raise equity money. Last year, there were eight Reg A's, offerings of under $500,000.

Venture capital is scarce. There is no venture capital for startups. There is a high degree of selectivity. When a deal is finally made, usually the venture capitalist winds up with a deal that involves greed beyond dreams of avarice, in terms of the percentage of the company he takes for his investment.

The particular topic that I would concern myself today with is long-term capital gains. This has been touched on earlier this morning.

Let us take a man who made an investment in 1940 of $50,000. Over the last 35 years, there is blood, sweat, toil, and tears, and an enormous amount of luck and success, and the investment is now worth $300,000. He is taxed on a gain, if he sells that business, of $250,000. If he lives in Massachusetts, on the first $50,000, he pays an effective tax rate of 34 percent, and on the amount over $50,000, of 44 percent. He pays on his $250,000, in effect, a tax of $140,000.

Let me go back on that. On the gain of $250,000, he is taxed on the first $50,000 at 34 percent and 44 percent on the balance of $200,000, for a total of $105,000.

Senator BENTSEN. Have you put your preference tax in there too?

Mr. WARD. That is why the balance over the $50,000—he then, in effect, gets back, for his investment, $195,000. If you take the wholesale price index between 1940 and the present, it has gone up 429 percent; in effect, he needs to get back $200,000 to have his original buying power back. He, in fact, has been taxed, on a nonactual gain, in terms of buying power.

We suggest one of two solutions to it—either indexing the base where, in effect, each year—for example, last year, the inflation rate in the country was 11.8 percent—in effect, the base would be indexed by this amount. If his base were $50,000 last year, his base would go up by the 11.8 percent, so that he would not be taxed on that inflation factor. It would be not until he came to a real gain that he would pay the tax.

The second alternative we suggest is to change the capital gains structure to recognize that a longer held investment should be taxed at a lower rate. We have suggested in our presentation to Congress 2 weeks ago that the base period be raised from 6 months to a year; that between 1 year and 5 years, the tax rate be 35 percent; between 5 and 10 years, it be 25 percent; and that after 10 years, it be 12.5 percent. This actually has a benefit to Treasury of a probable pickup because an enormous number of investments now are locked in, and have been held for a long period of time. They will get hit with this preference tax; they will pay the higher rate; they are waiting basically for death and a new basis. As a practical matter, an enormous number of investments that have been held for years will be freed up and as a result, Treasury will, in the near years, pick up.

I would now like to pass it over to Mr. Pendergast, who will talk about the surtax exemption.

[The prepared statement of Mr. Ward follows:]

STATEMENT OF

OLIVER O. WARD, PRESIDENT
GERMANIUM POWER DEVICES CORPORATION
ANDOVER, MASSACHUSETTS

AND PRESIDENT OF THE

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.
69 HICKORY DRIVE
WALTHAM, MASSACHUSETTS

HEARING

COMMITTEE ON FINANCE
SUB-COMMITTEE ON FINANCIAL MARKETS
AND
SELECT COMMITTEE ON SMALL BUSINESS

UNITED STATES SENATE

WEDNESDAY, JUNE 18, 1975

Messrs. Chairmen and Members of the Committee:

First, we of the Smaller Business Association of New England, the Smaller Manufacturers Council of Pittsburgh, the Council of Smaller Enterprises of Cleveland, and the Independent Business Association of Wisconsin, would like to express our appreciation for your efforts on our behalf with reference to the Tax Reduction Act of 1975. We are convinced that without your help, we would not have seen that Act in the form we did.

Whereas the Administration's proposal would have given 75% of the corporate tax relief to the 5,000 largest corporations, namely those with income over $1,000,000, the act actually spread the relief over all corporations which pay federal taxes this year. For this we are exceedingly grateful to you.

Today we are here testifying as a panel.

JUNE 18, 1975

What are the four regional organizations? We are highly participative. We are dedicated to helping small businesses be better businessmen. We are very active, towards that goal, in educational programs. During the course of the year, SBANE alone offers twelve one-day programs on such diverse topics as Cash Flow, Fundamentals of Accounting for the Non-Financial Executive, and the Art of Professional Selling. We offer two "live-in" seminars, one for three days at the Harvard Business School and one for five days at the Amos Tuck School for Business Administration at Dartmouth covering the basic disciplines of Marketing Strategy, General Management, Finance and Human Behavior, all critical in the running of a small business.

We are a coalition, a grassroots political movement seeking recognition of the unique problems of small business. We are working together to educate Congress as to these needs.

We represent small and medium-sized business. We wish to stress the concept of medium sized with reference to the small business community, those corporations with twenty or so employees to five hundred employees, the economic backbone of our economy. We note that most European countries, notably France, Germany and Belgium use the term small and medium-sized business. We feel that all too often only the largest and smallest businesses get attention from our government. It is from this medium-sized category of business that flows the intense competition, lower prices and higher quality, all essential to an efficient economy.

We are concerned by the declining share of business done by those other than the largest corporations. Whereas one employee in four in 1960 worked for either big business or the government, by 1975 that had reached one out of three. We do not view this as healthy for the country. We who are already in small business are not threatened as such. From the point of view of the country and the

JUNE 18, 1975

economy, we are concerned with the lack of new business formations. If small business, through a variety of machinations is not encouraged, the natural attrition of established small businesses, coupled with the proclivity of government and large business to grow, will cause small and medium-sized business to constitute a continuing declining share of employment.

The economics of scale are over-rated.

The opportunities for abuse are manifest.

Senator Church's Sub-Committee on Multinational Corporations of the Committee on Foreign Relations are producing disclosures of truly frightening activity.

Small and medium-sized,independent business due to its nature of being small, fragmented, and diverse does not accumulate such power. These very characteristics are both advantageous for the country and disadvantageous to small business in the political process where it comes to making small business' views known.

We are addressing ourselves today in particular to the capital formation issue. Assistant Secretary Frederic Hickman recently put it well when he said we must affect the decision made by anyone who is able to save as to whether he invests in the future growth of America or goes to Jamaica on holiday.

What affects that decision? Ultimately, that decision will be made on how attractive it is to be in a business or invest in a business, large or small. With the government about to pull huge amounts of money out of the marketplace to finance its deficit, interest rates will surely rise again. This will make for tough competition for what money is left. Large business, generally able to pass on its costs, including high interest, to the consumer, tends to be concerned more with availability than cost. Small business which frequently has its prices determined by market conditions rather than costs must absorb such increases. Last year interest rates for small business (usually at prime and 3 or so points) was paying effective rates of 15-16%. That is, if it could get money at all.

Equity through public markets is all but dead. Last year there were only eight Regulation A (under $500,000) offerings.

Venture capital is virtually unavailable, SBIC's and traditional venture capital sources will, in general, not finance start-ups. The latter are highly-selective and where a deal is finally struck, take a portion of the company with greed beyond the proverbial dream of avarice.

One of the key areas affecting the attractiveness of investment is the tax treatment of long term capital gains.

For purposes of example, let us take a man who made a $50,000 investment in a small business in 1940. Let us assume that with blood, sweat, toil and tears, and a certain degree of success, that business is now worth $300,000. When he sells that business he is taxed on $250,000 gain and that tax, at least in Massachusetts, is 34% on the first $50,000 in gain and 44% on the balance of $200,000, for a total state and federal tax of $105,000. That leaves him with $195,000 net out of the $300,000. In fact, to equalize the buying power of $50,000 in 1940, in 1975, he would need over $200,000 (consumer price index up 429% 1938-1975). So we find that at the same time our friend has been taxed $105,000 by his government's inflation, largely caused by the policies of these same governments, has actually reduced his purchasing power in spite of his apparent success. This does not seem fair to us.

We advocate indexing the investment which would have the effect of protecting the purchasing power of his investment. If indexation were in effect, our friend, would have paid a tax on the difference between the $200,000, which would have been his base of $50,000 indexed to $200,000, and $300,000 the selling price. This would have yielded a tax of $39,000 which, under the circumstances, seems fairer.

JUNE 18, 1975

As an alternative, we advocate changing the long term capital gains rate. We suggest extending the minimum holding period to one year. For one to five years we suggest a tax rate of 35%; 5-10 years, 25%; and over 10 years 12½%. This would have the effect of ~~somewhat inexactly~~ adjusting for inflation. It would also encourage long term productive investments. Also, with an eye to prospective eventual Treasury loss, we feel that it would be reasonable to limit such lower long term capital gains rates.

Either would benefit the prospects for investment in the "Jamaica or investment" decision made thousands of times each day all over America.

As to the consequences to Treasury, both would probably involve a net advantage over the next several years since many investors are now waiting for death and a new basis because of the present inequitable and not very sensible method of taxing long held investments. This freeing up would, according to most estimates, bring a net increase in revenue to the Treasury.

Thank you for the opportunity of presenting our views today.

STATEMENT OF EDWARD H. PENDERGAST, PAST PRESIDENT, SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND

Mr. PENDERGAST. Mr. Chairman, I would like to have my formal statement entered into the record.

Senator BENTSEN. It will be done.

[The prepared statement and attachments of Mr. Pendergast follow:]

STATEMENT BY

EDWARD H. PENDERGAST, JR., CPA

PENDERGAST, CREELMAN & HILL

236 LEWIS WHARF

BOSTON, MASSACHUSETTS

PAST PRESIDENT OF

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

BEFORE

SENATE SMALL BUSINESS COMMITTEE

AND SUB COMMITTEE ON FINANCIAL MARKETS OF THE SENATE FINANCE COMMITTEE

WEDNESDAY, JUNE 18, 1975

Mr. Chairman:

Thank you for this opportunity to discuss with you the tax rate structure as it affects smaller corporations. The material in this presentation can be outlined as follows:

1. Methods of Taxation of Business
2. History of Corporate Taxation
3. Small Business and the Surtax Exemption
4. Proposed Corporate Tax Structures
5. The Temporary Increase - the Corporate Surtax Exemption
6. The Future of the Surtax Exemption

Additional information can be supplied upon request.

1. METHODS OF TAXATION OF BUSINESS

Over the years, various proposals have been made to restructure the method of taxation of business. As shown on Exhibit C, the vast majority of businesses are not incorporated and operate as sole proprietors. This income is taxed to the individual directly at his rates. The estimate of over 9 million proprietorships is deceptive in number. Over 7 million have receipts of less than $25,000. An additional million have receipts of less than $50,000. These businesses are, in many instances, sidelines to supplement an income. Any tax practitioner can point to countless small proprietorships where the taxpayer is operating a very small enterprise on the side that they do not view as a business, but they must file a tax return as must any business.

An additional 900 thousand firms operate as partnerships. Their income is taxed substantially the same as proprietorships. Two-thirds of these have receipts of less than $50,000. Here again it is difficult to determine how many of these entities are bona-fide businesses.

The third vehicle used for operation of a business is the corporate form. Less than 13% of the total entities refered to in Exhibit C are corporations, but according to 1967 Enterprise Statistics of the Bureau of Census, these corporations employ 81% of all workers. Over 87% of business receipts comes from corporations as reflected in Exhibit D. Here is where the action is!

The corporation has been traditionally taxed at the corporate level. Dividends paid to individual shareholders get taxed a second time, this time at the recipient's level. To alleviate some of this burden, especially

on small business, a special type of tax entity was established, referred to as a Sub-chapter S corporation. The taxable income is taxed substantially the same as a partnership. This has proven so complicated that only one in eighteen corporations operate in this form. Almost 80% of total business receipts comes from corporations subject to the double tax applied first to income, then to dividends distributed.

2. HISTORY OF CORPORATE TAXATION

Section 11 of the Internal Revenue Code is the section that relates to the tax imposed on corporations. It is reproduced as Exhibit B. Its roots stem from the 1894 Income Tax which levied a 2% tax on corporate net income. The tax was held to be unconstitutional by the Supreme Court, primarily for reasons unrelated to the corporate tax.

The next attempt was the 1909 Corporations Tax which was 1% on corporate net income over $5,000. This time the constitutionality was upheld in Flint vs Stone Tracy Company (220 U.S. 107 (1911)). With the passage of the Sixteenth Amendment, Congress enacted the 1913 Income Tax setting corporate taxes at 1% of net income. With the passage of the Revenue Act of 1918, corporate taxes were up to 12% with a $2,000 exemption. An excess profits tax was also enacted. There is no intention to cover here excess profits taxes, credits or other special considerations such as exemptions for U.S. interest. The rates and exempt amounts fluctuated so that by 1934 the rate was 13 3/4% and the $2,000 exemption had been eliminated. The Revenue Act of 1936 imposed a graduated surtax on undistributed profits but the opposition was so extreme that this was

eliminated by 1939. This was the first graduated income tax for corporations. Exhibit B reflects the changes from that point. In 1950, the concept of a normal tax and a surtax was imbedded in tax law. This was recognition given by Congress that the smaller corporations had a need to be taxed at lower rates than more substantial corporations. The $25,000 exemption from the surtax granted in 1950 would be roughly $100,000 in 1975 dollars.

3. SMALL BUSINESS AND THE SURTAX EXEMPTION

Small Business which can be defined many ways, is best described as one with normally less than 500 employees that is not publically held. Usually these businesses are subject to control by a small number of people. Small business has traditionally held a role corollary to apple pie and hot dogs. Everybody is in favor but no one is excited about doing too much about them. Small business accounts for 45% of private sector employment and 43% of the business portion of total Gross National Product.[1] Over 85% of businesses have receipts under $100,000.[2] These businesses can generate capital from very limited sources. Private investment markets are usually closed to them and borrowings from banks are very limited. Growth must be financed from retained earnings. This growth is important to the growth of our economy. The old saying that "Tall oaks from little acorns grow." is indeed true. As Senator Sparkman said when he was Chairman of the Senate Small Business Committee in 1966, "The importance of small and growing businesses, particularly in the new technology areas of our economy, continues to be recognized at the highest

levels of our government." "Capital is the life blood of developing small businesses. Higher interest rates ..., and decreased availibility of money places additional burdens on our small businessmen, making them even more dependent on internally generated funds."[3] In 1964, a Senate Finance Committee report said "Your committee agrees with the House that it is important to provide a greater rate reduction for small business because of their importance in maintaining competitive prices in our economy, and also because of the greater difficulty small businesses have in finding outside funds to finance their expansion. As a result, they have traditionally found it necessary to expand largely out of income remaining after taxes.[4]

All of this leads to the logical conclusion that the small businesses that have the potential to grow into significant factors in the economy have some common characteristics:

1. They operate in corporate form.
2. They are not Sub-chapter S corporations.
3. Their main source of capital is internally generated (i.e. retained earnings).
4. Their growth is important to the growth of the economy.

These statements form the reasoning that has led Congress and Presidents to bring about legislation that puts the small business in a lower tax bracket than the large business. (It is not the purpose of this article to show that many large businesses have access to tax avoidance schemes bringing their effective tax rates down to, or even lower than, the rate paid by small business (but see page 15).

4. PROPOSED CORPORATE TAX STRUCTURES

The question is how much lower should the rate for small business be and how should the tax fall? Four basic alternatives have been suggested:

1. No tax for corporations.
2. No tax for very small businesses.
3. A graduated tax.
4. A two-step tax structure.

The income tax structure of corporations in 1974 was a "normal" tax of 22% of taxable income and a surtax of an additional 26% on taxable income with an exemption on the first $25,000 of taxable income.

The idea of no tax for business is not a new one, although it may seem radical to many. If the tax were paid by the owner of the business, every entity could then be taxed as proprietorships and partnerships are now. Many economists have suggested the idea for its simplicity and the elimination of much of the "tax dodging" that is rampant. The double tax "disadvantage" is used by many businesses to avoid tax by retaining earnings disproportionately to the needs of the business. At death the increase in value largely escapes taxation. Among the supporters of this theory is Professor Paul R. McDaniel of Boston College Law School.[5]

A total tax exemption for very small businesses or at least a total tax exemption for an initial period of time has been considered often. It gets very little support because of the general feeling that all businesses and people should pay their fair share, whatever that might be. Most people have felt any waiver of the total tax is not fair.

The graduated tax is a recurring proposal. In Congress, there are usually a number of proposals for some form of graduated tax. The Bible-

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Evins Tax Bill has been introduced for the last few years. It has received much publicity and has had a significant number of co-sponsors When it was introduced in the Senate on March 6, 1973, as S1098, it had nineteen Senators as signatories. No action was taken. In its current form, it was introduced into the House on March 4, 1975, as H.R. 4145 by Congressman Esch with no co-sponsors. It has been referred to the House Committee on Ways and Means. The Administration is not in favor of the graduated tax as typified by a letter from the President's chief economic advisor, L. William Seidman, where he says "Furthermore, the imposition of progressively higher graduated rates on corporate earnings would probably reduce the ability and incentives for business to invest." (6)

A two-step tax structure separates in effect the large and small business. It is set up so that the initial exemption from the higher tax is available to all corporations, large and small. It has the biggest advantage of all in that is is now law and is easier to work with because it does not represent a radical change. There are always a few bills in the Congressional "hopper" suggesting this be increased to $100,000. In the House, Congressman Archer introduced the bill as H.R. 2288 on January 29, 1975. It now has 44 co-sponsors. Congressman Archer is a member of the House Committee on Ways and Means. In the Senate, a similar bill, S949 was introduced by Senator Tower on March 5, 1975. It had 5 co-sponsors and was referred to the Senate Finance Committee. (The sponsors included Senators Buckley and Humphrey.)

5. The Temporary Increase in the Corporate Surtax Exemption

As a part of the Tax Reduction Act of 1975, an attempt we made to help small business. The surtax exemption was increased from $25,000 to $50,000 and the first $25,000 of taxable income is taxed at 20%, a 2% drop. The law is only for 1975.

The President's original proposal on corporate surtax was to reduce the top tax from 47% to 42%. The effect of this is shown on Exhibits E and F. The total revenue loss of $4 billion for the President's bill was supplied by the Administrator. Revenue loss figures for the plans were extrapolated by the author from the most recent Treasury Department figures available.

6. THE FUTURE OF THE SURTAX EXEMPTION

Washington has indeed gone a long way toward recognizing Small Business. The time has come to put that recognition into action, in the area where Small Business is most thoroughly overlooked: Taxes. Over the coming months, Congress will be considering broad moves to reform the nation's tax system. This reexamination of fundamentals is long overdue, and is particularly timely in view of the current economic crisis and the emergency steps taken in the Tax Reduction Act of 1975.

As it sutdies and plans, Congress should be sure to include Small Business. And the way to do that isn't to assume any reform affecting business generally also helps Small Business in particular. If Small Business is to make its contribution to economic recovery and future stability, tax reform measures directed specifically at this vital sector must be considered. The object isn't to grant Small Business unfair special relief. No one sector of the economy should receive preference, especially in these difficult times. But distinctions between Small Business and Big Business do exist, and they require distinctions in tax reform measures. What works for one sector won't automatically work for t' ~ other. If the aim of tax reform is to help ensure economic recovery -- which means jobs and capital -- then reform measures must

be effective, that is, they must actually help create jobs and capital.

The surtax exemption should be increased to $100,000.

Having made a first step in raising the exemption to $50,000 for one year, Congress should now complete the job of setting a realistic and effective cutoff point.

The logic behind the 1950 action establishing the surtax exemption is unassailable. Small businesses grow almost exclusively through retained earnings. Equity may get a new corporation off the ground, but that small company can't continue to rely on investors to meet its capital needs. While large corporations usually can sell more stock whenever they need additional capital, it's a fact of life for small businesses that they can't.

The only alternative for external financing is debt. And small businesses have fared poorly indeed at the debt counter. Small businesses traditionally pay the highest interest rates and have the least success in obtaining loans. Over a two-year period ending November 1974, small short-term loans (under $100,000) fell almost 50% as a percentage of total corporate short-term loans. In the long-term debt market, small loans accounted for less than two cents of every dollar loaned to business. This occured despite the fact that small businesses of a size most likely to need such loans account for over half of all corporate sales, and over half of all corporate employment.

The only avenue to growth for a small business is retained earnings. And yet small businesses retain less of their earnings than any other sector. After-tax profits in the fourth quarter of 1973, for example, were 2.4 cents on the dollar for companies of $1 million assets or less, 3.4 cents for companies up to $5 million in assets -- but 7.9 cents for

billion dollar corporations. The effective tax rate ranged from 42.8% to 51.4% for the small companies -- compared with only 28.8% for the large corporations.[7]

In other words, the companies that need retained earnings most are being starved. And that means the job market is being starved too. Small businesses are "where it's at", as far as creating new jobs is concerned. It's almost axiomatic to say that large corporations grow by buying machines, while small businesses grow by hiring people. Consider the period between 1963 and 1967, for example, the most recent period for which detailed statistics are available. In that period, the sales of large business spurted 60 %, but their employment fell 9 %. Small business, on the other hand, had a comparatively meager sales rise of 18 % , but on that, they boosted employment by 62 %.[8] Hindering small-business growth by curtailing retained earnings hits the economy at its weak spot, the job market.

The way to attack this problem is the same today as it was in 1950, when Congress first acted: permit smaller corporations to retain more of their earnings, for modernization and jobs. The method Congress chose 25 years ago was to exempt the first $25,000 of earnings from the full corporate tax rate.

The problem, of course, is that, like the nickel cigar, $25,000 isn't what it used to be. That amount is simply inadequate as a spur to growth. Look at the Consumer Price Index, for example. Since 1936, when the $25,000 cut-off figure was first used, the index has spurted over 400%. That means the $25,000 of 1936 is equal in effective purchasing power to over $100,000 today.

In other words, the surtax exemption of $25,000 long ago became little more than a pleasant relief at tax time. It accomplished little in terms of the surtax exemption's original intent. It was in recognition of this fact that Congress acted early this year to raise the exemption to $50,000, and to cut the rate on the first half of that to 20%. That was an imppртant first step. The exemption increase will allow corporations to retain an additional $1.2 billion of earnings, something on the order of $6,500 per company. That amount is insignificant, of course, for a major corporation. But for a small warehousing concern or small manufacturer, that amount means a needed fork-lift or upgrading of a production line.

Much more adequate, though, in terms of achieving the exemption's desired effect, would be to recognize the harsh fact of 400% of inflation since 1936, and to set the exemption for future years at $100,000. Doing so would bring tax rates more into line with current realities. Canada, for example, has already recognized the necessity of a $100,000 exemption. It began a staged increase from $35,000 three years ago and has now reached a surtax exemption of $100,000.

Providing such an incentive for growth does mean a near-term revenue loss for the government, but that loss is more than repaid over the long run as more and more companies venture beyond the $25,000 profit level made attractive by current law.

FOOTNOTES

1) "Small Enterprise in the Economy", Small Business Administration, December 1974.

2) "Number of Firms by Size of Receipts and Business Form", Department of Treasury, 1970.

3) "Statement of Senator John Sparkman" before the Senate Finance Committee October 6, 1966.

4) "Senate Committee Report", (88th Congress, second session, S. Rep. No. 830 (1964)31). (To accompany H.R. 8363 amending Section 11 of the 1954 Code.)

5) Conversation with Paul R. McDaniel, Professor of Law, Boston College Law School and the author, April 1975.

6) Correspondence, December 17, 1974, from L. William Seidman, Assistant to the President for Fconomic Affairs to Fred C. Young, President, Coordinated Planning Services, Inc.

7) Karsh, Norman, Office of Advocacy Small Business Administration, December 1974.

8) Report of Senate Select Committee on Small Business, September 1974.

54-397 O - 75 - 17

EXHIBIT A

INTERNAL REVENUE CODE SECTION 11

(Before Amendment by the Tax Reduction Act of 1975)

Tax Imposed.

(a) Corporations in General. - A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) Normal Tax. - The normal tax is equal to the following percentage of the taxable income:

(1) 30 percent, in the case of a taxable year beginning before January 1, 1964, and

(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

(c) Surtax. - The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

(1) 22 percent, in the case of a taxable year beginning before January 1, 1964,

(2) 28 percent, in the case of a taxable year beginning after December 31, 1963, and before January 1, 1965, and

(3) 26 percent, in the case of a taxable year beginning after December 31, 1964.

(d) Surtax Exemptions - For purposes of this subtitle, the surtax exemption for any taxable year is $25,000, except that with respect to a corporation to which section 1561 or 1564 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section.

EXHIBIT A

INTERNAL REVENUE CODE SECTION 11

(Continued)

(e) Exceptions. - Subsection (a) shall not apply to a corporation subject to a tax imposed by -

(1) section 594 (relating to mutual savings banks conducting life insurance business),

(2) subchapter L (sec. 801 and following, relating to insurance companies), or

(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

(f) Foreign Corporations. - In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

EXHIBIT B

HISTORY OF INCOME TAX ON CORPORATIONS 1936 - 1974

Revenue Act	Income for	Net Income	Rate (per cent)
1936	1936, 1937	First $2,000	8
		Next $13,000	11
		Next $25,000	13
		Remainder	15
1938	1938, 1939	First $5,000	12½
		Next $15,000	14
		Next $5,000	16
		Over $25,000	19
1940	1940	First $5,000	13½
		Next $15,000	15
		Next $5,000	17
		Over $25,000	24
1941	1941	First $5,000	15
		Next $15,000	17
		Next $5,000	19
		Over $25,000	to 31
1942	1942-1945	First $25,000	15-19
		Over $25,000	to 40
1946	1946-1949	First $25,000	15-19
		Over $25,000	to 38
1950	1950	First $25,000	23
		Over $25,000	42
1951	1951	First $25,000	28 3/4
		Over $25,000	50 3/4
	1952-1963	First $25,000	30
		Over $25,000	52
1964	1964	First $25,000	22
		Over $25,000	50
1965	1965-1974	First $25,000	22
		Over $25,000	48

EXHIBIT C

NUMBER OF FIRMS BY SIZE OF RECEIPTS AND BUSINESS FORM, 1970

(Thousands)

Size of Business Receipts	Partnerships	Proprietorships	Subchapter S Corporations	Other Corporations
Under 25 thousand	502	7,247	58	394
25 to 50 thousand	125	1,006	25	146
50 to 100 thousand	120	661	40	180
100 to 500 thousand	162	456	97	420
500 thousand to 1 million	17	23	22	119
1 million to 5 million	9	7	14	122
Over 5 million	1	.2	.8	27
Total	936	9,400	257	1,408
Percent of Total	7.8%	78.3%	2.1%	10.8%

Source: Internal Revenue Service

EXHIBIT D

BUSINESS RECEIPTS BY SIZE AND BUSINESS FORM, 1970

(Millions of Dollars)

Size of Business Receipts	Partnerships	Proprietorships	Subchapter S Corporations	Other Corporations
Under 25 thousand	$ 3,290	$ 43,830	$ 391	$ 1,715
25 to 50 thousand	4,361	35,729	876	3,938
50 to 100 thousand	8,436	46,278	2,886	11,160
100 to 500 thousand	32,920	82,624	22,254	94,169
500 thousand to 1 million	11,545	15,142	15,480	79,149
1 to 5 million	17,236	11,912	25,923	237,444
Over 5 million	12,420	2,211	8,287	1,117,213
Total	$ 90,209	$ 237,727	$ 76,097	$1,544,790
Percent of Total	4.6%	12.2%	7.9%	79.3%

Source: Internal Revenue Service

EXHIBIT E

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND

EFFECTS OF VARIOUS APPROACHES TO REDUCTION IN CORPORATE TAX RATES

(February 24, 1975)

Size of Corporations (000's omitted)	0-25	25-50	50-100	100-250	250-1,000	Over 1,000	Total
# of Corporations (1970)	584,057	64,339	40,835	26,681	13,725	4,806	734,443
	79.5%	8.8%	5.6%	3.6%	1.9%	.6%	100.0%
Average Benefit							
Plan I 22% to $50,000, 48% on excess	None	$ 2,700	$ 6,500	$ 6,500	$ 6,500	$ 6,500	
Plan II 22% to $100,000, 48% on excess	None	2,700	11,450	19,500	19,500	19,500	
Plan III 20% to $50,000, 45% on excess	$ 153	3,400	8,070	10,580	32,060	315,500	
Plan IV 20% to $100,000, 45% on excess	153	3,400	12,800	23,080	32,410	328,000	
Plan V 22% to $25,000, 48% on excess	None	670	2,850	8,270	30,000	667,500	
Cost to Treasury (Millions)							
Plan I 22% to $50,000, 48% on excess	None	194 (23.4%)	296 (35.7%)	204 (24.6%)	100 (12.0%)	36 (4.3%)	830 (100.0%)
Plan II 22% to $100,000, 48% on excess	None	194 (11.4%)	522 (30.7%)	581 (34.2%)	299 (17.6%)	104 (6.1%)	1,700 (100.0%)
Plan III 20% to $50,000, 45% on excess	98 (3.1%)	241 (7.6%)	365 (11.5%)	310 (9.8%)	485 (15.3%)	1,671 (52.7%)	3,170 (100.0%)
Plan IV 20% to $100,000, 45% on excess	99 (2.6%)	241 (6.3%)	577 (15.1%)	680 (17.8%)	489 (12.8%)	1,734 (45.4%)	3,820 (100.0%)
Plan V 22% to $25,000, 48% on excess	None	43 (1.1%)	116 (3.0%)	221 (5.5%)	417 (10.3%)	3,203 (80.3%)	4,000 (100.0%)

Mr. PENDERGAST. I serve as chairman of our tax committee of the Smaller Business Association of New England, and am a professional tax counselor. And in SBANE, as we call our association, we have devoted a significant portion of our effort toward analyzing what role Federal Government should or should not play vis-a-vis small business.

Senator McIntyre's statement, made earlier today, I think was most cogent when he says that the first step to help small business is to inform the Congress of the impact of each piece of legislation. He was referring particularly to paperwork, and I think it generally can be expanded to the whole effect of each piece of legislation.

The next proposed important step, I think, that can be done is to present each piece of legislation with a view toward integrating that piece of legislation with the old, and not just overlaying a new law on the old, as is done so often. The aim should be to simplify it, so compliance will not be difficult and sufficient time be given before implementation of the law to allow for guidelines to be established. A current example is the Pension Reform Act, which has had a series of reporting delays because of the complications and misunderstandings of what is covered by the Pension Reform Act.

Some examples of areas of simplification were recited here this morning, but I would like to repeat some of them. I cite chapter S, particularly, the method of transfer of business at time of death, so the business will not be destroyed, which happens very often; an allowance of net operating loss to be carried over for a longer period of time. The simplification of the depreciation rules so that somebody, please, somebody can understnad them. Some sort of a tax and reporting relief particularly aimed toward startup of businesses, to allow them to grow. And, I think, making the legal form that the business takes be less important than the fact that they pay their fair share of tax. Stimulation of growth of small business is the basis for the future economic growth of this country.

A long-term view of this can be paralleled, I think, with the GI bill, which became an investment. Money for education translated into earning power, and therefore, tax dollars for the Federal Government. A corollary is to allow the small business to retain a significant portion of its earnings to use as investments for its future growth. This points to a reduction in taxes, as this is the only way that a small business can increase its working capital. We suggested, in my statement, a change in the tax structure to make the first $100,000 of taxable income subject to the normal tax and exempt from the surtax.

The basic difficulty is compounded by the lack of understanding of our problem. The administration's chief formulator of tax policy said this year, and I quote, "What is good for big business is good for small business." The second quote, "Credit is available to small business, and at a reasonable cost." He went on to say——

Senator BENTSEN. Who said this?

Mr. PENDERGAST. This is Mr. Hickman, the Undersecretary of the Treasury for Tax Policy. And he summarized it to see if he could inflame, as much as possible, the small businessman, by saying, "These companies tend to be owned by persons who by most of our standards are considered wealthy." In the first place, that is an irrelevant comment. The problem is not whether the owner is wealthy or

not; the questions is whether the business is contributing to the economic stability of the country. So the problem is communicating the need. Somehow we need to show that, while we may not have the resources for lobbying that the large multinational companies have, we are in the aggregate at least as important as the large businesses. If we do not foster growth, our economy will decay.

In summary, reporting requirement reduction and simplification, and tax reduction and simplification are the most important measure Congress can take. If Congress will take these steps, small business will grow and take care of its growth, and therefore enhance the general economic health of our Nation.

Thank you.

Senator BENTSEN. Thank you very much.

I have heard other testimony of Secretary Hickman, where he opposed the surtax exemption increases that we gave in the last tax bill.

Mr. PENDERGAST. I have a chart here that would show that Mr. Hickman's original recommendation would have given about 85 percent of the benefit to less than seven-tenths of 1 percent of the corporations in this country. The proposal that we have to allow the surtax exemption to go to $100,000 would still give some benefit to the large corporations, but the benefit would be spread more equally among corporations that we hope are growing into eventually becoming a public corporation.

Senator BENTSEN. If you will excuse me, I have a markup session on another piece of legislation. So if you would please go ahead with your testimony.

Senator NELSON [presiding]. Please go ahead.

Mr. MURRAY. My name is Ralph Murray, and as was mentioned I am the vice president of the SMC, the Smaller Manufacturers Council. I am also president of IDL. It is a display and decal manufacturing company in Pittsburgh.

The council is composed of 580 small companies located in Pennsylvania and bordering States that are primarily in the manufacturing and processing business. Although we are small companies, in total we employ over 60,000 people, and our estimated sales are over $1 billion. We do have a written statement which we will submit, and I will try to comment on it briefly.

[The prepared statement and attachments of Mr. Murray follow:]

Statement by
Ralph W. Murray, Vice-President
Government Relations Committee
Smaller Manufacturers Council
339 Boulevard of the Allies
Pittsburgh, Pennsylvania 15222

Senate Select Committee on Small Business
June 18, 1975

Gentlemen:

I am Ralph W. Murray, president of IDL, Inc., a screen printing concern in Pittsburgh, Pa., and I am vice president-government relations of the Smaller Manufacturers Council, Pittsburgh. The Council is composed of 580 small companies in the multi-state area of Pennsylvania, Ohio, West Virginia, New York, and Maryland, all of which do at least 60% of their sales volume in manufacturing, fabrication, or processing. Though individually we are small companies, it is estimated our combined annual sales are over a billion dollars and that we employ more than 60,000 persons.

The SMC will be testifying today on four subjects: Energy, Domestic International Sales Corporations, Subchapter S Corporations, and Depreciation. However, we would also like to reaffirm our support of the increase in the surtax exemption to $100,000 on a permanent basis. Our friends from the Smaller Business Association of New England are testifying in detail on this.

As to our four subjects, we are submitting material in support of our positions on DISCs, Subchapter S, and Depreciation. On Energy, the situtation is so fluid that this morning's backup material would be out-of-date this afternoon.

But, gentlemen, we all know that Energy is probably the most critical problem facing us today--in our homes, in our cars, and, most especially, in our factories. In our area, utilities are informing our members that there will be a 40% cutback in natural gas this coming winter. If this goes through, according to a recent news article, at least one of our companies will go out of business, putting 140 persons out of work, forcing American steel firms to buy their crane hooks overseas--as it is the only manufacturer of crane hooks in the United States.

Another of our companies, in the refractory field, has gone so far as to drill two gas wells in a nearby county and has found Pennsylvania law prohibits transmission of this extra gas to supply to its plant.

Electrical rates are soaring and, while supply in our area is no particular problem because of the abundance of coal, the cost of that coal is pushing rates alarmingly high. This cuts into cash available for such things as new equipment, new employees and, last, but not incidentally, profits.

The need for action is urgent--survival of much of small business in this country depends on it.

DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCs)

Domestic International Sales Corporations were established in 1971 to encourage exports. Large corporations recognized their value immediately, and by 1972, over 80% of the 2,249 DISCs were owned by corporations with assets over $1 billion.

Smaller businesses were slower to recognize the value of DISCs.

3-3

Not only does it take longer for new legislation to filter down to smaller concerns, but there has been a long-standing hesitation among small businessmen over the complexities and paperwork mire involved in exporting. Our best estimate, on the basis of our corporate members, is that the DISC law is just now starting to have noticeable impact on smaller companies. Hundreds of small concerns are being lured into the export market for the first time, adding a new avenue of growth for themselves and helping to improve the nations's balance-of-payments. In February, the U. S. had its most favorable balance-of-payments surplus ever.

Altogether, the Treasury estimates DISC brought about an extra $2 billion of exports in 1973--$2 billion that would not have been shipped were it not for the DISC incentive. Our research has shown DISCs' increase in exports is estimated to increase GNP by $21 to $27 billion, the Federal revenues by $3.9 billion and employment by 329,000 to 473,000 jobs.

DISCs are working for smaller businesses. Repeal of the DISC legislation would undermine a law that is clearly succeeding.

SUBCHAPTER S

We recommend two changes that would make Subchapter S more responsive to current needs. Neither would have more than nominal impact on tax revenues.

1. The maximum number of shareholders should be increased from 10 to 15. As with the surtax exemption, the current limit was established in a less expensive era. Where it once might have taken 10 investors to

finance a new company, today it necessitates more. This is especially true in a tight loan market.

2. Certain trusts should be allowed to be shareholders, including voting trusts, grantor trusts, and trusts where the holding is only temporary, such as passing through a residuary trust to individual beneficiaries. Each beneficiary of a trust should be counted as a shareholder in determining the limitation on the number of shareholders. The current exclusion of trusts is an unreasonable limitation on the ability of owners to locate new sources of capital.

Also, inclusion of trusts would remove the unfair burden that currently afflicts many businesses when one of the owners dies and his holdings revert to a trust. Under current law, this trust status of one holder would remove the Subchapter S status of all other stockholders of the concern. An owner's untimely death should not be an immediate burden on the living.

DEPRECIATION

We see a need for more flexibility in deciding when to take depreciation and in what amount. The flexibility would be especially important for smaller businesses. We suggest consideration of a system being used in Canada called the "Capital Cost Allowance System". Canada permits depreciation in two years on machinery and equipment, which are the heart of the productive process. Canada also allows companies to establish pools or classes of assets. Each class is assigned a maximum depreciation rate.

Within those limits it is left to the taxpayer to decide how much depreciation to claim at a given time. This enables the taxpayer to gear the depreciation allowance to the business income. In a good year he would depreciate more; in a poor year he would depreciate less, but the total depreciation would be the same.

Canada's system also features fewer classes for assets. This, along with the other features, yields a benefit especially vital for smaller businesses: it reduces the mountain of paperwork and computations that existing depreciation methods entail. While no particular burden for computer-aided large corporations, the current depreciation system is simply too complex for the average small business.

One additional thought. Pittsburgh Congressman H. John Heinz III is working on legislation which would help small business. A part of this legislation would be increasing investment credit to 25% on the first $100,000.

Gentlemen, that concludes our part of the testimony today. We appreciate the opportunity to speak with you today and offer our cooperation in any way necessary to assure that small business remains a viable part, and major part, of our American economy.

# # # # # # # #

Smaller Manufacturers Council
Pittsburgh, Pa. 15222
U.S. Senate Select Committee on Small Business

Wednesday, June 18, 1975

Domestic International Sales Corporations (DISC)

All of the arguments which were made at the time of adoption of the DISC Program are still valid. It is not our purpose to review them in detail here, but to suggest that the primary intent of the program was to provide an incentive to export products, and minimize the "exportation of jobs" through the construction of factories in foreign countries. It was clearly intended that the DISC Program would offset some of the advantages of "tax havens" which many foreign countries offer to new industry coming in from abroad.

We believe the DISC Program has generally been instrumental in achieving its purposes.

A significant feature of the DISC Program is that it tends to "enforce" capital growth. It is not necessary to review here the extensive current discussion of one of the critical problems of our time; namely, sources of investment capital. However, there is no question but that the DISC Program encourages capital retention.

The corporations to which the incentive is provided are primarily small and medium sized manufacturers. Particularly for the small company, the DISC Program offers an additional motive to incur the extra costs that export selling usually involves. The

repeal of DISC would be a blow particularly to small and medium sized corporations.

Members of the House Ways and Means Committee have expressed the viewpoint that small business needs some additional tax breaks, and it appears to us that many members of Congress share this same sentiment. It appears that the Tax Reform Bill under current consideration will offer insufficient tax relief to small businesses, and repeal of the DISC would have a further negative impact on many small businesses.

Some small businesses have spent considerable management time and legal expense to establish a DISC, expecting that what seems to be such a fundamentally sound program would be a permanent part of tax policy. Repeal at this time would be totally unfair.

If it is felt that the DISC Program is being abused as a "tax shelter" by some large corporations, and if it is found that such is in fact true, then it is suggested that possibly an annual limit be placed on the amount of earnings which do not have to be distributed from the DISC.

We sincerely plead that DISC be retained. Our reasons include:

1. DISC will increase revenue to the U.S. Government and aid the U.S. balance of payments. Currently, this revenue goes to the benefit of foreign governments. With DISC, U.S. corporations can do "at home" what previously necessitated going abroad to do.
2. With DISC, more jobs are created within the United States. This in turn produces more tax revenue for the U.S.

3. DISCS are a valuable assistance to the U.S. Department of Commerce's export expansion program.

4. DISC, in most instances, provides virtually the only method, incentive and means for smaller companies to "afford" the risk of entry into export markets.

   Otherwise, their manpower, finances, lack of knowledge and inability to acquire it, make them unable to even attempt such a venture.

5. DISC increases tax revenue from all sources, including: profits; employee taxes; property taxes; local, state and federal taxes; capital stock taxes; inheritance taxes and others.

We cite an example of one SMC member company alone with annual export sales in 1973 of $94,000. Although its tax deferral amount was only $2,700, it certainly did not create a financial hardship to the federal government, but certainly was sufficient working capital for use to expand its next year's operations to produce a greater amount of revenue and resulting tax dollars increasing to $7,500. in 1974.

May we have your cooperation to retain DISC?

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Smaller Manufacturers Council
Pittsburgh, Pa. 15222
U. S. Senate Select Committee on Small Business
Wednesday, June 18, 1975

SUBCHAPTER S

Revision and modernizing of the rules governing Subchapter S corporations to help in the realistic financing of such organizations and to help provide for the succession of privately-owned business can be undertaken without time-consuming effort on the part of the Congress or the Administration.

The cost in revenue to the Government because of the changes proposed would be quite nominal since it is estimated fewer than 10% of the small businesses in the U.S. are organized as Subchapter S. corporations.

However, the revisions proposed are vitally important to those companies which are under such corporate structure. We propose:

A. The maximum number of shareholders be increased from the present 10 to 15.

B. Certain trusts be allowed to be shareholders, including Voting Trusts, Grantor Trusts, and Trusts where the holding is only temporary, such as passing through a residuary trust to individual beneficiaries.

When Subchapter S went into effect, 10 shareholders could finance a new company. But in today's economy it often requires substantially more dollars than any 10 shareholders can invest in any one company. This is particularly true when commercial or government loans cannot be obtained or, if they can be obtained, at higher rates than other businesses.

The above changes would foster the establishment and healthy expansion of many small businesses and allow these small businesses to recognize key people in the company which is virtually impossible with the present limit of 10 shareholders.

The current exclusion of trusts as shareholders could result in the dissolution of a company and the loss of jobs by the employees. If trusts were included the continuity of the business would be greatly strengthened.

The proposed changes, singly or together, would, we believe;

1. Provide additional financing for:
    a. Increasing employment (and, therefore, wages and tax revenue)
    b. Purchasing capital equipment
    c. Research and Development
2. Provide for increased profits and tax revenues
3. Would help to ease the borrowing climate
4. Provide for more equitable distribution of estates.

Smaller Manufacturers Council
Pittsburgh, Pa. 15222
U. S. Senate Select Committee on Small Business
Wednesday, June 18, 1975

AN ALTERNATIVE SYSTEM OF DEPRECIATION

The Smaller Manufacturers Council (SMC) proposes for considera- tion an alternative form of depreciation similar to that which is now being successfully used in Canada. The Canadians call this method the Capital Cost Allowance System, and the Council believes it has several advantages which would be particularly beneficial to small business.

Basic Mechanics of the Cost Allowance System

The major feature of the system is the establishment of asset pools or classes. Each class is assigned a maximum percentage allow- ance rate on which the annual depreciation charge is based. There is no need for the assets in the pool or class to be homogeneous. Purchases are added to the balance of the amount in the class and the proceeds from the sale of assets are deducted from the balance. The depreciation allowance is computed by multiplying the statutory per- centage rate, up to the maximum specified by the class, times the balance in the class at yearend. The account balance is then reduced by this amount. An important aspect of the system is that the mechanics of the computation provide a built in stimulus for invest- ment. As the cost of newly purchased assets is added to the class balance, the depreciation allowance increases, and it decreases as assets age or are sold.

A major provision of this system is that it permits a substantial degree of flexibility in the amount of depreciation taken. In Canada, a taxpayer may claim any amount of depreciation as long as the maximum rate is not exceeded, or claim no allowance whatsoever, without reducing the continuing depreciable basis of property. In this manner, the tax- payer can gear the depreciation allowance to the business income.

Advantages to Small Business

The Council foresees the following advantages in adopting this system:

1. The flexibility of the method, when taken in conjunction with the Council's recommendation to increase the surtax exemption to $100,000, is particularly advantageous to small businesses. By varying the amount or rate of the depreciation allowance taken, depending on the income of the enterprise, a small business can take full advantage of the lower tax rate or income below the surtax. Freezing additional funds for re-investment, in low income years, the allowance can be foregone, whereas the maximum amount can be charged against the income of highly profitable years.
2. The system will eliminate many conflicts between taxpayers and the Internal Revenue Service because it eliminates the need for estimating salvage value and useful life. Eliminating these disputes would be especially helpful to small businesses because they often require costly consultation with outside professionals; small businesses generally do not have such expertise on their own staff.

The Congress, the Council believes, indicated its support for minimizing such conflicts over depreciation by adopting the Asset Depreciation Range (ADR) System in 1971. However, the complexities of this elective system, including very detailed record keeping requirements and special rules regarding those assets which may be excluded, have limited its usefulness to small business. Under the Capital Cost Allowance System, only a small number of classes would

be required by a small business, thereby simplifying record keeping and still eliminating disputes.

Attached to this memorandum is a table which highlights the major similarities and differences between the U.S. depreciation system and the Canadian capital cost allowance.

The Smaller Manufacturers Council realizes that this proposal may require a major revision in the U.S. approach towards claiming depreciation and may not be appropriate as part of your immediate objectives. However, the Council does believe that the Capital Cost Allowance System has several advantageous characteristics, and that it is worthy of consideration.

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—PITTSBURGH POST-GAZETTE: SATURDAY, MAY 17, 1975—

Columbia Cuts Industries' Gas During Winter

By RICHARD F. FONTANA
Post-Gazette Staff Writer

Columbia Gas of Pennsylvania, citing a reduction in its own supplies, announced yesterday it would curtail gas supplies to industrial customers by 55 per cent next winter and one of the companies said the action may drive it out of business.

"It will just about destroy us," said Arthur W. Davidson, general manager of C. M. American Corp. in Stowe Township. "It is one hell of a situation...I'd hate to see 140 people out of work here."

The area's other gas companies—Equitable and Peoples—said they had no plans for further curtailment. All three already have reduced industrial gas supplies by 20 to 35 per cent of normal.

Other companies affected by the Columbia announcement are able to switch to oil—as they have done during the present cutback—but they point out that oil is three to four times more expensive than gas.

Additionally, said Al Dahlgren, plant engineer for Babcock & Wilcox in Beaver Falls, the size of the curtailment makes it touch and go whether the necessary equipment can be installed to prevent a break in production.

Babcock & Wilcox is not fully oil-convertible and has been making the switchover for two years. The cost is estimated at more than $6 million.

D. W. Blasche, manager of Columbia Gas here, said the action was taken because his supplier, Columbia Gas Transmission Corp., will curtail deliveries by 28 per cent.

"The high level of curtailment of industrial customers is required because the 28 per cent shortfall in available supply must be absorbed solely by this segment of Columbia's market to make gas available for human needs customers," the company said in a statement.

Columbia serves 176 industrial and 180,000 residential customers in Western Pennsylvania.

C. M. American's position is tinged with irony. It is the only company in the

(Cont'd on Page 3, Column 4)

Columbia Curtails Industries' Gas

(Continued from Page 1)

United States that manufactures crane hooks used in steel mills.

"This presents a very interesting aspect," said Davidson. "Customers who have been buying these crane hooks from us are now going to be forced to go out of the country for their requirements."

C. M. American has no oil-burning facilities.

"We could install it," Davidson said, "but that would be a very costly capital investment. But oil is considerably costlier than gas, and we could make this investment and find out we can't get the oil."

The same concern was expressed by Chester Kennedy, vice president of Washington Steel Co.

"It's going to be bad," Kennedy said. "It all depends on the oil situation, whether we'll be able to get oil to pick up this slack."

Like Babcock & Wilcox, the higher oil costs have cut into Washington Steel's profits. It's not an amusing element to Dahlgren of Babcock & Wilcox.

"We have more employes today (3,700) than we ever had in the history of the plant. We've been running at peak production for more than two years (but) our energy conservation efforts are just about offsetting the increased productivity," Dahlgren said.

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STATEMENT OF RALPH W. MURRAY, VICE PRESIDENT, SMALLER MANUFACTURERS COUNCIL

Mr. MURRAY. We are primarily going to talk about four areas—energy problems, Domestic International Sales Corp. subchapter S, corporations, and depreciation. But we would like to support the comments that were just made on the increase in the surtax exemption to $100,000 on a permanent basis. In polling our members, this was the major point that they wanted us to stress. We have backup material, by the way, on the subjects that we are discussing.

Energy is probably one of the most critical problems facing the small businessman today. In our areas, the utilities are informing our members that there will be a 40-percent cutback in natural gas this coming winter. If this goes through, we know that at least one of our companies will go out of business. This business employs 140 people, and it manufactures crane hooks, the only manufacturer of crane hooks in the United States. If this company does fail, American steel companies will have to purchase their crane hooks overseas.

Senator NELSON. Could you explain why this particular company would go out of business?

Mr. MURRAY. They have been given this notice officially by the gas company in their area, that they will have to operate at 40 percent less gas than they have now. The conversion costs are, according to their manager, too costly for them to absorb now. The electrical rates are soaring, of course, and so are the oil rates, and this constantly is cutting into the cash available for small companies to buy equipment, new employees, and last, but not incidentally, profits.

Domestic International Sales Corps.—they were established in 1971 to encourage exports, and large corporations recognized their value immediately, but smaller businesses are slower to recognize the value of DISC's.

Our best estimate, on the basis of our corporate members, is that DISC laws now are just beginning to have an impact on smaller companies. Smaller companies are just getting to the export market, and it is adding new growth for both themselves and helping them improve the Nation's balance of payments. We feel DISC's are working for smaller companies, and the repeal of the DISC legislation would undermine a law that is clearly succeeding.

On subchapter S, we have two recommendations, neither of which would have an impact on revenue to any degree. One would increase the number of shareholders from 10 to 15. We feel this is necessary to start up a subchapter S corporation, and to help it expand, particularly in a tight loan market, as we have now.

We feel that certain trusts should be allowed to be shareholders——

Senator NELSON. That certain what?

Mr. MURRAY. Trusts. To back up what Ed has just said, we feel that the death of an owner can undermine the subchapter S category by having his beneficiaries become shareholders.

In depreciation, we feel more flexibility is needed, and we suggest that consideration of a system being used in Canada, called the capital cost allowance system. Canada allows some depreciation in 2 years on machinery and equipment, and also allows companies to establish pools or classes of assets. Each class is assigned a maximum depreciation rate, and the taxpayer is allowed to decide when the depreciation could be taken.

Senator NELSON. Would it be a maximum of 100 percent in the first year—is that the Canadian system or the British system?

Mr. MURRAY. No; I think—as I understand it, 50 percent is the most you can get in Canada.

Senator NELSON. Oh, 50 percent in 1 year, and then the business can stretch the remaining depreciation out to whatever length he desires—is that correct?

Mr. MURRAY. Yes, sir; that is correct.

Senator NELSON. A maximum of 50 percent; yes, I remember.

Mr. MURRAY. What that does is, it allows the company to take the depreciation when he desires. If he has a good year, he can take more depreciation; if he has a poor year, he takes less.

Senator NELSON. And there is no time limit on the period over which he may take his remaining depreciation deduction—is that right?

Mr. MURRAY. That is my understanding.

Mr. PENDERGAST. There is some flexibility, but it can go, I think, up to a minimum or maximum figure.

Senator NELSON. What?

Mr. PENDERGAST. I think there are maximum figures.

Mr. MAUER. There is a range allowance in the system.

Mr. MURRAY. We have one additional thought—Pittsburgh Congressman John Hines III is working on legislation which would help small business, and one of the parts of his legislation would increase the investment credit to 25 percent on the first $100,000. We support this as a definite aid to small business.

That is the end of our testimony. We are very grateful that the Smaller Manufacturers Council could be heard.

Senator NELSON. Mr. McDonald, you are testifying in place of Mr. Richards.

Mr. McDONALD. Rather than testifying in his stead, sir, I am apologizing. He is suffering from one of the syndromes of the small businessman—he has to stay home and watch his store once in awhile. He requests permission to come in tomorrow and complete his testimony.

Senator NELSON. Please go ahead with any remarks you wish to make at this time.

Mr. McDONALD. I am not going to testify.

Senator NELSON. I see; he is going to present the testimony for the Cleveland organization in full tomorrow.

Mr. McDONALD. Yes, sir.

STATEMENT OF BRUNO J. MAUER, PRESIDENT, INDEPENDENT BUSINESS ASSOCIATION OF WISCONSIN

Mr. MAUER. I am Bruno J. Mauer, president of Rickert Industrial Supply Co. I am also a vice president of the Tool Fabrication Corp. in Milwaukee, Wis., a trustee-director of the National Federation of Independent Business, president of the Central States Industrial Distributor's Association and president of the Independent Business Association of Wisconsin.

First, I would like to say, we would like to present our Washington presentation for an official document of all of our associations that are present for the record.

[The prepared statement and attachments of Mr. Mauer follow:]

Statement by: Bruno J. Mauer
President, Independent Business Association of Wisconsin
President, Rickert Industrial Supply Co., Inc.
2942 North 117 Street
Milwaukee, WI 53222

Before the: Senate Select Committee on Small Business
and the Sub-Committee on Financial Markets of the
Senate Finance Committee
June 18, 1975

THE NEW MINORITY

My name is Bruno J. Mauer, president of Rickert Industrial Supply Co. I am also a vice president of the Tool Fabrication Corporation in Milwaukee, Wisconsin, a trustee/director of the National Federation of Independent Business, president of the Central States Industrial Distributor's Association and president of the Independent Business Association of Wisconsin.

Today, I am in the minority in this country. My employees, young, old, men and women are also in the minority. We in business are the minority.

Why? Because we pay the taxes that support the new American majority -- those Americans that live on the tax dollars of others.

A recent study prepared by Ford Motor Co. revealed that more than 80 million people were being supported by tax dollars -- taxes paid by the remaining 72 million people working the private sector of the economy. That includes myself, my employees and the total private sector of American business.

Private businesses are the job creators and the innovators. We in business and the people we employ are the new minority. The continued growth and success of the American enterprise system depends upon us.

Business cannot grow without a steady infusion of capital. New capital investment creates new jobs, and these jobs support the families of the new minority. Business needs to invest new capital and expects to take the risks involved in creating new jobs. It helps us and it helps America's economic growth. Future investment is part of our social responsibility, and if we are to continue solving the social problems our nation presently faces, an even larger investment will be needed.

We are not asking for subsidies. We are, however, asking for your help and understanding. We are asking for the ability to support the American enterprise system -- to enhance its growth and to create new jobs. The private sector -- business and industry -- provides employment for more than 83 percent of the jobs in this country.

One area that needs further study and research is the difficult effort of private business to increase capital retention.

Retained earnings are the primary source of both short and long term capital. Small independent business is presently starving for that capital.

Increased retained earnings are essential for economic growth, improved productivity and the end result -- creation of jobs. That is why we are now working to secure an increase in the corporate income tax surcharge exemption to $100,000. These retained earnings are vitally needed for economic growth.

Statement by Bruno Mauer
Page 3

The N.A.M. in a recent article by President Douglas Kenna states that it costs more than $30,000 in capital investment to support each job in the private sector.

My own experience as president of a small, independently owned, growing business shows that we require over $40,000 of invested capital for every tax paying employee.

Gentlemen, this has been accomplished through the generation of profits and the subsequent reinvestment of earnings in equipment, inventory and yes, even bricks and mortar.

Another drain on working capital are the inheritance tax laws which require the investment of dollars today for the future pay-out to the government upon the death of the owner/manager of a privately held business.

In my own situation, Rickert Industrial is required to divert funds to purchase life insurance on the owners to assure that cash will be available to meet the future estate tax liability. These are dollars which could be spent now for expansion and economic growth. Instead, we must protect our business so that it won't have to be merged or sold in order to raise the necessary funds for the death debt settlement. This is another unique problem not faced by large corporations, but one which is continuously faced by small, independent businesses.

Statement by Bruno Mauer
Page 4

There is another option available to our Congress. That is to radically change our corporate and business tax codes rather than continue to patch, sew up, add to and delete, with the sometimes traumatic after effects for years to come. It is a radical proposal but one that may in the long run benefit government and business and society in general on a much more effective level. I ran into the proposal in BUSINESS WEEK MAGAZINE and its author is Professor Robert Eisner of Northwestern University. He proposes that we eliminate the corporate income tax. At first this concept floored me, but after serious consideration and weighing several of the pros and cons, it had a great deal of merit, and should be given very serious consideration.

The job creators, whether small business, medium size or big business, are all vitally interested in continuing to contribute to the growth of free enterprise. In order to better study and measure the impact of government on these businesses a more effective method of differentiating size must be devised.

A three-tier standard should be developed based upon both employment and gross revenues by major industry classifications, such as manufacturing-mining, wholesaling, retailing, service and professional. The SBA business size standards must be revised to include the important middle size, growing business. Small business, medium business and big business -- all growing to help create more jobs.

Statement by Bruno Mauer
Page 5

I strongly feel that the time has come to declare a moratorium on unneeded legislation and regulation. What we need is simplification and reform. Our nation and its people have long ago reached the point of saturation. We have not only saturated ourselves with laws, regulations and problems that have reached the crisis proportion of credibility, but we have far surpassed the point where we must undo much of the damage created.

The primary task of lawmakers the balance of this decade should be to remove the tangle of restrictive laws we have created. Lawmakers should become law reducers if we are to face the balance of this decade with a system of government that operates under the guidance and a heritage of a republic within a democratic framework.

What 100 Extra Jobs Mean*

Personal Income	$100,016,000 Yearly
Bank Deposits	490,000
Grocery Stores	16,660,000
Car Dealers	89,000
Department Stores	59,000
Restaurants	43,000
Service Stations	41,000
Clothing & Shoe Stores	30,000
Furniture & Appliances	26,000
Lumber & Hardware	23,000
Drug Stores	19,000
Miscellaneous Retail	116,000

(*Prepared by: F. P. Neuenschwander & Associates, 50 West Broad Street, Columbus, Ohio 43215)

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INTRODUCTION

When a new manufacturing plant goes up, there is a net addition to income in the local community. The new payroll dollars flow into the cash registers of local merchants and into the coffers of local banks. Since the plant may purchase locally many materials, utilities and services, the local economy expands. This economic expansion is usually reflected in increases in population, school enrollment, and other concomitants of general community growth.

A number of attempts have been made to measure the quantitative effects of new industrial payrolls upon a community. No exact measurement is possible because many other influences are simultaneously at work in the particular community. The National Chamber's Economic Analysis and Study Group attempted in 1954 to measure such changes using nine counties which became industrialized between 1940 and 1950, and again in 1962 attempted to measure such changes in eleven counties which industrialized between 1950 and 1960, as contrasted with eleven counties which did not industrialize.

The earlier studies were widely cited by business firms, chambers of commerce, business development groups, state industrial development departments, and others. In response to many requests for updated figures, the present report studies economic and other changes occurring in ten counties which became industrialized between 1960 and 1970, as contrasted with ten counties which did not industrialize.

Also, in response to requests from several large chambers of commerce for data more applicable to metropolitan areas, we have compared economic changes between 1960 and 1970 in 127 standard metropolitan statistical areas having greater employment growth (both manufacturing and nonmanufacturing), as contrasted with 127 areas having lesser employment growth.

But the desirability of industrial growth as we have known it—in fact, economic growth in general—has been fundamentally questioned in the last few years by growing numbers of people concerned with unwanted side-effects. The time has long since passed when local and state governments, relying on an optimistic view that all growth is beneficial per se, compete with one another for new industry. Today a more sophisticated analysis of the costs and benefits of new industry characterizes industrial development efforts. This new

attitude is found at the federal level as well, as indicated by recent legislation affecting product quality and safety, environmental quality, occupational health and safety and equal employment opportunity. Further evidence of a more critical approach to the relative costs and benefits of economic growth is to be found in local and state governments' greater awareness of the added public service costs of new industry and population attracted by industrial development programs. Greater public resistance to the higher tax burdens associated with such growth has forced governments to rethink their development programs from this viewpoint as well as from the viewpoint of environmental, aesthetic and health considerations.

It would be unwarranted to infer from this latest attempt to measure "What New Jobs Mean to a Community" any value judgment on the goodness or badness of, for example, a larger population and more school children resulting from new businesses attracted to a community. On the other hand, our comments on the social costs of industrial development should not be construed as support for the "Zero Growth" movement.* These are questions that individual communities will have to resolve for themselves.** Economic growth will still be needed in the future, if only to provide the means of improving the quality of life; and growth can occur as a result of technological progress and more efficient use of resources even if population growth tapers off. The real issue is not growth or no growth, but rather the nature of economic growth, especially its qualitative aspects.

In using data from this report it must be remembered that every case of industrial expansion is unique. No two communities will experience exactly the same effects from a new payroll.

This study was prepared by Senior Associate Fred D. Lindsey of the Economic Analysis and Study staff.

CARL H. MADDEN
Chief Economist
Economic Analysis and Study

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*For a fuller discussion of the related "social responsibility of business" issue, see *The Corporation in Transition* (Chamber of Commerce of the U.S., 1973), publication No. 2838, $2.50 per copy.

**See "Industrial Development Undergoing Changes as Economic Trends Shift," *Journal of Commerce*, January 4, 1973, p. 1, for a description of the changing attitude of communities to local industrial development.

I. INDUSTRIALIZATION OF RURAL COUNTIES

Increased manufacturing employment is usually accompanied by economic expansion of the community. The National Chamber attempted to measure the increases in population, school enrollment, personal income, retail sales, bank deposits and other economic factors in counties which became industrialized during the 1940's, and again for counties which industrialized during the 1950's. This third study attempts to measure the impact of industrialization during the 1960's.

Industrial growth has costs as well as benefits. Capital outlays and increased community expenditures are often required to provide services for the new firms and their employees. Water supply and sewage disposal systems may require expansion. New streets and highways may be needed, and traffic control expenditures may increase. More police and fire protection may be required. Moreover, the new firm may create air and water pollution, noise and other nuisances, or may preempt sites better suited for recreation. The costs of industrial growth are discussed in Section III of this booklet.

This study attempts to measure economic changes in several rural counties which became industrialized between 1960 and 1970. The statistics, however, are subject to limitations arising from the nature of the problem. The relationship between industrial growth and general community development is a chicken-and-egg relationship—you can't have one without the other. Similarly, while industrial growth stimulates the remainder of the local community, the prior existence of the community with its diverse services makes industrial growth possible.

Hence, statistical measures of the effect of new industrial jobs upon various other local economic and social factors do not provide a one-way, cause-and-effect relationship. However, in the sample areas selected for this study, there is a very strong connection between the growth of industrial payrolls and changes in other indexes such as bank deposits and retail sales.

The ten counties chosen to be used in this analysis met the following criteria:

1. Manufacturing employment in 1970 was more than double that of 1960, with a numerical increase of over 1,000 manufacturing employees.

2. Manufacturing employment was more than 20% of total employment in 1970.
3. The major employment change between 1960 and 1970 was an increase in manufacturing employment.
4. The county was neither a part of, nor adjacent to, a metropolitan area.

The requirement that the number of manufacturing employees must have increased by more than 1,000 during the decade guards against inclusion in the sample of counties which may have had a 300% increase in manufacturing employees—say from 10 to 40 workers. The requirement that manufacturing provides over 20% of total 1970 employment, and that the major employment change during the decade must have been an increase in manufacturing employment, also guard against attributing to an increase in manufacturing employment a community growth not reasonably related thereto. The exclusion of metropolitan area counties, and counties adjoining them, avoids, insofar as it could be avoided, measuring the impact of influences from outside the particular geographic area.

No more than one country was chosen from any one state.* The counties selected were:

Cullman, Alabama
Benton, Arkansas
Montgomery, Kentucky
McLeod, Minnesota
DeSoto, Mississippi
Hall, Nebraska
Wayne, North Carolina
Florence, South Carolina
Johnson, Tennessee
Hopkins, Texas

Eight of the ten sample counties are in southeastern states. A more geographically dispersed sample would be preferable, but for the present analysis it seemed desirable to apply the criteria strictly rather than to modify them in the interest of a wider geographic spread.

Manufacuring employment characteristics of the sample counties are shown in Table 1.

Total 1960 employment of the ten counties was 25.4% agricultural, 14.8% manufacturing. In 1970 they were 14.8% agricultural, 28.1% manufacturing. Agricultural employment dropped from 30,507 in 1960 to 16,430 in 1970. This 46% decrease in agricul-

*For a further discussion of the method of choice of counties, see Technical Appendix, page 16.

tural employment obscured many economic changes resulting from increased industrialization.

To compensate for this distortion, changes in the ten industrialized counties were compared with changes in ten rural counties which did not industrialize. The counties chosen for control purposes were from the same ten states as the industrialized counties, they also were neither part of nor adjacent to metropolitan areas, and each had approximately the same proportion of manufacturing employment in 1970 as in 1960.

The 1960 population and employment in the nonindustrialized counties totaled slightly less than half that of the industrialized counties. To compensate for this difference economic changes of the nonindustrialized counties were multiplied by an appropriate factor —in this case 2.32, which is the ratio between the 1960 total employment in the industrialized counties (120,251), and the nonindustrialized or control counties (51,863).*

Economic changes between 1960 and 1970 in the two groups of counties are summarized in Table 2, together with the net changes between the two groups, and the changes corresponding to an increase of 100 manufacturing employees. These economic changes are also shown in chart form on page 8.

Each one hundred more manufacturing employees was accompanied by an increase of 68 nonmanufacturing employees, distributed as follows:

EMPLOYMENT CHANGES	*Number of workers*
Manufacturing	+100
Nonmanufacturing:	
Wholesale and retail trade	+21
Professional and related services	+17
Transportation, communication and other public utilities	+11
Finance, insurance and real estate	+6
Business and personal services	+5
Construction	+3
Other industries	+5

* Additional information regarding the choice of this factor is given in the Technical Appendix, page 16.

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The $565,000 increase in annual retail sales associated with each 100 new manufacturing workers was not computed separately for individual business lines. However, based upon total retail sales for the United States, it would be distributed approximately as follows:

Grocery stores	$119,000
Motor vehicle dealers	89,000
Department stores	59,000
Eating and drinking places	43,000
Gasoline service stations	41,000
Clothing and shoe stores	30,000
Furniture, home furnishings and household appliance stores	26,000
Lumber, building materials and hardware dealers	23,000
Drug stores	19,000
Other retail stores	116,000
Total increase in retail sales	$565,000

TABLE 1

MANUFACTURING EMPLOYMENT, 1960 AND 1970

	Manufacturing employment		*Change in manufacturing employment*		*Per cent of employed persons in manufacturing*	
County	*1960*	*1970*	*Number*	*Per cent*	*1960*	*1970*
Cullman, Ala.	2,828	6,028	+ 3,200	+113%	20.1%	32.2%
Benton, Ark.	2,725	6,639	+ 3,914	+144	21.4	35.1
Montgomery, Ky.	536	1,823	+ 1,287	+240	12.1	33.2
McLeod, Minn.	1,579	3,426	+ 1,847	+117	16.4	31.1
DeSoto, Miss.	752	3,326	+ 2,574	+342	10.8	29.0
Hall, Nebr.	1,147	3,471	+ 2,324	+203	8.7	20.1
Wayne, N. C.	3,041	6,271	+ 3,230	+106	13.5	23.2
Florence, S. C.	3,930	8,611	+ 4,681	+119	14.3	26.2
Johnson, Tenn.	347	1,935	+ 1,588	+458	12.8	47.9
Hopkins, Texas	922	1,954	+ 1,032	+112	14.2	24.7
Total	17,807	43,484	+25,677	+144%	14.8%	28.1%
Total for 10 counties without industrial growth	7,876	9,030	+ 1,154	+ 15%	15.2%	18.0%

SOURCE OF DATA: *United States Census of Population*, 1960 and 1970.

TABLE 2

CHANGES BETWEEN 1960 AND 1970 IN COUNTIES WHICH INDUSTRIALIZED AND COUNTIES WHICH DID NOT INDUSTRIALIZE

	Changes in Counties which Industrialized	*Changes in Counties which did not Industrialize**	*Net Change between two Groups of Counties*	*Net Change per Increase of 100 Manufacturing Employees*
Population	+56,796	−23,989	+80,785	+351
Families	+19,642	−2,610	+22,252	+97
School Enrollment	+18,080	−16	+18,096	+79
Personal Income**	+$562,427,000	+$324,109,000	+$238,318,000	+$1,036,000
Retail Establishments***	+372	+158	+214	+1
Retail Sales***	+$241,143,000	+$111,147,000	+$129,996,000	+$565,000
Bank Deposits	+$276,962,000	+$164,200,000	+$112,762,000	+$490,000
Employment in:				
Manufacturing	+25,677	+2,677	+23,000	+100
Wholesale & Retail Trade	+7,353	+2,485	+4,868	+21
Professional and Related Services	+10,812	+6,870	+3,942	+17
Transportation, Communication and other Public Utilities	+2,791	+276	+2,515	+11
Finance, Insurance and Real Estate	+1,900	+585	+1,315	+6
Business & Personal Services	+436	−682	+1,118	+5
Construction	+2,428	+1,761	+667	+3
Agriculture, Mining and Industry not Reported	−16,929	−18,210	+1,281	+5
Total, All Industries	+34,468	−4,238	+38,706	+168

*Actual changes in these counties multiplied by 2.32 to compensate for smaller population and employment in the group of counties which did not industrialize. For explanation, see page 16.

**Change in personal income is from 1959 to 1969.

***Change in retail establishments and retail sales is from 1958 to 1967.

SOURCE OF DATA: Population, families, school enrollment, personal income and employment from United States *Census of Population*, 1960 and 1970. Retail establishments and retail sales from United States *Census of Business*, 1958 and 1967. Bank deposits from Federal Deposit Insurance Corporation.

What 100 New Factory Workers Mean To A Town

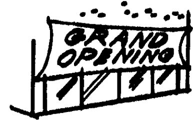
351
More People

79 More
School Children

$1,036,000
More Personal
Income Per Year

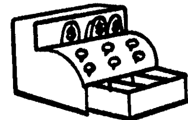
97
More
Families

$490,000
More Bank
Deposits



1 More
Retail
Establishment

68 More
Employed in
Non-Manufacturing



$565,000
More Retail
Sales Per Year

II. WHAT NEW JOBS MEAN TO A METROPOLITAN AREA

Concentrated in 264 metropolitan areas are 69% of our population and 72% of our employment. Both population and employment increased twice as fast in metropolitan as in nonmetropolitan areas between 1960 and 1970.

In measuring the effects of increased metropolitan area employment, economic trends of faster growing areas were compared with trends of slower growing areas. Manufacturing employment constitutes only 25% of the total metropolitan area employment, and manufacturing employment growth accounts for only 15% of total employment growth in metropolitan areas since 1960. Therefore, total employment was used rather than manufacturing employment.

The 264 standard metropolitan statistical areas have 1970 population ranging from 11.5 million to 55,959. The 10 largest areas were omitted because: (1) These 10 areas have a total population of 48 million, or 34% of the population of all 264 areas. Including the 10 largest areas would obscure the economic changes of many smaller areas. (2) Bank deposits of the 10 largest areas include considerable funds from the rest of the United States, and from the rest of the world. Deposits in 1970 averaged $3,598 per capita in the 10 largest areas, but only $1,889 in the other 254 areas. Bank deposit changes in the 10 largest areas are much less representative of local economic changes than in the 254 other areas. For economic changes both including and excluding the 10 largest areas see Technical Appendix, page 17.

For this study the 254 metropolitan areas were divided into two groups, according to change in total employment between 1960 and 1970. The 127 areas with greater employment growth (ranging from +125.1% to +20.0%) were compared with the 127 areas with lesser employment growth (ranging from +20.0% to −8.8%).

The areas with greater employment growth had total 1960 population of 43,932,000, and the areas with lesser employment growth had total 1960 population of 35,770,000. To compensate for this difference, the 1960 and 1970 economic data of the areas with lesser employment growth were multiplied by the ratio between the two population totals, or 1.23.

For each group the 1960 data were subtracted from the 1970 data, and the differences attributed to increased employment.

As shown in Table 3 and the chart on page 11, an increase of 100 employees (both manufacturing and nonmanufacturing) was associated with the following changes in other economic factors:

Population	+245
Families	+69
School enrollment	+80
Personal income	+$872,000
Retail establishments	+2
Retail sales	+$395,000
Bank deposits	+$481,000

Several changes above, resulting from an increase of 100 manufacturing plus nonmanufacturing employment, are considerably less than the corresponding changes associated with an increase of 100 manufacturing employment shown on page 7. This does not necessarily mean nonmanufacturing employment has less impact upon the community than manufacturing employment.

When a rural county becomes industrialized the increased manufacturing workers provide employment for more school teachers, more sales clerks, and other nonmanufacturing workers in the immediate area. On page 7 the total change in the area was associated with increased manufacturing employment.

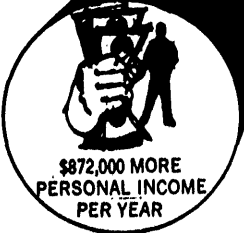
When nonmanufacturing employment increases in an area more manufactured goods are purchased in the area, but manufacture of much of the goods—and the resultant increase in employment—occurs in other parts of the United States. Due to the impossibility of measuring such changes in other areas, this section of the study measured only changes in the individual metropolitan areas.

If the changes shown on page 7 for 100 manufacturing employees are recomputed for change per increase of 100 in total employment (manufacturing plus nonmanufacturing) they are:

Population	+209
Families	+58
School enrollment	+47
Personal income	+$617,000
Retail establishments	+1
Retail sales	+$336,000
Bank deposits	+$292,000

All the above changes are less than corresponding changes for metropolitan areas shown earlier, but some of the difference may be due to differences in levels of incomes, bank deposits, and other factors between metropolitan and nonmetropolitan areas.

WHAT 100 NEW WORKERS
(manufacturing and nonmanufacturing)
MEAN TO A METROPOLITAN AREA



Chamber of Commerce of the United States

TABLE 3

CHANGES BETWEEN 1960 AND 1970 IN METROPOLITAN AREAS WITH GREATER AND LESSER EMPLOYMENT GROWTH

Item	*Metropolitan areas with greater employment growth*	*Metropolitan areas with lesser employment growth**	*Net change between two groups of areas*	*Net change per 100 increase in employment*
Employment (manufacturing and nonmanufacturing) ..	+5,690,652	+2,000,430	+3,690,222	+100
Population	+12,519,000	+3,461,000	+9,058,000	+245
Families	+3,533,540	+971,171	+2,562,369	+69
School enrollment	+6,012,287	+3,069,701	+2,942,586	+80
Personal income**	+$112,598,000,000	+$80,425,000,000	+$32,173,000,000	+$872,000
Retail establishments*** ...	+42,969	−31,882	+74,851	+2
Retail sales***	+$37,193,000,000	+$22,612,000,000	+$14,581,000,000	+$395,000
Bank deposits	+$54,984,000,000	+$37,252,000,000	+$17,732,000,000	+$481,000

*Actual change in these areas multiplied by 1.23 to compensate for smaller total 1960 population in the group of areas with lesser employment growth. For explanation see page 9.

**Change in personal income is from 1959 to 1969.

***Change in retail establishments and retail sales is from 1958 to 1967.

SOURCE OF DATA: Employment, population, families, school enrollment and personal income from United States *Census of Population*, 1960 and 1970. Retail establishments and retail sales from United States *Census of Business*, 1958 and 1967. Bank deposits from Federal Deposit Insurance Corporation.

III. COSTS OF INDUSTRIAL GROWTH

Industrial growth, with workers moving from agriculture to more productive higher paid manufacturing and service industry jobs, has for centuries characterized the United States and many other countries.

Industrial development was welcomed, as it brought higher incomes, and provided working conditions often less laborious than farm work. (The United States 1970 median income of farm families was $5,800, but of manufacturing families $11,100.)

The higher nonfarm incomes supplied tax revenues to government, supported retail business, and provided markets for service industries.

But, during recent years, there has been increasing realization that industrial growth often brings rising social costs—jammed highways, crowded airports, honky-tonk developments, smog, foul air, polluted water, disagreeable noise, despoiled nature and urban sprawl.

Higher government costs of expanded and improved schools, library and recreational facilities, hospitals, transportation, waste disposal, police and other services have been reflected in higher taxes.

As just mentioned, some forms of production and consumption generate social costs, like noise, congestion, or environmental pollution. These costs are borne by the general public rather than the industrial firms or consumers involved. Public concern about deteriorating water and air quality, dwindling green space, inadequate transportation, housing and pollution, have caused some areas, particularly along the Atlantic and Pacific coasts, to restrict growth by means of stringent land-use and antipollution laws. Some thinly populated areas, anticipating a flood of refugees from heavily populated metropolitan areas, have adopted new zoning regulations attempting to restrict population growth. As the public, acting through government, increasingly imposes higher performance and product quality standards on business, these higher social costs will be passed forward in the form of higher prices for affected products or services.

These recent developments have caused some localities to reevaluate the relative advantage of attracting certain types of industry. Furthermore, most local governments are now aware that the typical new individual household costs more in services than it pays the government in taxes. If the new industrial operation is fully or partially tax exempt, it and the new workers it attracts may result

in higher tax levels. City planners are today developing what they consider optimum economic growth plans for given areas. New industry is no longer evaluated simply in terms of the number of additional employees and payroll income, but rather in terms of whether or not the industry will on balance be an asset to the area. For example, a benefit/cost study* for Montgomery County, Maryland, estimated that a light manufacturing activity and its employees would pay the County only 79¢ in taxes for every $1.00 it would cost the County to provide education, police and fire protection, traffic direction, streets and access roads, courts, libraries, etc., for the plant and its employees.

However, a large private tax-paying white collar activity, with large numbers of clerical workers and expensive computing and data processing equipment would pay the County $2.34 in taxes for every $1.00 in costs to the County. A large federal government research installation, despite impacted area payments in lieu of taxes, would pay the County only 69¢ for every $1.00 in County costs.

Industrial growth may not be the economic solution for high unemployment in a depressed area if the new industry's work force requirements do not match the skills and educational levels of the area's unemployed. An instance of this was an aluminum reduction and rolling mill constructed in 1956 in a depressed area. Most local workers lacked the education and experience level qualifying them for the difficult and complex work of the plant. Many employees hired were natives of the area who had migrated and wished to return, or were persons on temporary layoff from other industrial plants. Almost all professional, technical and managerial employees came from other areas. Employment in the area grew about 4,000 due to the plant, but of this number only about 300 to 500 local workers were employed in the aluminum plant, and about 300 more worked in retail stores and other establishments existing because of the plant. About 100 new professional jobs (teachers, physicians, ministers, etc.) resulted, but they were almost all filled by outsiders. Lack of business experience and necessary capital prevented most local people from starting business operations. Almost all new stores

**The Relative Importance to Montgomery County of Selected Economic Activities,* Boise Cascade Center for Community Development, Washington, D. C., 1970.

were started by persons bringing capital into the town, or as branches of national firms.*

But nowadays, in addition to these conventional benefit-cost comparisons, more and more local governments are being forced by public opinion to take into account social costs and benefits in evaluating the net benefit of new business firms to the community. So today it is not advantageous for a community to attract new enterprises if the full costs to the community (including social costs) exceed the benefits to the community. If the advantages of industrialization are to be realized fully and without offsetting disadvantages, care must be exercised in the attraction of new firms.

*Irwin Gray, "Employment Effect of a New Industry in a Rural Area," *Monthly Labor Review*, Washington, D. C., June 1969, pp. 26-30.

IV. TECHNICAL APPENDIX

Choice of Counties. Analysis of data for the 3,049 United States counties revealed about 30 meeting the industrial growth criteria listed on pages 3 and 4. In states with more than one county meeting the criteria, the county chosen was that with the greatest percentage increase in manufacturing employment between 1960 and 1970.

Counties without industrial growth meeting the criteria were more numerous. In each of the 10 states a county without industrial growth was chosen which most nearly approximated the 1960 total population and the percentage of total employment engaged in manufacturing as the industrialized county already chosen for that state.

Adjustment of Data in Counties without Industrial Growth. Total 1960 population and employment in the 10 counties with industrial growth were about twice that of the counties without industrial growth.

	Total for 10 counties with industrial growth	*Total for 10 counties without industrial growth*	*Ratio between the two groups of counties*
Total population (1960)	375,210	158,712	2.36
Total employment (1960)	120,251	51,863	2.32
Manufacturing employment (1960) ..	17,807	7,876	2.26

In this study the ratio between total employment (2.32) was used as a multiplying factor for the counties without industrial growth. The following table shows the relative small difference in economic growth trends associated with an increase of 100 manufacturing employees which occur if either of the two other factors is used.

	Using total population factor (2.36)	*Using total employment factor (2.32)*	*Using manufacturing employment factor (2.26)*
Total population	+354	+351	+347
Nonmanufacturing employment	+69	+68	+67
Personal income	+$1,015,000	+$1,036,000	+$1,069,000

Exclusion of 10 Largest Metropolitan Areas. The 132 metropolitan areas with greatest 1960-70 percentage increase in employ-

64-397 O - 76 - 20

ment included only two (San Francisco and Washington) of the 10 largest metropolitan areas. The 132 areas with lesser employment growth included the five largest metropolitan areas plus three more of the 10 largest areas. The 10 largest areas constituted 10% of the 1970 population of areas with the greater employment growth, and 54% of the population of the areas with lesser employment growth.

The following comparison shows effects of including and excluding the 10 largest areas in the computations.

	Change per 100 increase in employment	
	Including 10 largest areas	*Excluding 10 largest areas*
Population	+230	+245
Families	+68	+69
School enrollment	+74	+80
Personal income	+$647,000	+$872,000
Retail establishments	+2	+2
Retail sales	+$380,000	+$395,000
Bank deposits	+$175,000	+$481,000

OTHER CHAMBER OF COMMERCE PUBLICATIONS

Business and the Consumer—A Program for the Seventies. Analyzes the scope of modern consumerism, consumerism and the changing environment, and makes recommendations for business action. Publication No. 1929, $1.00.

Business and the Future—America's Next 30 Years. Identifies some major trends shaping the future American environment within which business will operate. Publication No. 1884, $1.00.

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Employee Benefits, 1971. Shows employer payments for vacations, holidays, sick leave, pensions, insurance, and other employee benefits. Include 22 table and 4 charts. Publication No. 2758, $2.00.

Environment and Population Growth. Studies the dilemma posed by the world population increase, and modern man's greatly enlarged ability to utilize and transform nature's limited resources. Publication No. 1902, $1.00.

Manpower for the Seventies. Examines prospective problems and changes in our labor force during the next decade, what policies will increase labor force participation, how we can improve employment opportunities. Publication No. 1905, $1.00.

Order above publications from Chamber of Commerce of the United States, Washington, D. C. 20006. Please include publication numbers, and enclose check payable to Chamber of Commerce of the United States.

Small Business WASHINGTON PRESENTATION 1975

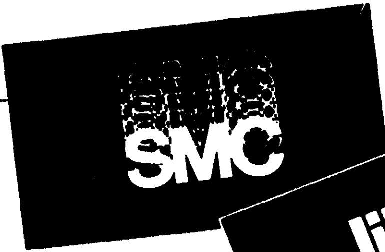


TABLE OF CONTENTS

TAX REFORM FOR SMALL BUSINESS — 1975

	Page
Background	(See Below)
Small Business in the Spotlight	1
The ACTION Scoreboard	2
Action Now: TAX REFORM	2
Introduction	3
The Theme for Action in '75 is: TAX REFORM	5
The Surtax Exemption	6
Retain DISC	8
Subchapter S Rules	8
Interstate Taxation Act	9
Estate Tax Law	9
Simplify Depreciation	10
Revise Long-Term Capital Gains	10
Summary	11
Smaller Business Association of New England	12
Independent Business Association of Wisconsin	15
Smaller Manufacturers Council	17
Council of Smaller Enterprises	19

BACKGROUND

Some 30 years ago, the Small Business Washington Presentation began under the auspices of the Smaller Business Association of New England, Inc. (SBANE). Two years ago, we were joined by the Independent Business Association of Wisconsin (IBA-W), the Smaller Manufacturers Council (SMC) of Pittsburgh, Pennsylvania and last year, the Council of Smaller Enterprises (COSE) of Cleveland, Ohio.

Over the years this Small Business Washington Presentation has led to significant legislative accomplishments on behalf of small business. For instance, last year's Presentation proposed that the Small Business Administration create an Office of Advocacy. Through the efforts of Congresswoman Margaret Heckler, Congress established a Chief Counsel for Advocacy within this agency.

The theme of this year's Presentation is tied in with the intent of the Congress to initiate major tax reform legislation. The Presentation covers Tax Reform for Small Business pointing out the urgent need that tax relief will result in capital formation to the smaller enterprise as the number one priority in small business legislation for 1975.

Small business has always received a warm welcome on Capitol Hill. The Presentation's purpose is to translate this cordial reception into action, by articulating the concerns and problems of small business to our national lawmakers. We thank the Senate and House Small Business Committees and staffs for making it possible for the four organizations to give this presentation.

CREDITS: The Presentation was delivered in Washington by Arnold Zenker, Arnold Zenker Associates, Newton Centre, Massachusetts; art work for the slide portion was produced by BKB Studios, Inc., Boston; this book was printed by The Cricket Press, Inc., Manchester, Massachusetts.

SMALL BUSINESS IN THE SPOTLIGHT

This was the scene two decades ago when Small Business made its "Washington Presentation". Only a handful of Congressmen showed up at this small, out-of-the-way office in the Capitol. Most were New Englanders, because there was only one sponsor, the Smaller Business Association of New England. "We had to really twist some arms," says an early organizer.

What a change in 20 years! Over 300 people turned out for last year's Washington Presentation, including 150 Senators and Representatives from across the nation, agency heads and other top policy-makers. They heard a hard-hitting presentation by not just one regional Small Business group, but FOUR regional associations covering key industrial areas of the U.S. The results: ACTION.

The ACTION scorecard:

SBA Chief Counsel for Advocacy

State of Small Business Amendment

Small Business represented on Commission on Government Procurement

Small Business represented on Commission on Government Paperwork

House Small Business Committee made a standing committee

IRS Small Business Advisory Council

House action on Interstate Taxation Act

OSHA Revisions for Small Business

SBA decentralization

Increase in SBA Management Assistance

Repeal of Fair Trade

Export incentives

Two-tier prime rate

Three-stage wage and price controls

Surtax exemption raised to $50,000

Investment tax credit increased

Action Now: TAX REFORM

1. Surtax exemption — increase to $100,000.
2. Nelson-Evins Small Business Tax Reform and Simplification Act of 1975.
3. Retain DISCs — they're working for Small Business.
4. Subchapter S. — change.
5. Interstate Taxation Act — needs Senate approval.
6. Depreciation — simplify.
7. Section 303 of the Estate Tax — lower restrictions.
8. Revise long-term capital gains tax rates.

introduction

The spotlight on Small Business grows brighter every year.

Small Business: A Different Breed

As the pictures on the previous pages show, more and more and more people are hearing Small Business' story. That isn't because the food gets better. It's because policy-makers and planners are increasingly aware of Small Business as a *unique* entity in the American economy. No longer do policy-makers indiscriminately lump small corporations in with larger ones. They recognize that small businesses are fundamentally different in their sharply reduced ability to raise capital by the public sale of stock or the assumption of long-term debt. Small businesses rely on one-shot infusions of capital by family and friends to start in business, and they rely on retained earnings to stay in business. That makes smaller businesses a different breed, and that's what government is starting to recognize. Several key government planning groups, for example, now require one of their members to be a representative of Small Business. The Committee on Interest and Dividends recognized the uniqueness of Small Business when it encouraged banks to set up a "two-tier" system of lending rates to businesses.

Government Listens & Takes Action

The annual "Washington Presentations" of the Small Business Coalition are a good measure of this increased awareness of Small Business. In the early years, three decades ago, Small Business had a hard time even convincing Congress it existed. The tendency then was to assume that the needs of Small Business were amply met whenever Big Business' needs were met. Government agencies and lawmakers in Congress assumed that all corporations were alike. Corporate size or capital-raising ability was never considered in laws or regulations affecting corporations. Unconcern extended even to smaller matters like forms used for government reports and questionnaires. The same forms were sent to big and small business alike, disregarding the fact that a large corporation has a special staff just to handle such paperwork, while in a small corporation the one-man bookkeeping "department" must work overtime to fill out voluminous forms. In this environment, it was small wonder that only a handful of Congressmen turned out to hear the first Washington Presentation in 1948, put on by the Smaller Business Association of New England. At that time, Small Business was, in a very real sense, invisible, at least from the policy-makers' point of view.

Result: Small Business No Longer Invisible

That invisibility has been significantly overcome during the past three decades. Four regional Small Business associations covering the nation's key industrial areas now join forces to air their concerns each May in Washington. The handful of Congressmen who attended the first session has grown to over 300 people. From short speech-and-a-handshake, the presentation has developed into a sophisticated mixed-media effort, bolstered by the kind of statistics and other data that policy-makers need. Follow-up discussions have taken place at the White House and with key members of Congress.

Scorecard:

The results of this ever-brighter spotlight have been gratifying. Several specific measures suggested by Small Business have been enacted. And in general, Small Business encounters a more

receptive regulatory environment in Washington, at least on matters concerning the mechanics of government regulation.

SBA Advocacy Counsel

Item: The Chief Counsel for Advocacy was created within the Small Business Administration. The central recommendation of the 1974 Washington Presentation was creation of this new SBA office: to provide Small Business with a focal point to express its views, and to serve as an advocate for Small Business in government. A month after the Washington Presentation, Rep. Margaret Heckler proposed an amendment to the SBA Act creating this office. It was quickly enacted by Congress and signed into law by President Ford.

"State of Small Business"

Item: After the 1973 Washington Presentation, Sen. Edward Kennedy introduced an amendment to the SBA Act providing that the SBA Annual Report include a section on the "State of Small Business". This comprehensive overview of the future needs and problems of Small Business, which became law, is an aid to planners throughout government and industry.

Seats on Government Commissions on Procurement...

Item: A special seat for a representative of Small Business was established on the Commission on Government Procurement, at the coalition's suggestion. The Commission's report has already led to substantial changes in government purchasing policy, and the interests of Small Business were recognized.

...and Paperwork

Item: Legislation creating a similar Commission on Government Paperwork also provided a special seat for Small Business. Participation in special studies is important to ensure consideration of Small Business' interests.

House Committee Upgraded

Item: The House Small Business Committee was elevated to standing committee status, which gives it legislative power.

Special IRS Committee

Item: Informal meetings between Small Business groups and the Internal Revenue Service, initiated by the Senate Small Business Committee, led to formation of an official Small Business Advisory Committee to the IRS. The Committee meets regularly with the IRS on measures to simplify and revise tax forms and requirements as they uniquely affect Small Business.

OSHA Revisions

Item: Congress has made important revisions for Small Business in enforcement of the Occupational Safety and Health Act.

Interstate Taxation Act Passed by House

Item: The House twice has passed an Interstate Taxation Act to create a uniform system for business reporting and paperwork. The bill, unfortunately, has been bottled up for seven years in the Senate Finance Committee.

SBA Begins Needed Decentralization

Item: Needed decentralization of the SBA was begun by redistribution of manpower to regional offices. This helps make the SBA's services more available to local business concerns.

SBA Beefs Up Its Management Aid

Item: The SBA has increased its management assistance program, adding over 300 new management assistance officers the past two years. Further steps to strengthen the SBA are necessary to handle additional legislative responsibilities and to counteract the insensitivity toward Small Business shown by the Office of Management and Budget.

Repeal of Fair Trade Laws

Item: Repeal of Fair Trade legislation seems virtually assured, thus removing a major roadblock to effective business competition.

"Two-tier" Prime Rate

Item: A "two-tier" prime lending rate was supported by the Commission on Interest and Dividends during the height of the anti-inflation battle. Further concern for Small Business' unique problems was evident in the three-stage wage and price controls.

Taken separately, none of these measures would seem like a major accomplishment. But taken together, they add up to an

encouraging trend. The invisibility that once buried Small Business within the overarching rubric "Corporations" is being replaced by recognition of this sector as unique.

Surtax Exemption in '75 Highlights the Trend

Nowhere is this recognition more evident than in the recent emergency tax reform package signed into law by President Ford. Though the new law covers a broad scope of tax matters, one section makes it a milestone act for Small Business. That was the one year increase in the *surtax exemption* to $50,000 — the first change in this exemption since 1938 and the first tax measure aimed specifically at Small Business in nearly two decades. The law also cut the rate on the first $25,000 of profit to 20%, increased the investment tax credit to 10% and increased provisions for its use to $100,000 on used equipment combined with an increase in accumulated earnings to $150,000.

Steps to Correct Unrealistic Exemption Cutoff

The surtax exemption had stood at $25,000 for nearly 40 years, despite persistent inflation that long ago made the cutoff point unrealistic. Even the new $50,000 limit fails to keep pace with inflation, but the increase does show concern for Small Business. As Sen. Gaylord Nelson said when recommending the change: "The new tax measure does an important thing that is not widely recognized. It in effect acknowledges distinctions between small, medium-sized and large businesses by formalizing a graduated tax burden similar to the graduation that guides our individual taxe codes. . . . Thus we have, in effect, affirmed for business the principle that the stronger and more affluent are better able to pay more and should."

THE THEME FOR ACTION IN 1975 IS:

tax reform

Action '75 Theme: TAX REFORM

Washington has indeed gone a long way toward recognizing Small Business. The time has come to put that recognition into action, in the area where Small Business is most thoroughly overlooked: *taxes*. Over the coming months, Congress will be considering broad moves to reform the nation's tax system. This reexamination of fundamentals is long overdue, and is particularly timely in view of the current economic crisis and the emergency steps taken in the March Tax Act.

Don't Forget Small Business—It's Vital

As it studies and plans, Congress must be sure to include Small Business. Lawmakers cannot assume that any reform affecting business generally also helps Small Business in particular. Rather, if Small Business is to make its contribution to economic and future stability, tax reform measures directed specifically at this vital sector must be considered. The object isn't to grant Small Business unfair special relief. No one sector of the economy should receive precedence, especially in these difficult times. But distinctions between Small Business and Big Business do exist, and they require distinctions in tax reform measures. What works for one sector won't automatically work for the other. If the aim of tax reform is to help ensure economic recovery — which means jobs and capital — then reform measures must be effective, that is, they must actually help create jobs and capital.

THE SURTAX EXEMPTION SHOULD BE INCREASED TO

$100,000

Surtax Exemption: Finish the Job of Updating

Having made a tentative first step in raising the exemption to $50,000 for one year, Congress should now complete the job of setting a realistic *and effective* cutoff point.

Small Companies Can't Sell Stock...

The logic behind the 1938 action establishing the surtax exemption is unassailable. Small businesses grow almost exclusively through retained earnings. Equity may get a new corporation off the ground, but that small company can't continue to rely on investors to meet its capital needs. While large corporations usually can sell more stock whenever they need additional capital, it's a fact of life for small businesses that they can't.

...or Find Loans

The only alternative for external financing is debt. And small businesses have fared poorly indeed at the debt counter. Small businesses traditionally pay the highest interest rates and have the least success in obtaining loans. Over a two-year period ending November 1974, small short-term loans (under $100,000 and less than 36 months) fell almost 50% as a percentage of total corporate short-term loans. In the long-term debt market, small loans accounted for less than two cents of every dollar loaned to business. This occurred despite the fact that small businesses of a size most likely to need such loans account for over half of all corporate sales — and over half of all corporate employment.

Retained Earnings Are the Answer

The only avenue to growth for a small business is retained earnings. And yet small businesses retain less of their earnings than any other sector. After-tax profits in the fourth quarter of 1973, for example, were 2.4 cents on the dollar for companies of $1 million assets or less, 3.4 cents for companies of up to $5 million in assets — but 7.9 cents for billion-dollar corporations. Altogether, the 600,000 small businesses that employ 16.8 million people retained less than half as much profit as the largest corporations. The effective tax rate ranged from 42.8% to 51.4% for the small companies — compared with only 28.8% for the large corporations.

Payoff: JOBS

In other words, the companies that need retained earnings most are being starved. And that means the job market is being starved, too. Small businesses are "where it's at," as far as creating new jobs is concerned. It's almost axiomatic to say that large corporations grow by buying machines, while small businesses grow by hiring people. Consider the period between 1963 and 1967, for example, the most recent period for which detailed statistics are available. In that period, the sales of large business spurted 60%, but their employment *fell* 9%. Small business, on the other hand, had a comparatively meager sales rise of 18%, but on that, they *boosted* employment by 62%. In other words, small businesses translate growth into jobs. Hindering small-business growth by curtailing retained earnings hits the economy at its weak spot, the job market.

Congress Acted Wisely 37 Years Ago

The way to attack this problem is the same today as it was in 1938, when Congress first acted: permit smaller corporations to retain more of their earnings, for modernization and jobs.

The method Congress chose 37 years ago was to exempt the first $25,000 of earnings from the full corporate tax rate.

But 429% Inflation Has Changed Things

The problem, of course, is that like the nickel cigar, $25,000 isn't what it used to be. In fact, the $25,000 of 1938 equals $6,452 in 1975. That amount is simply inadequate as a spur to growth. Look at the Wholesale Price Index, for example. Since 1938, the index has spurted 429%. That means the $25,000 of 1938 is equal in effective purchasing power to $107,250 today. Or, using the 392% increase in the Consumer Price Index since 1938, the $25,000 then requires $98,000 now.

Congress Took First Step

In other words, the surtax exemption of $25,000 long ago ceased to have its original strength. That means the exemption accomplished little in terms of its original intent. It was in recognition of this fact that Congress acted early this year to raise the exemption to $50,000, and to cut the rate on the first half of that to 20%. That was an important first step. The exemption increase will allow corporations to retain an additional $1.2 billion of earnings, or about $7,000 per company. That amount is insignificant, of course, for a major corporation. But for a small warehousing concern, that amount means a needed fork-lift can be bought — and a man hired to drive it.

The Realistic Target: $100,000 Exemption

Much more adequate, though, in terms of achieving the exemption's desired effect, would be to recognize the harsh fact of 429% of inflation since 1938, and to set the exemption for future years at $100,000. Doing so would bring tax rates more into line with current realities. Canada, for example, has already recognized the necessity of a $100,000 exemption. It began a staged increase from $35,000 three years ago and has now reached a surtax exemption of $100,000.

Providing such an incentive for growth does mean a near-term revenue loss for the government, but that loss is more than repaid over the long run. For a smaller business, retained earnings are the only route to growth. For a smaller business, opportunities for growth are translated immediately into jobs, capital-equipment purchases and goods and services. And that, before long, adds up to additional tax revenues.

retain DISC,

AT LEAST FOR SMALL BUSINESS

Retain DISC: They're Working

Domestic International Sales Corporations were established in 1971 to encourage exports. Large corporations recognized their value immediately, and by 1972, over 80% of the 2,249 DISCs were owned by corporations with assets over $1 billion.

Smaller businesses were slower to recognize the value of DISCs. Not only does it take longer for new legislation to filter down to smaller concerns, but there has been a long-standing hesitation among small businessmen over the complexities and paperwork mire involved in exporting. Our best estimate, on the basis of our corporate members, is that the DISC law is just now starting to have noticeable impact on smaller companies. Hundreds of small concerns are being lured into the export market for the first time, adding a new avenue of growth for themselves and helping to improve the nation's balance-of-payments. In February, the U.S. had its most favorable balance-of-payments surplus ever.

Altogether, the Treasury estimates DISC brought about an extra $2 billion of exports in fiscal 1973 — $2 billion that would not have been shipped were it not for the DISC incentive.

In other words, for smaller businesses, DISCs are working. Repeal of the DISC legislation would undermine a law that is clearly succeeding.

SUBCHAPTER S RULES

should be improved

Subchapter S: Make it More Responsive

We recommend two changes that would make Subchapter S more responsive to current needs. Neither would have more than nominal impact on tax revenues.

1. The maximum number of shareholders should be increased to 15 from 10. As with the surtax exemption, the current limit was established in a less expensive era. Where it once might have taken 10 investors to finance a new company, today it takes more. This is especially true in a tight loan market.

2. Certain trusts should be allowed to be shareholders, including voting trusts, grantor trusts, and trusts where the holding is only temporary, such as passing through a residuary trust to individual beneficiaries. Each beneficiary of a trust should be counted as a shareholder in determining the limitation on the number of shareholders. The current exclusion of trusts is an unreasonable limitation on the ability of entrepreneurs to locate new sources of capital.

Also, inclusion of trusts would remove the unfair burden that currently afflicts many businesses when one of the owners dies and his holdings revert to a trust. Under current law, this trust status of one holder would remove the Subchapter S status of all other stockholders of the concern. An entrepreneur's untimely death should not be an immediate burden on the living.

senate should pass

THE INTERSTATE TAXATION ACT

Interstate Taxation: Stop the Hodge-Podge

This bill establishes uniform jurisdictional standards for interstate taxation. In so doing, it removes from companies the burden of a hodge-podge of varying state practices for reporting which often leads to double taxation. The House long ago recognized the value of such uniform standards. The Senate Finance Committee should release the legislation it has refused since 1969 to act on.

lower

RESTRICTIONS ON SECTION 303 OF THE ESTATE TAX LAW

Estate Tax Law: Don't Penalize the Living

At present, in order for an estate to undertake a Section 303 redemption at time of death, the closely-held stock must be at least 35% of the gross estate or 50% of the taxable estate. We suggest these restrictions be changed to 20% and 40% respectively.

This change would facilitate stock redemptions through which an individual's estate pays the estate taxes. This, in turn, would be an incentive for small businesses to be continued in operation rather than being sold out to big business. Under existing law, the estate of the deceased must often sell the whole business in order to pay estate taxes. Small businesses usually aren't liquid enough to redeem stock easily. Such a sale to an outside company usually is at a substantial loss and often leads to quick dissolution of what could have been an on-going business. Or, the small business might try to redeem stock using its limited cash reserves, and what often happens is the company pulls out so much cash that it dies. Either way, everyone loses.

Adopting lower restrictions is especially important in view of lower stock prices, which have decreased the value of stock as compared with the total estate, making it more difficult to qualify for a Section 303 redemption.

simplify

DEPRECIATION, POSSIBLY USING THE CANADIAN SYSTEM

Simplify Depreciation — Canada's System Promising

We see a need for more flexibility in deciding when to take depreciation and in what amount. The flexibility would be especially important for smaller businesses. We suggest consideration of a system being used in Canada called the "Capital Cost Allowance System". Canada permits depreciation in *two years* on machinery and equipment, which are the heart of the productive process. Canada also allows companies to establish pools or classes of assets. Each class is assigned a maximum depreciation rate. Within those limits it is left to the taxpayer to decide how much depreciation to claim at a given time. This enables the taxpayer to gear the depreciation allowance to the business income.

Canada's system also features fewer classes for assets. This, along with the other features, yields a benefit especially vital for smaller businesses: it reduces the mountain of paperwork and computations that existing depreciation methods entail. While no particular burden for computer-aided large corporations, the current depreciation system is simply too complex for the average small business.

revise

LONG-TERM CAPITAL GAINS

Long-term Capital Gains: Discourage "Hit & Run" Speculation

We recommend a stepped reduction of capital gains tax rates, in order to encourage long-term investment in smaller enterprises, rather than hit-and-run speculation. We recommend a rate of 35% on investments held one to five years; 25% on those held five to ten years; and 12½% on investments held ten years or longer. Such a stepped reduction would make "quick-kill" speculation less attractive and would encourage the kind of long-term investment that is so badly needed. At present, the capital gains system is an incentive for turnover of capital, not steady infusion. Long-term growth, obviously, is more likely to occur when a business has stability and can operate without the fear that large chunks of capital will be quickly withdrawn.

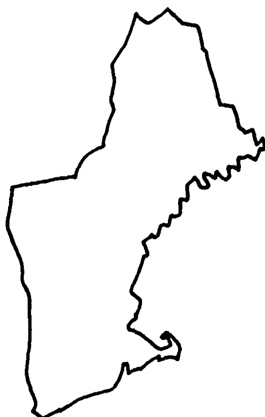
summary

"By stifling small business our business tax structure also stifles economic growth at a time when we desperately need it."

That's how Sen. Gaylord Nelson summarizes the tax dilemma of Small Business. And that's why his Small Business Committee is about to initiate action. The committee will begin next month an in-depth inquiry into the structure of small business taxes. It will be a thorough examination of what makes Small Business tick, and how taxes hinder growth now but could be changed to stimulate growth in the future. Findings of this study will help shape the Nelson-Evins Small Business tax bill to be introduced in 1975.

In all likelihood, the nuts-and-bolts of this tax reform package will be proposals such as those we outline in our Washington Presentation this year. These are unglamorous, highly technical proposals, but they're the kind of tax reform that will bring results — the results this economy needs: GROWTH and JOBS.

About SBANE



The Smaller Business Association of New England, Inc., is a private, non-profit, non-partisan association of New England small companies. It was founded in 1938 to promote and protect the welfare of small business throughout the six-state region. This is accomplished by:

(1) grouping together, articulating the needs of small business, and taking common action;

(2) promoting and supporting legislation and government activities beneficial to small business and opposing those activities and legislation detrimental to the interest of the smaller business;

(3) cooperating with other small business groups; and

(4) the education of the small businessman and others in the problems which they must face in order to be successful, and the education of the small businessman as to matters which both threaten and preserve the system of free, profit-incentive, private, competitive enterprise.

The major emphasis in the programs offered to the membership are in the areas of legislation on the national level and education programs.

Besides appearances before various Congressional committees, the Association appears on Capitol Hill once a year for a Washington Presentation of specific proposals designed to assist small business.

The education activities are many and varied. They include seminars and conferences held throughout New England often sponsored in conjunction with leading New England universities and Federal agencies such as the Small Business Administration.

Best known of SBANE's educational programs for the past 16 years has been the annual "Live-In" Seminar on the campus of the Harvard Business School. Others include a Fall seminar at the Amos Tuck School at Dartmouth College and a series of one-day seminars called "50 x 50" featuring a variety of business subjects presented by an outstanding faculty drawn from throughout the country.

The Association also publishes a monthly newsletter, SMALL BUSINESS NEWS, containing information and educational features for the small business executive and news about SBANE's monthly activities.

The Association's services also extend to counselling its members on small business problems and serving as a source of business information. Furthermore, the Association provides government liaison, procurement assistance and offers its members group insurance programs and trade missions.

SBANE offices are located at 69 Hickory Drive, Waltham, Massachusetts 02154, 617-890-9070.

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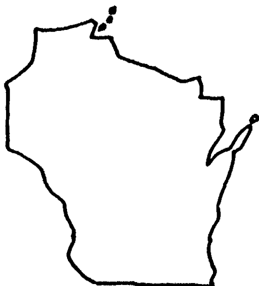

The Independent Business Association of Wisconsin, Inc. was organized as a result of a Statewide Conference on Independent Business Problems in Wisconsin held on October 14, 1970. As a result of this day-long conference, a small group of dedicated businessmen formed a Steering Committee to explore the establishment of an organization to represent Independent Business in Wisconsin.

Under the strong leadership of Chairman Herman Williams, this committee developed IBAW as a non-profit, non-partisan association for the purpose of encouraging stability, growth and profit, with high ethical standards, for independent business in Wisconsin. Membership is open to businesses engaged in manufacturing, wholesaling, retailing and service industries. Businesses which provide advisory services are able to join as Professional Members.

The objectives of IBAW are:

...TO INFORM ON LEGISLATION & TAXATION ON A LOCAL, STATE & NATIONAL LEVEL.

...TO EDUCATE FOR MANAGEMENT DEVELOPMENT & PERSONAL BUSINESS GROWTH

...TO EXCHANGE IDEAS, DISCUSS COMMON PROBLEMS & THEIR SOLUTIONS

...TO PROVIDE FOR EFFECTIVE EXPRESSION OF OUR MEMBERS' VIEWPOINTS

IBAW has organized and sponsored programs in cooperation with the University of Wisconsin Extension; Small Business Administration; local chambers of commerce; State Division of Economic Development; Council of Independent Managers, Inc.; Center for Venture Management; National Council for Small Business Management Development and other groups interested in the growth of independent business in the State of Wisconsin.

Quarterly round table workshops present opportunities for management development of owner-managers and their management team. Breakfast Club programs deal with a subject of current concern to the independent business sector.

The governmental programs work on both the national and state level with the highlights being the Washington Presentation and the annual Wisconsin Legislative Day in Madison. Legislative luncheons are held during the year with individual legislators.

A newsletter, INTERCOM, covers the activities of the Association.

IBAW offices are located at 11050 W. Bluemound Rd., Milwaukee, WI 53226, telephone (414) 258-7055.

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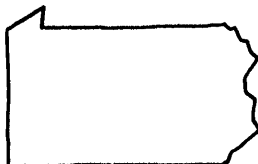


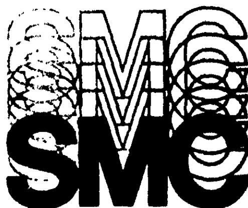
The Smaller Manufacturers Council, the only organization in the United States serving small manufacturers exclusively, was formed in 1945 by a group of 16 Pittsburgh manufacturers.

During World War II the U. S. Government sponsored the Smaller War Plants Corporation to assist small industrial plants in bidding on and carrying out defense contracts. The need for the corporation ended with the end of the war but the 16 Pittsburgh entrepreneurs didn't want to give up the close working relationships which had developed during the war years. If working together as a group, meeting to exchange ideas and pool experience had worked during the war, why not also in peace, they reasoned.

In April, 1945, the Council was organized on the basic idea that "In Unity There Is Strength." The purpose from the beginning was to serve member-companies and the Tri-State area of Western Pennsylvania, Eastern Ohio and Northern West Virginia through cooperative action — to pool experience, resources and energy to achieve constructive business and civic results that no individual small manufacturer could hope to accomplish alone. Thirteen active committees, operating under General Chairmen of Government Relations, Company Services, Growth and Communications, and Organization Development, assure that the original purpose of the organization is continued today.

The SMC, as the recognized spokesman for smaller manufacturing in the Tri-State area of Western Pennsylvania, Eastern Ohio, and Northern West Virginia, has representatives on federal, state, regional, and local advisory groups — governmental and civic — such as the President's Small Business Economic Council, the Governor's Business Advisory Council, Penn's Southwest Association, the Mayor's Committee on Employment, and the IRS Committee studying revisions to the "Tax Guide for Small Business."

These original companies in the SMC were headed by men who knew how to get things done. Through the years the same has been true of the various officers and directors and that, more than anything else, explains the dynamic growth of the first Smaller Manufacturers Council from a group of 16 member-companies to more than 575 member-companies today, employing some 60,000 persons and with annual collective sales of over one billion dollars.



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About COSE

The Council of Smaller Enterprises (COSE) was established in August 1972, as a department of the Greater Cleveland Growth Association, formerly the Cleveland Chamber of Commerce, to serve the small business members of the Growth Association and give them a stronger voice in Northeast Ohio and provide assistance in a wide range of small business problem areas. The Council represents 800 smaller business companies employing a total of over 30,000 workers.

Through COSE, we offer our members an ongoing program of benefits: communication and interaction with other small businesses; education through a monthly program of seminars; regular monthly publications devoted to our interests and our needs; continuing assistance with business problems such as OSHA, environment and personnel. In addition, COSE members automatically receive the full services and activities of the Growth Association, a most important plus.

We also serve as the spokesman and advocate for small business on the local, state and federal levels.

We certainly should learn from the Labor Movement that "in union there is strength". The only way the small business person can make their problems known is to band together with other small businessmen.

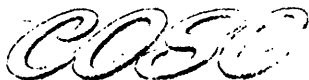
Among the specific programs the Council has secured a group rate for medical expenses from Blue Cross and Blue Shield. The Council also operates an informal management consulting service, with its own members, and executives from larger companies and faculty members and students from area colleges serve as consultants.

At the same time, the Council has been able to get help for its small business members in environmental matters from some of Cleveland's major corporations.

A series of seminars dealing with financing and accounting for the non financial Executive. Other seminars include taxes, estate planning, salesmanship and time management.

The Council of Smaller Enterprises offers every business person who heads a company with one to 150 employees the opportunity to be heard, to stand up and be counted on major problems or undertakings in our areas, the state or the nation.

The COSE offices are located in the Growth Association offices at 690 Union Commerce Building, Cleveland, Ohio 44115 and our telephone number is (216) 621-3300 ext. 45.



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[From Conference Board, May 19, 1975]

A Capital Idea

By
E. Douglas Kenna
President, National Association of Manufacturers

When Andrew Jackson was President of the United States, he faced a financial crisis—a surplus in the U.S. Treasury. Today, he would see a crisis in reverse—a massive federal deficit and a crying need for investment capital to fuel the nation's industries and give the country a shot in the arm.

Is it any wonder Old Hickory looks out from our $20 bills with a bemused expression? The drift of the economic pendulum has confounded many a man since his time.

Today, the American world is less exuberant, troubled by solutions that turn out not to be solutions at all. National crises, instead of being portentous, have become commonplace. John Doe has grown suspicious and downright uneasy.

National moods tend to intensify. Uneasiness triggers skepticism, then negativism and disillusionment, producing a behavioral pattern of excessive caution.

This general malaise, plus rising interest rates, has dampened enthusiasm for investment.

The New York Stock Exchange has noted a decline in the number of shareowners from an estimated peak of 32.5 million in early 1972 to 30.9 million in 1974.

The dropout is not surprising if you survey the scene on Wall Street. Last September, the market value of Big Board stocks had almost halved from their all-time high at year-end 1972—from the bull's lustiest bellow to the bear's most ominous growl. It represented a $400 billion blow to the New York Stock Exchange alone in less than two years. And during the first quarter of this year, the number of U.S. corporations reducing or omitting dividends was the highest in at least a decade.

Curiously, many stocks appear to be real bargains, selling at historic low price-earnings ratios. But super caution makes many people hesitant to invest when stocks are cheap. They fear a further plummet. On the other hand, many investment counselors feel the time is ripe for the plucking. They claim the market has bottomed out and advise clients to invest now in common stocks. History bears witness that every bear market has been followed by a bull market and vice versa. And the recent upswing in Wall Street trading indicates that now is the time, with the bull alive and combative and staging a comeback.

But the bull needs to be nurtured. The free enterprise system depends on the outcome. To accommodate a growing work force, America must create millions of new jobs every year. More than 83 per cent of this country's jobs are in the private sector—business and industry—and it costs more than $30,000 in capital investment to support each job (in the oil industry, it soars to almost $193,000).

That adds up to a massive collective investment. And capital funds are proving elusive, as we all know.

Traditionally, industry expansion has relied on three sources—profits, borrowing and equity financing. But recent years have brought an erosion of the equity base, with corporations turning increasingly to debt—even short-term debt—to finance capital needs. In 1969, company equity issues accounted for 51 percent of all new security financing. By 1974, they accounted for a mere 13 per cent.

A major deterrent to the issuance of new stocks has been competition for money from big government. That omnipotent force has been demanding more and more for deficit financing, thus tending to push interest rates up and stock prices down.

The situation has been exacerbated by the sharp impact of inflation on corporate profits. It is also reactive to a tax structure that actually penalizes corporations for *not* going heavily into debt, since interest payments are deductible as business expenses for tax purposes but dividends payouts are not.

The government bite out of corporate profits has been gargantuan. Yet, as the Wall Street Journal points out, businessmen have been their own worst advocates because of their "deeply rooted assumption . . . that to call for a cut in corporate taxes is a waste of breath, so why bother?"

Diagnosing the ailment does not provide the cure, but it does give us an inkling of the forces with which we must contend.

And regardless of adversities, we must step up efforts to market new common stock issues. To accomplish this, we need the broadest possible base of equity ownership, which means encouraging the small investor to return to the market.

The money may be stagnating but it is there. New York Stock Exchange officials say there is "a lot of money around" that could be put to work in the corporate sector to help boost productivity.

But what a task lies ahead!

The exchange has estimated American business must raise $250 billion in new stock offerings alone over the next 10 years. If it does so at the rate of $25 billion a year, the challenge is formidable because in no single year in recent history has American business raised as much as $20 billion.

The Chase Manhattan Bank of New York projects overall capital needs of $4.1 trillion for all industry over the next 10 years, with supplies of $2.6

THAT LEAVES A 1.5 TRILLION SHORTFALL

NAM Reports

Mr. MAUER. I will try to keep my comments as brief as I can.

We are all aware that business cannot grow without a steady infusion of capital, and new capital investment creates new jobs. And I think we are all very interested in that today. These jobs support the families of what I call the new minority, and what I refer to as the new minority in this country are the employees that are working; the young, the old, the men and the women. We in business today are the new minority. A recent study by Ford Motor Co. economists—and this is very recent—revealed that more than 80 million people are now being supported by tax dollars, whereas there are 72 million people now in the private economic community. When I say that new minority, I feel that, without the growth of future investment, and the massive size of our social responsibility that we are all cognizant of today, that we are not going to be able to continue to solve the social problems of our Nation that we are presently facing. Without an increase in the capital investment that will be needed for those of us in the private segment, to continue to increase our growth. We will not be able to meet the needs of our Nation's new majority.

We are really not asking for subsidies. We are not asking for handouts. We are asking for your help and your understanding in this area so we can all be more productive. We are asking for the ability to support the American enterprise system, to enhance its growth, and to help us to create those new jobs that are so necessary today.

This private sector, the new minority, business and industry, provides employment for over 83 percent of the jobs in this Nation. We also need further study and research, as it was well pointed out this morning by the people from the Wharton School. We need good information so we can all better utilize our present resources.

All of us here need retained earnings, because that is the prime resource of both long- and short-term capital. The small, independent business sector is presently starving for that capital. The other major area for capital, the debt market, has largely been preempted by Government, to the tune of about 60 percent, of this total available market today. These are the increased retained earnings that we feel are essential for economic growth, improved productivity, and hopefully, of course, the end result, the creation of jobs. That is why we are working very hard to secure an increase in the corporate income surtax exemption to that $100,000 level. These earnings are vitally needed for our Nation's economic growth.

The National Association of Manufacturers, in a recent article by president Douglas Kenna, stated that it costs more than $30,000 in invested capital to support each job in the private sector. My own experience as the president of a small, independent firm, is that we need $40,000 in our small business for every taxpaying employee that we have. This has been accomplished through the generation of profits and reinvestment of the earnings in our equipment and in our inventory and in the bricks and mortar that we need. And gentlemen, it is getting extremely difficult for us under present conditions.

There is another area that I would like to mention, and Senator Curtis also mentioned it earlier, and it is a major concern of mine. It is the drain on our working capital of the inheritance estate tax laws. These laws require the investment of major dollars today, for the future payout to our Government upon death of the owner-

manager of the privately held business. In my own situation, at Rickert Industrial, I am required to divest sizable funds to purchase insurance, life insurance, of course, on the owners of our company to insure that cash will be available to meet the future estate tax liabilities. These are dollars which could be spent for expansion and economic growth. Instead, we must protect our business so that it will not have to be merged and sold or acquired in order to raise the necessary funds for the death debt settlements. This is another unique problem not faced by large corporations, but rather this is a unique problem that we in the small business segment face alone.

The job creators, whether small business, medium or large, are all vitally interested in continuing to contribute to the growth of our Nation, and its system, in order to better study and measure the impact of Government on these businesses. A more effective method of differentiating size standards hopefully will be forthcoming. We in I.B.A.W. are advocating a three-tier size standard. We feel it should be developed, based upon both employment and gross revenues by major industry classifications.

The Small Business Administration's business-size standard should be revised to include what we consider that important middle size, that growth and innovative area of small business. Hopefully, all of us, then, if we have good information, and good incentives, can create more jobs through better and more productive uses of our Nation's capital.

I also strongly feel that the time has come to declare a moratorium on unneeded legislation and regulation for this, again, is a major drain on our badly needed capital resources. Frankly, gentlemen, what we need is simplification and reform. I feel our Nation and its business people have long ago reached the point of saturation. We have not only saturated ourselves with laws and regulations and problems that have reached a crisis proportion of credibility, but we have far surpassed the point where we must undo much of the damage created.

I feel the primary task of lawmakers, and hopefully for the balance of this decade, would be to remove the tangle of restrictive laws we have created. I hope lawmakers could also become law reducers. I feel it is absolutely essential if we are to face the balance of this decade with a system of government that operates under the guidance and heritage of a republic within a democracy.

Thank you very much, Mr. Chairman.

Senator NELSON. Thank you very much, Mr. Mauer.

Senator CURTIS. I am very much in sympathy with all efforts to bring about a situation where small business could accumulate more capital and retain more, the estate tax and these other matters. Something was said several times this morning in reference to Secretary Hickman's testimony. I think in all fairness the record should indicate that what the administration was asking for was a quick refund or rebate that did not affect our permanent tax structure. many of these items they suggested be considered in other bills.

I am not arguing with the rightness or the wrongness; but I think in all fairness, they have been interested in the problems of business. How many corporate taxpayers have a taxable income of $25,000 or less? Do any of you know?

Mr. PENDERGAST. Yes. The most recent figures we have would indicate probably 80 percent of the corporations have taxable income—these are corporations that are paying tax that are not subchapter S—80 percent of them.

Senator CURTIS. All right.

Now, when we raise the surtax exemption from $25,000 to $50,000, by that act alone, how much tax relief did we give to the corporation making $25,000 or less?

Mr. PENDERGAST. Well, of course, you understand we also lowered the first $25,000 from 22 percent to 20 percent, and so the amount of benefit maximum——

Senator CURTIS. I understand. I am talking just about the vehicle of raising the surtax. How much tax relief did that alone bring to a corporation that pays $25,000 or less?

Mr. PENDERGAST. Zero.

Senator CURTIS. Zero.

And, it brought about $7,000 tax relief to a corporation that was making $50,000?

Mr. PENDERGAST. Yes.

Senator CURTIS. Now, you have somewhat the same situation in going from $25,000 to $100,000. Now, I do not say we should not raise the surtax; but I think that the relief should either go through the rates or at least a blend of a couple in order to do justice; because it has been my understanding, just as yours, that about 80 percent of the corporations had a taxable income of less than $25,000. I think many of these things that you have mentioned have already been discussed.

I hope that before very long we can get some relief from the estate tax because that is a certain occurrence in the life of every individual.

Mr. MAUER. Could I address myself to that question, Senator Curtis?

Senator CURTIS. Yes.

Mr. MAUER. That is one of the reasons we are advocating a three-tier, size standard structure, so we can begin to recognize some of the unique problems in the small- to medium-sized, or independent, as we often call it, sector.

We feel very strongly, and I know Senator Nelson does also, that there are some unique problems and characteristics in the different sized standards that we are discussing here today. This is one of the problems we are trying to face. Frankly, we are trying to get data and information so we can better answer some of these problems.

Senator CURTIS. Yes.

Now, the American Farm Bureau is backing a bill on estate tax. It was not exactly in the form that I had introduced the bill in the previous Congress. Nevertheless I introduced that bill because I welcome the support of a nationwide organization that would create a public sentiment and an understanding about the need for this. I just mention that. Without a doubt, the bill would not meet all of the details of what you men would recommend based on your study and experience.

But, I do think, as organized small businessmen, that you would have something to gain by joining hands with every other organization that wanted to work on this estate tax, because the living things it

will never happen to them, or it will be a long time away. But, the people that are being hit by it are just facing disaster in many instances.

Mr. Chairman, I will not take any more time for any other questions. But, I do want the record to show that in what was done in this last bill, lowering the, or shifting the tax from 22 and 26 percent to 20 and 22 percent, we gave $500 tax relief to the corporation making $25,000; but by the other part of it, we gave $7,000 tax relief to the corporation making $50,000.

That is all, Mr. Chairman.

Senator NELSON. Thank you.

Mr. PENDERGAST. Mr. Chairman, if I might.

Senator Curtis, I would like to give some of our feelings about some of the first part of your statement, because I think you have hit upon some very important things that sometimes we do not get the opportunity to explain.

The amount or number of corporations who have taxable incomes of $25,000 or less, which represents, as I said, about 80 percent of the corporations, is not a very revealing statistic. A lot of these corporations arrange their affairs by paying additional salaries to their chief executives or to other people, or increase their profit sharing with an eye on that limit of $25,000.

Senator CURTIS. Does that temptation end when they cross the line to $25,000?

Mr. PENDERGAST. The temptation never ends. One thing that you will accomplish, however, if you raise the limit to $100,000, you will rescue some corporations that will be declaring tax at a higher amount, and they will retain that money in their business, as well as paying additional taxes, which we think are both very important facets of the problem. It is very difficult to tell you statistically what percentage of corporations will be in the zero to $50,000; but I predict it will be a larger percentage in the $25,000 to $50,000 range this year than ever before.

The other thing that concerns me a little bit is I agree that the administration's proposal was for a quickie tax bill, one shot. The thing we were concerned about is not that, but that 80 percent of the benefit is going to 0.6 percent of the corporations, to those corporations that have over $1 million of taxable income; whereas if the benefit had been given at approximately the same cost by increasing the surtax exemption to $100,000, the benefit to those 0.6 percent would have been 6 percent, and small business would have benefited more considerably and would have been allowed to provide a vehicle for the future program.

Senator CURTIS. Would small business have benefited from the recommendation that the total corporate tax be lowered from 48 to 42 percent?

Mr. PENDERGAST. That was a proposal that the administration made originallly, and that would have made it so that 80 percent of that benefit would have gone to corporations with taxable incomes in excess of $1 million, and the next 10 percent would have gone to those with taxable income of $250,000 to $1 million, so that 10 percent of the benfit would have gone to businesses with taxable income of $250,000 or less, which we do not consider reasonable.

Senator CURTIS. Well, it would have reduced every corporate entity's tax by 6 percentage points, would it not?

Mr. PENDERGAST. It would not have reduced the first $25,000—corporations paying on the first $25,000; and those corporations, for example, in the $25,000 and $50,000 range, their average benefit would have been very low. It would have been $670; whereas the average benefit for a corporation with taxable income in excess of $1 million would have been $667,000.

Senator CURTIS. I suppose we can all cite some figures that support our theory. But, I believe that any taxpayer that is subject to a 48-percent tax and has the total rate lowered to 42 percent, that he has a 14-percent tax reduction. Six percentage points is 14 percent.

Mr. PENDERGAST. Well, for a corporation with a taxable income of $50,000, that is cut in half, because the first $25,000 gets no benefit.

Senator CURTIS. I understand. We are talking about the surtax. Now, I made a mistake in my figure.

Mr. PENDERGAST. They get a 14-percent reduction in the surtax. The overall reduction is considerably less.

Senator CURTIS. It is about 12.5 percent. If the surtax is lowered, or if the total tax is lowered from 48 to 42 percent, that is 6 percentage points; according to my figures 6 percent of 48 percent is 12.5 percent, or thereabouts.

Mr. PENDERGAST. That is assuming their effective rate is 48 percent; and their effective rate very frequently is lower than that, so that the benefit would be considerably lower than that. A corporation, for instance, with a taxable income of $100,000, one-quarter of that income would be taxed at only 22 percent, so that the overall effective rate is considerably lower than that. So, the benefit is considerably lower, and you can see that because you can see the amount of benefit that goes to, as I said, the small corporation with $50,000 of taxable income. Their benefit is less than $1,000, which is a very small percentage of their taxable income.

Senator CURTIS. I think there have been many forces deliberately trying to kill off business with reports, inspections requirements, environment, consumerism, taxes, the works; that those who want to do something for business had better stick together rather than worrying too much about the figures.

Mr. MAUER. We are trying.

Senator NELSON. Senator Hathaway.

Senator HATHAWAY. Thank you, Mr. Chairman.

First of all, I want to commend this group for the lead it has taken in its suggestions to the Congress on tax reform measures, some of which we managed to incorporate into a tax act this spring. We hope that you do keep us informed.

I was wonder if it might be better to wait to see what the effect would be of the tax reform measures we incorporated before we go into more tax reforms of small business.

What do you think of that?

Mr. PENDERGAST. Well, in the first place, the surtax exemption is only in 1 year. The increase is for 1 year. So, there would be no benefit after 1975.

Senator HATHAWAY. But we can find out what that 1-year benefit did.

Mr. PENDERGAST. Up until January of 1975, the only accurate figures we had from the Treasury was 1970, so there is a 5-year lag before we are able to get a good, clear analysis of what the effect of that is. That is a problem, I think, to a great extent.

Senator HATHAWAY. What worries me is do we have enough economic studies to back up each of the suggested changes that you are making?

Mr. PENDERGAST. I think probably, as a matter of fact, Senator Hathaway, until the law is actually effected, all of the extrapolations and projections that are made turn out to be irrelevant. But it does look as if the dollar value of this will give significant benefit to small business, and also end up in the long run providing increased taxes for two reasons. One is that many small businesses will start retaining larger amounts of tax and therefore being allowed to grow, at which point they will be able to pay a higher amount of taxes in the future. Some of the rate suggestions we have made really have no significant revenue impact. They are in simplification areas. For instance, subchapter S. I went to a seminar a number of years ago presented by a lawyer who was supposedly the outstanding national expert on subchapter S. After 25 minutes, he stopped and looked at the audience, and he said, "I hope you are thoroughly confused, because I am, and anybody who has read that law would feel the same way." And, in the same context, depreciation rules. I sat down with Under Secretary of the Treasury Knowland, when he was Mr. Hickman's predecessor, and talked about depreciation. He was astounded that a small businessman would consider it complex. I started to talk to him about the variances between straight line and accelerated depreciation, first year allowances, section 1238, section 1245, section 1250, and recapture laws, and then the ADR (asset depreciation range) which was imposed by the administration. He sat back and he said, I guess it is pretty complicated.

We have let all of this accumulate to the point that, as practitioners, we have learned to deal with each new overlay of the law so it does not seem quite as complex to us. But a small businessman comes in and he says to me, I do not want to be confused with all of that. Take the simple route; make it straight line so that I can understand. It is going to take him 10 years to depreciate that asset. When he is not taking advantage of some other things that he could because it is too complex for him, he feels like he has cheated.

Senator HATHAWAY. Will we not be able to tell in a relatively short period of time, for example, whether the increase in the investment tax credit actually has led to greater investment in goods?

Mr. PENDERGAST. Yes, I think that is one area where you can see.

Senator CURTIS. Well, that is the only way to get the credit.

Mr. PENDERGAST. Pardon me?

Senator CURTIS. That is the only way to get the credit, is that right? Unlike some other types of relief, it is granted in the hope that it will generally spur the economy. But in the investment credit, you do not get it unless you——

Mr. PENDERGAST. I think you are right in the effect of that, Senator.

Senator HATHAWAY. I think that what Mr. Pendergast was suggesting was that small business be allowed a specific extra credit invest-

ment which would not have results under this present system of analysis we have. We would not be able to know whether small business used it more or less than large business, and those figures would not be available for a long period of time. I think that Mr. Pendergast is looking at that as a way of incentive for the small business to expand. That is the only way he was looking at that.

What bothers me somewhat is, is there going to be a revenue loss if we amend the code to comply with some of the requests that you have made? Maybe having in mind that we just have a limited amount of revenue loss that we could tolerate, maybe we should be giving it to a low income wage earner so that it will spur demand, rather than giving it to small and large businesses to spur investment; because there will not be any investment unless there is a demand. You are not going to invest in a lot of material if you do not know there is going to be somebody out there to buy it.

Mr. PENDERGAST. I think you get——

Senator HATHAWAY. How do we make a decision as to which way we go?

Mr. PENDERGAST. I think we get into the chicken and the egg argument. It is to a certain extent; how do you generate jobs unless you have some investment; how do you generate the investments unless you have people who have gotten some benefits and are able to go out and work?

So, it comes around full circle, and I think it is very difficult to answer. I think what you probably need is some even spread or some equitable spread between the wage earner and small business.

What we are concerned about as small businessmen, or at least I personally and I think our associations feel, is not our individual growth but the ultimate growth of the economy. If the Polaroids and the Xeroxes of the future are not allowed to grow, there will be no Polaroids and Xeroxes of the future. "Fortune's" 500 has in it only about 25 corporations that were in "Fortune's" 500 when it first started; and if the laws are not allowed to stimulate further growth of Polaroids and Xeroxes, we are going to be in for very serious problems, I think, in the Nation's economy.

Senator HATHAWAY. I realize that is true. But what if we stimulated demand by saying that anyone who makes an adjusted gross of $10,000 or under does not have to pay any taxes at all, so that they would have additional money, so they would be buying Polaroids, and that would give them additional money to take and use for investment purposes.

Mr. PENDERGAST. There is no question in my mind that some of the benefit should go in that direction. I think if you put it all in that direction, you will have a lag-time, and you have a period whereby there will be no distinguishment of whether a small or large businessman is given encouragement to grow. I think what we are saying is if we do not have special encouragement for small businesses to grow and to become a larger taxpayer, in the future we will not have those larger taxpayers. In the short run you will; in the long run you will not. That is what we are concerned about.

Senator HATHAWAY. What about tying tax breaks to investment? Say, we give you a 2-year write-off on all equipment you buy. There is no guarantee you are going to use that tax saving to invest. You could just pay higher salaries or pay it out in dividends.

Mr. PENDERGAST. I have a lot of small businessmen around me.

Senator HATHAWAY. Maybe you individually; but we are talking about some others. You know, a lot of millionaires own small businesses. The administration pointed out to us at the time we wanted to get more breaks for small businesses, they opposed these breaks, and one of the grounds they used was that many of these small concerns are really owned by very wealthy people and they do not need these tax incentives.

Mr. PENDERGAST. I think the question is not whether the individual needs the tax incentive. I think you can control that at another level. I think the question is does the business need the incentive to grow? We feel it does. That is what is going to make the economy grow. I think it is an entirely different problem the administration ties into this, it is how do you handle the wealthy individual who is investing in small business. That is one problem, distinct from how do you generate the growth of small business. They merged the two so that we have become confused. The statement that Mr. Hickman makes, that the owners of the small business are by and large rich individuals, which he extrapolated with a series of figures that I could argue with for half an hour. He and I did, and we both came to the same conclusion, that we disagreed at the start, and we disagreed at the end. But, the important thing is how do we stimulate the growth of that small business. Ancillary to that you may decide how do we discourage that wealthy man from becoming wealthier at the loss of the consumer. I think that can be taken care of; but I think that is a separate question. I think the first question we should address ourselves to is how do you stimulate that small business towards growth.

Senator HATHAWAY. But you would have no objection to tying in any breaks to investment so that if the savings were not invested in new equipment, then the person would not get the tax break?

Mr. PENDERGAST. I think new equipment is one thing. I think new jobs is another thing I would like to see some incentive towards.

Mr. WARD. Well, by definition, you cannot depreciate an asset you have not bought. By definition, your investment tax revenue depreciation can only apply to an asset that has been purchased, and thereby——

Senator HATHAWAY. That is true. But if you have an asset that you can presently depreciate over a 10-year period, we say well, you can do that over a 2-year period. You are going to have a tremendous tax savings, correct?

Mr. WARD. If you retroactively applied depreciation to an asset that——

Senator HATHAWAY. What I am saying is should we tie this tax savings to some investment rather than just——

Mr. WARD. Sure. Make it apply to after-acquired assets.

Senator HATHAWAY. Right. Anything like that.

The same thing goes for changes in estate taxes.

Mr. PENDERGAST. I hesitate to have that left on just that level, because I think one of the most important things you are trying to generate is jobs, and I think that the service industries, which represent a significant portion of commerce in this country and a more significant portion each year, their investment in equipment is minimal. Their investment in human beings is large. If we can en-

courage that investment, I think that is some sort of a job credit, or something along that line, as well.

Senator HATHAWAY. Oh yes, that would be considered.

Mr. WARD. When we testified 2 or 3 months ago, one of the things we suggested was some sort of a job credit program whereby the service industries were permitted to get credit for adding people to the payroll, which is, after all, what the whole thing is all about.

Senator CURTIS. Is that not the law, now?

Senator HATHAWAY. Yes, we incorporated that.

Senator CURTIS. If you take them off of welfare rolls?

Mr. PENDERGAST. You are talking about the WIN program, are you?

Senator CURTIS. Yes.

Mr. PENDERGAST. Which I think for a small businessman is a pretty complex thing for him to deal with. I think if he wants to hire craftsmen, or something, to expand his business at a particular moment in time, to get involved in the WIN program for one person or for two people is impractical.

Senator HATHAWAY. There was an amendment offered and accepted by Senator Talmadge that would allow you certain deductions for taking a person who was a recipient of welfare and giving him a job. I forget exactly how much you got, but it is quite a tax break.

Mr. PENDERGAST. I think there are some qualification problems involved. I think certification and other types of information are pretty complex.

Senator HATHAWAY. Regulations might not have been drawn up yet. As it passed, it was a fairly simple program. The person just had to be on welfare for a month or so. You could qualify; you could hire him and get a large reduction.

Mr. PENDERGAST. That is one source of additional employees. In my profession, one of the prime sources of additional employees are newly graduated college students who we are not hiring now because we do not need them in the economy. We have no incentive. How do you provide incentive to absorb that group?

A lot of the young people who comprise the largest percentage of unemployed are not eligible for welfare for one reason or another. The program I think is complex enough so that most of my clients, small clients do not understand it. It has not been communicated to them properly, and I think there are some paperwork problems involved with it. I think the idea is a good idea; but I think it needs to be made more simple.

Senator HATHAWAY. I just wanted to ask one last question of Mr. Mauer.

You mentioned on the first page of your statement some Ford Motor Co. studies saying that 80 million people are being supported by tax dollars. Do you have that study that you could submit for the record? I would like to see a breakdown of it?

Mr. MAUER. Yes, I have the news report of the study.

Senator HATHAWAY. Well, you could argue that 210 million people are being supported by tax dollars, to a certain extent, depending on whether you call something an incentive or a subsidy.

Mr. MAUER. I do not not have the actual Ford study, but I do have the news report which I would be glad to submit.

Senator HATHAWAY. Good, thank you.
[The information referred to follows:]

[From Newsweek, June 9, 1975, page 26]

PETER AND PAUL

Taxpayers have long suspected it, but it took a set of economists at Ford Motor Co. to come up with proof: there are more people being supported by tax dollars than there are workers in the private sector to support them. Adding up government employees, the military on active duty, the disabled and unemployed, the retired and those on welfare, the Ford economists found a total of 80,655,000 tax dependents vs. 71,650,000 nongovernment workers.

Senator HATHAWAY. Thank you very much, Mr. Chairman.

Could I just ask you one more question which does not really pertain too much to this, but it does pertain to the overall economy?

I would like to know, from your personal experience, do you think that the schools and the colleges in this country are adequately training people to take the jobs that you offer them? I am also on the Education Committee; that is why I ask that question. I am very much interested in career education. We had testimony years ago about how 80 percent of high school graduates were not equipped to take much of any jobs whatsoever that they could not have taken without the high school education. We have had similar testimony with respect to liberal arts colleges. We are in the process now of offering amendments to the Higher Education Act. I would like your off the top of your head thoughts on that—or maybe you have more than just off the top of your head thoughts.

Mr. WARD. I think it is our experience that our society is educating far too many young students not well for what is required in the economy in the next 10 to 20 years, I think, as opposed to Europe, which educates far too few people exceedingly well. I think our economy appears to require an enormous number of technically skilled people in the future; what we are getting is people with a general education which is in many instances valueless to the general economy. I do not think a liberal arts degree today is worth any more than a high school degree was worth 20 years ago alone, in and of itself. I think it is one of the difficult things that we face. There is a tremendous problem of a tremendous shortage of technically trained people in our economy, and I think this appears to be getting worse rather than getting better. So, I think that we are probably putting far too great an effort as a nation on the general education, than on the specific education. I think a lot of these people would be much better employed in the economy, and ultimately probably a great deal happier, if they had more specific skills.

Mr. PENDERGAST. The conundrum that you are involved in very frequently is that although an industry requirement may train somebody for an industry, your particular company might have specific requirements that are quite different. As an example, in my profession of public accounting, we find very frequently that if you look ten years down the tube, the best qualified professional is a man who had a liberal arts education. The technically competent man who started out with a technical education is allowed to go only to a certain skill level, and then he cannot handle or cope with broader responsibilities. So, it becomes a very difficult, again, almost a chicken and the egg type of complex problem.

Take people with a technical education. One of the major accounting firms gives them four weeks of in-house training right off because they do not understand how to do the basic parts. So, the first two or three years are difficult; but as time goes on, that broad based background allows them to cope with a broader range of problems.

So, I do not know the answer to that.

Senator HATHAWAY. Thank you very much.

Senator NELSON. Mr. Mauer, I understand that the Wisconsin Independent Business Association has done some kind of a study on the impact of mergers on local ownership—the effects of absentee ownership.

Mr. MAUER. We are doing some work in that area, Senator, but also the University of Wisconsin has been doing some very interesting studies on those kinds of impact, of merger acquisitions. I do have some of those studies. I do not have them here with me; but I would be glad to furnish them to you.

Senator NELSON. Who is heading up the University of Wisconsin study?

Mr. MAUER. The initial study was done by Professor Jon Udell at the Graduate School of Business there.

Senator NELSON. Anything you have on that we would be glad to have for the record.[1]

Mr. MAUER. Certainly.

Senator NELSON. Thank you very much, gentlemen. You have given a very useful contribution to these hearings. I appreciate your taking the time to come.

The hearings will open at 9:30 tomorrow in the same room.

[Whereupon, at 12:15 p.m., the Committees recessed, to reconvene at 9:30 a.m. on Thursday, June 19, 1975.]

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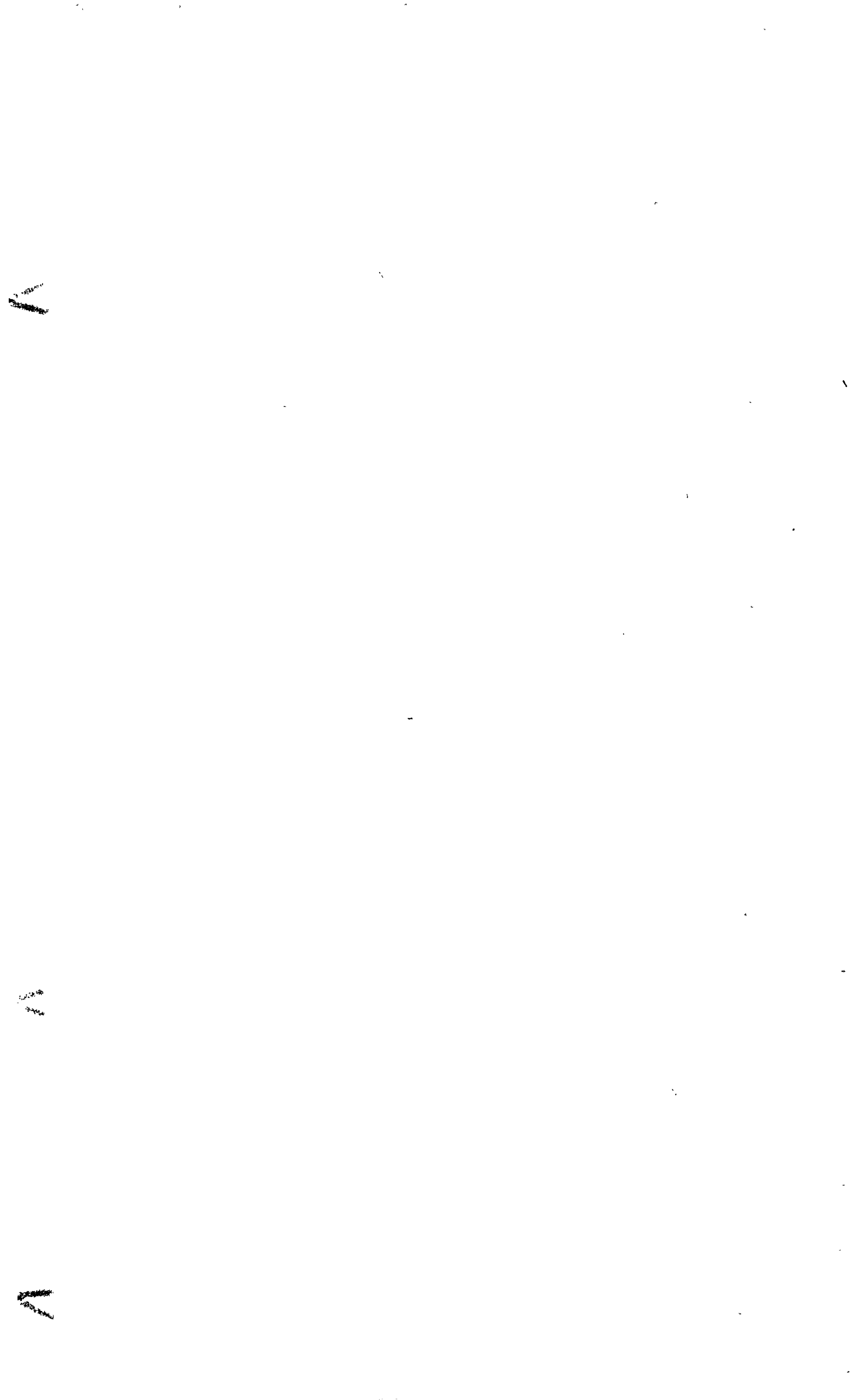
[1] NOTE.—The study, entitled "Social and Economic Consequences of the Merger Movement in Wisconsin," by Jon G. Udell, Graduate School of Business, University of Wisconsin (May 1969) is reprinted in the record as Appendix VI.



SMALL BUSINESS TAX REFORM

THURSDAY, JUNE 19, 1975

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
AND THE SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The committees met, pursuant to notice, at 9:45 a.m., in room 2221, Dirksen Senate Office Building, Senators Gaylord Nelson (chairman of the Select Committee on Small Business), and Lloyd Bentsen (chairman of the Subcommittee on Financial Markets of the Committee on Finance).

Present: Senators Nelson, Bentsen, Clark, Haskell, Packwood, and Laxalt.

Also present: Herbert L. Spira, tax counsel, Select Committee on Small Business; Richard R. Rivers and Michael Rowny, professional staff, Senate Finance Committee; and David Allen, office of Senator Bentsen.

Senator NELSON (presiding). The hearings will be open. We will call first this morning on Mr. Edward Richard, who was to be on yesterday's panel, so that he can present his testimony; and then we will move to the witnesses scheduled for today.

(The prepared statements of Senators Nelson and Bentsen follow:)

STATEMENT OF HON. GAYLORD NELSON, A U.S. SENATOR FROM THE STATE OF WISCONSIN

This is the third day of joint hearings on the business tax structure as it affects smaller firms.

During the past two days we have seen some fine presentations on basic questions of taxation and capital markets as they affect the survival and profitability of smaller ventures and the future of our free private enterprise system. We have benefited from the observations and questions of members of both the Senate Small Business Committee and the Senate Finance Committee.

We appreciate the efforts which today's witnesses have made to prepare their statements and are looking forward to hearing them at this time.

STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM THE STATE OF TEXAS

Today we begin the third of a three-day set of hearings by the Senate Financial Markets Subcommittee, which I chair, and the Small Business Committee, which is chaired by Senator Nelson.

We will receive testimony this morning on the farm credit crunch problem and also on the scarcity of venture capital for commercial businesses.

Since 1969 farm debt has increased 80%. While net farm income in 1974 fell 37% to $26.9 billion, farm indebtedness increased about 25%. Thus it is important for these Committees to review the financial needs of agricultural as well as commercial businesses.

With respect to commercial businesses, venture capital is in very short supply these days. The individual investors, long the primary source of this capital, have been deserting the stock market.

According to Congressional testimony, 409 new security issues were underwritten in 1972, compared to only 101 in 1973 and only 9 new issues last year.

Few people realize just how important venture capital is in financing new business and industry, promoting healthy competition and spurring noninflationary economic growth.

Without a ready source of venture capital, many of today's industrial and commercial giants may have never gotten off the ground. And, we may never know how many potential "xeroxes" or "polaroids" have failed to get started over the past few years for a lack of venture capital. We may never know how many jobs we never created, how much economic growth was never realized.

Senator NELSON. Mr. Richard, we are pleased to have you here this morning. You may go ahead and present your testimony.

STATEMENT OF EDWARD H. RICHARD, PRESIDENT, MAGNETICS INTERNATIONAL, INC., AND CHAIRMAN, COUNCIL OF SMALLER ENTERPRISES, CLEVELAND, OHIO

Mr. RICHARD. Thank you, Mr. Chairman. My remarks will be brief, and we do appreciate your fitting us in this way. We strongly support our sister small business organization who testified yesterday, and we emphasize our belief in strong, regional, small business groups.

Senator NELSON. Will you please pull the microphone over closer to you?

Mr. RICHARD. Today business concerns face seemingly insurmountable problems caused by inflation, falling demand for goods and services and tight money. I am not sure that there is a direct solution to these problems.

However, there are two small business problems common to all smaller concerns which do lend themselves to direct solution. Inequitable income tax structures and unreasonable tax reporting requirements have become just as harmful to small business as inflation, falling orders, and tight money.

Earlier this year, the Council of Smaller Enterprises and our sister small business organizations testified before this Committee. At that time we quoted statistics which documented the unequal tax burden carried by smaller enterprises. The average effective tax rate for corporations with assets less than $10 million was 46 percent, compared to 29 percent for corporations with assets over $1 billion.

During this same testimony, we also pointed out the complexities of jurisdictional reporting requirements between Federal, State, county, and local taxing authorities, not to mention the structural complexities of tax laws and regulations. We are not going to repeat all of these figures.

And we believe, from information received, that Congress is recognizing the critical challenges faced by small business concerns in our fight for survival.

Accordingly, the objective of our testimony today is to discuss programs that we are undertaking to develop information that will lead to eventual tax and regulatory reform measures.

Hopefully, these reform measures will enable smaller concerns to accumulate capital for reinvestment in machinery and equipment and expansion in employment.

The second goal of such reform measures will be to rid small business of unreasonable regulatory reporting requirements which result in a duplication of reported information at an unreasonable cost in terms of time and money.

Mr. Chairman, I am going to brief my statement and present the whole statement for the record.

Senator NELSON. Your statement will be printed in full in the record, as well as your extemporaneous remarks.

[The prepared statement of Mr. Richard follows:]

Statement by Edward H. Richard, President, Magnetics
International, Inc. and Chairman,
Council of Smaller Enterprises
690 Union Commerce Building
Cleveland, Ohio 44115

Before Senate Select Committee on Small Business June 19, 1975

Chairman Nelson and Distinguished Committee Members:

I thank you for asking me to testify before this important Committee. My remarks today are made on behalf of the membership of the Council of Smaller Enterprises as well as the nation's 12 million enterprises which are considered small business concerns.

Today business concerns face seemingly insurmountable problems caused by inflation, falling demand for goods and services, and tight money. I'm not sure that there is a direct solution to these problems. However, there are two small business problems common to all smaller concerns which do lend themselves to direct solution. Inequitable income tax structures and unreasonable tax reporting requirements have become just as harmful to small business as inflation, falling orders and tight money.

Earlier this year, the Council of Smaller Enterprises and other small business organizations testified before this Committee. At that time we quoted statistics which documented the unequal tax burden carried by smaller enterprises (average effective tax rate for corporations with assets less than $10 million was 46% compared to 29% for corporations with assets over $1 billion). During this same testimony, we also pointed out the complexities of jurisdictional reporting requirements between federal, state, county and local taxing authorities not to mention the structural complexities of tax laws and regulations.

Mr. Chairman, I do not believe it is necessary to repeat all the facts and figures of our earlier testimony. Based on the reports we have recently been receiving from Washington, it appears that congress is finally recognizing the critical challenge faced by small business concerns in their fight for survival. Accordingly, the objective of my testimony to discuss some programs we are undertaking to develop information that will lead to eventual tax and regulatory reform measures. Hopefully, these reform measures will enable smaller concerns to accumulate capital for reinvestment in machinery and equipment and expansion in employment.

A second goal of such reform measures will be to rid small business of unreasonable bureaucratic regulatory reporting requirements which result in a duplication of reported information at unreasonable costs in terms of time and money.

Simplification of tax regulations and reporting requirements would be a large step in the direction of scaling down the size of government. A move in this direction would free thousands of highly

trained government employees who would be available to employ their knowledge and skills in solving the complex problems that challenge today's small business concerns.

There is a great deal of literature nowadays which suggests that many of today's economic woes are caused, to some extent, by a shifting of employment effort from tangible production of the nation's business concerns to nonproductive activities conducted by many governmental agencies. We are not trying to imply that government regulation is unnecessary. We are, however, trying to demonstrate that much of the unproductive effort put forth by government is caused by needlessly complicated laws and regulations. We only need to look at recent tax legislation (The Employee Retirement Income Security Act, Occupational Safety and Health Act and the Tax Reform Act of 1969) for examples of laws which have imposed unreasonable burden on small business establishments. The Employee Retirement Income Security Act lists over 30 different reports and notices which are required to be furnished annually or periodically.

We are critical of the laws that were passed by congress not the objectives behind the legislation. We are calling for responsible legislation; legislation which considers impact from the point of view of both public and private sectors.

This point raises an interesting side issue. Recently, there has been much commentary from Washington concerning the power wielded by big business. It is surely apparent that heavy concentrations of power and influence can present a potential threat to the continuation of the free enterprise system. It is our opinion, however, that big government presents an even larger threat to the survival of the free enterprise system. Small business faces extinction because of the enormous expenditures of time and money which must be expended, in ever increasing sums,-to meet the growing information reporting demands made by multi-layered, overlapping government agencies.

We want to channel our energies and resources to productive endeavors. After all, it is the production of the nation's farms and factories that have made our standard of living possible, have made the dollar a world currency and made this country a world economic power.

It is with this background that we have mobilized our resources to develop a program that will investigate and report on needed reform in areas of taxation and regulation. To accomplish our objectives, the Council of Smaller Enterprises has formed a committee of volunteer professional accountants and lawyers whose familiarity with the problems of small business is invaluable in getting at the roots of small business problems. Accordingly the committee has been charged with the responsibility for:

- Investigating and reporting on unfair tax laws which suppress the health of small business.
- Developing meaningful tax reform measures which will provide small business with internally generated capital needed to support growth and provide jobs.

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- Examine unfair regulatory and reporting requirements imposed on small business accompanied by alternative plans of action.

The Committee has been asked to identify key problems, present evidence supporting the existence of problems, recommend solutions to problems and develop evidence supporting the feasibility of the solutions.

The Committee has developed a preliminary listing of tax reform targets. During the next few months, Committee members will be conducting research studies to support their tax reform and simplification proposals. The prime goal of this research is to develop conclusive evidence that tax reform will provide small business with dearly needed capital which may be reinvested in human and capital assets. At the same time, the research data will attempt to determine that initial tax revenue losses will be eventually overcome by profits from a healthy viable small business community.

I will now proceed with a technical discussion of the committee's proposed tax reform research projects.

I. Increase The Corporate Surtax Exemption To $100,000

A. Why small business favors an increase in the surtax exemption.

1. The original logic that brought about the initial $25,000 exemption in 1938 continues to hold true today - small businesses grow almost exclusively through retained earnings. Small companies are just not capable of relying on the outside capital market every time that additional funds are needed in the business.

2. The only alternative course of financing is through debt. This too, however, is not a reliable source of funds as small businesses have traditionally paid the highest rates and had the least success in obtaining loans. This can be evidenced by the fact that over a two year period ending November 1974 small short-term loans fell almost 50% as a percentage of total corporate short-term loans. Furthermore small loans accounted for less than two cents of every dollar loaned in the long-term debt market despite the fact that small businesses of a size to need such loans account for over 50% of all corporate sales and corporate employment. It is evident then that because small businesses do not have ready access to the external capital markets, they must rely on internal capital formation.

3. An exemption at the level of $25,000 is too low to allow for the needed internal capital growth of small businesses so that they can continue to expand and employ more people.
   a. The effects of inflation have greatly decreased the impact that a $25,000 exemption can have as a spur to growth. Since 1938 the Wholesale Price Index has jumped 429% making $25,000 in 1938 equivalent to over $100,000 of effective purchasing power today. The Consumer Price Index has increased 392% meaning that what required $25,000 in 1938 requires $98,000 now.
   b. Other costs have made the $25,000 amount inadequate. These include social security costs, pension costs, government paperwork and the removal of the multiple surtax exemption.
   c. Congress did take the first step early this year by raising the exemption to $50,000. However, it would be more effective in terms of its desires result to recognize the full impact that inflation and other costs have had on the exemption and increase it to the level of $100,000.

4. The increased exemption would provide a necessary impetus to capital growth and continued expansion of small businesses. While there would be an initial revenue loss, in the long run, considering the reinvestment factor, improved profits, improved productivity and increased employment, the overall effect could be a revenue gain and would most certainly be a gain for the economy as a whole.

I. Increase The Corporate Surtax Exemption To $100,000, Continued

B. Planned research into the increase in the corporate surtax exemption.

1. Survey of members of COSE emphasis to be on:

a. The earnings and retained earnings growth that would result from the increased exemption.
b. Examine to what use such savings would be put.
c. The current availability of money to these corporations through loans.

2. Inquire of the economic research department of the SBA as to:

a. The class of corporations most benefited by the increased exemption.
b. What amount of savings would result to these corporations as a result of the increased exemption.

3. Inquire of the business administration departments of local universities as to any research into the economic impact that an increased exemption would have. Also area law schools where tax policy courses are held would be contacted for any available information.

C. It is felt that such research will support the reasons small business favors an increase in the corporate surtax exemption by showing:

1. The dependence of small business on internally generated capital for growth.

2. The savings that would result to these corporations as a result of the increased exemption.

3. That such savings would most likely be put to (1) increasing or maintaining employment or (2) purchasing new or used equipment. This means that savings from an increased exemption would be recycled into the economy compounding the benefits.

4. That any loss in revenues as a result of the exemption increase would be made up by the increased employment and productivity.

II. Depreciation Regulations Need To Be Revamped

Present depreciation accounting regulations need to be overhauled. We are recommending that traditional useful life concepts of depreciation be abandoned in favor of a less complex capital cost recovery (CCR) program. CCR will provide the small businesses the flexibility to internally generate capital by employing a liberal, noncumersome rapid depreciation write-off which will maximize depreciation charges during periods when funds are needed for expansion.

A second goal of the committee's depreciation reform measures is simplification. Tax depreciation regulations provide a larger potential for simplification than many other regulations. Depreciation accounting is primarily concerned with the timing of depreciation deductions, not the avoidance of taxation. Accordingly, a logical assumption states that broad uncomplicated depreciation rules will enable the small business concern to simplify accounting procedures (reduce operating expenses) without a resulting negative impact on income tax revenues.

Finally, the committee is planning to investigate the feasibility of permitting small business concerns to coordinate depreciation write-off periods with loan amortization periods where capital assets are being financed with debt instruments. This proposal will help the small business borrower to better plan his cash flow requirements. The committee believes such a concept would be welcomed by lending institutions and would provide such institutions with an incentive for making funds available to small business enterprises.

A. Capital cost recovery as an alternative to present useful life methods of depreciation accounting

1. Assets would be pooled into basic functional categories; a reasonable grouping may be:
   a. Depreciable real estate
   b. Machinery equipment and fixtures
   c. Furniture and fixtures
   d. Transportation equipment
   e. Other (special)

2. Depreciable lives would be stated in a range of years for each pool. Present Asset Depreciation Range (APR) guideline lives would be adjusted by utilizing Asset Guideline Periods as the longest life period and liberalizing Lower Limit lives; for example:

Guideline Class		Asset Depreciation Range Years: Lower Limit*	Upper Limit
00.22	Automobiles	1	3
35.2	Machinery	5	12

*These lives would be determined on the basis of revenue generated by a reasonable rate of return (to be explained in more detail later in the report).

II. <u>Depreciation Regulations Need To Be Revamped</u>, Continued

3. Each year, a dual composite depreciation computation would be made for assets recorded in each pool:

   <u>Straight-Line</u> - The cost of each year's additions would be divided by the Upper Limit lives assigned to the respective pools and the result of these calculations would be added to the current year straight-line depreciation of prior year asset additions to determine the year's expense.

   <u>Accelerated</u> - The maximum depreciation allowable is determined by multiplying the net pool value by the maximum depreciation rate assigned to the applicable pool (i.e., 5 year Lower Limit life equals 20%). The company may, at its option, claim this amount or a lesser amount based on the company's reinvestment program.

   <u>Reinvestment Program</u> - The excess of the maximum depreciation expense calculated over the year's depreciation can be taken as a tax deduction if it can be demonstrated that the tax benefit has been reinvested, in the current year or within a reasonable future period, in capital equipment or expanded employment.

B. Planned research into depreciation tax reform measures

1. The strength of the capital cost recovery theory lies in the assumption that reinvested tax benefits will result in improved company profits by employing the return on invested capital concept. This concept follows the theory that the entrepreneur will not make a capital investment unless the investment earns a reasonable rate of return. Thus, the scope of capital cost recovery research projects will entail a series of studies geared to determine both short-term and long-term impact on tax revenues, determining if rate of return concepts will improve tax revenues on a long-term basis.

2. Research into tax simplification aspects to depreciation tax reform will be structured to identify overly complicated regulations which affect capital cost depreciation and to determine their impact on tax revenues. Topics scheduled for investigation include:
   a. Unnecessary accelerated depreciation methods
   b. Regulations limiting the amount of first year depreciation allowable on capital additions
   c. Additional first-year 20% depreciation bonus; is it enough?
   d. ADR regulations are overly complicated
   e. Increasing the dollar value of minor capital assets which may be written off as purchased
   f. Eliminate salvage value accounting requirements

II. Depreciation Regulations Need To Be Revamped, Continued

3. Matching capital asset useful lives with the amortization period of related debt instruments will be examined for feasibility through surveys of both COSE members and lending institutions. The surveys will attempt to determine if the concept would be attractive to borrowers and lenders. The surveys would also attempt to determine the impact such a program would have on tax revenues.

C. The committee believes that the above programs will demonstrate that reform of depreciation regulations will provide an effective source of capital to small business concerns. Also, reform should eliminate much of the compliance accounting caused by the complicated regulations.

The primary objective of the committee's research will be to demonstrate that reform measures will be advantageous to small business concerns but will not adversely affect tax revenues.

III. Increase The Accumulated Retained Earnings Credit

A. Why small business wants to increase the accumulated retained earnings credit:

1. By allowing a greater accumulation of liquid assets, a cushion would be made available to small businesses enabling them to survive economic fluctuations. This would result in fewer business failures, fewer plant closings and fewer unemployed workers.

2. The excess of the accumulated earnings credit does not currently take economic fluctuations into account in the measurement of such excess. If the credit is increased, businesses would be in a better position to withstand business losses caused by economic fluctuations.

3. Small businesses are particularly affected by the current low limit on the accumulated retained earnings credit since a greater proportion of the total capital of a small business is internally generated.

B. Planned research into the increase in the retained earnings credit:

1. Survey of COSE members with emphasis on:
   a. Current amounts of accumulated retained earnings
   b. History of accumulated earnings penalty taxes
   c. Extent of any current losses in relation to accumulated earnings
   d. The amount of capital generated internally
   e. Business failures

2. Inquire of the economic research department of the SBA concerning:
   a. The extent of accumulated earnings of small business
   b. The history of penalty tax payments by small business
   c. The extent of current small business losses
   d. General information on the sources of small business capital

C. It is felt that this research will support the reasons small business wants an increase in the accumulated earnings credit by showing:

1. That small businesses rely on internally generated capital more than large business.

2. That a larger cushion of accumulated liquid assets would provide small businesses with a better chance of surviving economic fluctuations in order that fewer plants would close and less people would be out of work.

3. A negligible impact on revenue in relation to the benefits of business survival.

IV. Enactment Of An Interstate Taxation Act Is A Must If Tax Simplification Is To Be Achieved

A. Why small business wants an interstate taxation act

1. The current multiplicity of state taxing procedures requires a substantial duplication of general information

2. Certain items and procedures that are available for federal purposes, such as LIFO, ADR and the capital gain deduction may or may not be available for state purposes. This often means that small business must keep dual sets of books, greatly increasing their costs and reducing their profitability.

3. Income apportionment formulae may differ so greatly from state to state that it results in double taxation.
   a. Sales factors may be allocated on either a destination or contract finalization basis.
   b. Property may be allocated on either a fair market value, net book value or original cost basis.

4. Even cities within the same state may have a variety of modifications to federal taxable income and vary the apportionment formulae which only serves to further compound the multiplicity of effort that must be expended by small businesses.

B. Planned research into an interstate taxation act

1. Survey of COSE members. Emphasis to be on:
   a. Extent of multi-state business
   b. The differences in reporting and apportionment that occurs among the states
   c. The additional burden that the multiplicity of effort places on the small businesses

2. Research the variety of modifications and income apportionment formulae that exist among the states.

3. Contact the business administration departments of local universities to see if any research has been done in this area.

C. It is felt that this research will support the reasons small business wants an interstate taxation act by showing:

1. That the current system may result in the unfair burden of double taxation on small businesses.

2. That the multiplicity of effort required to comply with these various standards lowers profitability due to increased costs.

V. Retain Domestic International Sales Corporation (DISC) Provisions For Small Business

A. Why small business wants DISC retained:

1. Smaller businesses have required a longer time to become aware of the complexities and advantanges of DISC. The result is that only now is the DISC beginning to have an impace on small businesses as many small firms are being lured into the export market.

2. Entry into the export market via DISC can provide an important avenue of growth for smaller enterprises. Increased growth tends to increase employment while at the same time minimizing the exportation of jobs to foreign countries that often occurs when factories are built abroad.

3. The DISC provisions in general, by providing an incentive to export business, serve to improve the nation's balance-of-payments. With small business engaged in exporting the problem would be further helped.

B. Planned research into DISC:

1. Survey members of COSE with emphasis on:
   a. Who is using DISC.
   b. Factors important in decision to use DISC.
   c. For those who are not using it, why not.
   d. Results that have been achieved by the use of DISC.
      1) Sales growth.
      2) Employment growth.

2. Survey the Cleveland World Trade Association members with emphasis in addition to the items in the COSE survey on:
   a. Whether or not members feel DISC and tax incentive provisions in general serve to increase world trade.
   b. What role does the Association see for small business in world trade.
   c. What impact on world trade does the Association foresee if DISC is repealed.

3. Contact the business administration departments of area colleges and universities as to what research has been or is currently being done on the impact of DISC on the operation of business enterprises. Also contact the tax professors of local law schools as to the impact of DISC.

4. Inquire of the economic research department of the SBA as to the current use of DISC by small business including statistics on dollar volume and export growth.

V. Retain Domestic International Sales Corporation (DISC) Provisions For Small Business, Continued

C. It is felt that this research will support the reasons why small business wants DISC by illustrating:

1. The recent nature of DISC's impact on small business.

2. The growth of small business export trade and its favorable affect on employment. Each new billion dollars of exports creates an estimated 60,000 jobs.

3. The important role that small business can play in the nation's balance-of-payments problem. Since the enactment of DISC, exports have increased $55 billion.

. <u>Subchapter S Provisions Should Be Revised</u>

The following revisions of the subchapter S rules are needed:

A. Increase the number of permissible shareholders from 10 to 15.

B. Allow certain trusts to be qualified shareholders.

C. Amend the termination provisions to provide for termination only by a majority or at least provide that a new shareholder's affirmative refusal to consent to the election is necessary so as to prevent inadvertent termination.

D. Allow additional investments by the shareholders so that any excess losses can be carried forward rather than forever lost.

E. Allow for property distribution of previously taxed income.

Why small business wants these changes in the subchapter S rules.

A. Subchapter S has been of benefit to both small business and the economy.

1. Subchapter S is now being used by over 10% of small business enterprises that are corporations.

2. The provisions allow new businessmen the opportunity to limit his liability to his investment in the enterprise.

3. Limited liability also makes raising additional capital from new investors easier.

4. An additional benefit is that losses up to the extent of the investment are passed through to the individual shareholders.

5. Subchapter S eases the flow of funds generated by profitable operations back to the shareholders for reinvestments in other enterprises to promote further economic growth.

B. The revisions of subchapter S outlined above are necessary so that its advantages may be used by a greater number of smaller enterprises.

1. In light of today's prices and the tight loan market it certainly can take more than 10 investors to finance a new company.

2. Prohibiting trusts from being qualified shareholders places a burden on entrepreneurs in their search for new sources of capital. There are certain trusts where there appears to be no reason for exclusion as qualified shareholders. A voting trust where shareholders get together to combine their corporate suffrage should not serve to revoke the subchapter S election. All the beneficiaries are shareholders of the corporation and each beneficiary would be counted as a shareholder for purposes of the number limitation. Because of this and the fact that the term of the trust is limited and each

VI. Subchapter S Provisions Should Be Revised, Continued

shareholder beneficiary has agreed to be bound to the trust terms, indicate that a voting trust agreement should not terminate a subchapter S election. A grantor trust is another instance where shares held by a trust should not prevent a subchapter S election. The grantor is still being taxed on the income from the corporation so the fact that he desires to place his stock in trust should not prevent the availability of subchapter S. The current subchapter S provisions on trusts also creates the unfair burden of removing the subchapter S status of all other shareholders when one of the owners dies and his holdings revert to a trust. As such in the case of trusts which serve as a conduit for the decedents shares the subchapter S election should not be revoked. When the ultimate beneficiaries receive their stock, in accordance with the other reforms sought, there would only be a termination of the subchapter S status if a majority wanted it, otherwise the election would remain in force.

3. Because subchapter S is an elective provision it is important to safeguard against inadvertent termination of the election. Requiring affirmative refusal to consent would ease the impact of this problem. It creates an unfair burden on the qualified shareholders to allow one shareholder to void the election. The election provision should be by majority to alleviate this burden.

4. Allowing increases in shareholder investment to take advantage of excess losses in prior years would put the subchapter S provisions on par with partnership provisions and serve as an incentive to increased investment.

5. It may be impracticable and cause a substantial hardship to the small businessman to require cash distributions of previously taxed income. This burden should be alleviated by also permitting property distributions to qualify.

Planned research into subchapter S revisions:

A. Survey COSE members with emphasis on:
   1. Use of subchapter S.
   2. History of election and termination.
   3. Amounts of any unused excess losses.

B. Inquire of the economic research department of the SBA as to:
   1. The extent of the use of subchapter S by small businesses.
   2. The amount of capital that has been raised through subchapter S.
   3. The rate of terminations of elections and the reasons for such terminations.

It is felt that this research will support small business' reasons for revision in subchapter S provisions by showing:

A. New business and economic growth in general needs the greater amount of capital that additional shareholders could provide.

B. That termination of elections occur too frequently and unnecessarily either through inadvertence or from the fact that trusts cannot be qualified shareholders.

C. That additional investment would be encouraged if unused excess losses could be carried forward.

VII. Net Operating Loss Carryover Periods Need To Be Extended For New Business Concerns

Extend the net operating loss carryover period for corporation which have been in existence less than three years so that initial losses can be absorbed.

A. Why small business wants extended loss carryover:

1. New corporations, particularly smaller businesses, often undergo a substantial period of initial operating losses. Due to inability to carryback such losses and the 5 year carryover limit, current regulations often results in the inability of small business to utilize these initial losses.

B. Planned research into extended loss carryovers:

1. Survey members of COSE with emphasis on:
   a. Extent and amount of initial net operating losses.
   b. Carryover that was unusable due to the 5 year limitation.
   c. The extent of reliance on internally generated capital.
2. Inquire of the economic research department of the SBA as to the overall extent and amount of new small business net operating losses.

C. It is felt that this research will support the reasons why small business wants an extended initial net operating loss carryover period by showing:

1. That due to the current time limits and amounts of net operating losses some initial losses cannot be absorbed.
2. New business would be stimulated by the ability to absorb initial losses.

VIII. Regulations Regarding Overpayments Of Estimated Tax Need Amendment

Amend Sec. 6425 to allow a corporate taxpayer to file for a quick refund of certain overpayments of estimated installments prior to the end of the taxable year. Presently, tax payers must wait until after their fiscal year-end to receive tax refunds.

A. Why small business needs early quick refunds:

1. The value of this is well illustrated by the current recessionary period. As business slackens and working capital becomes tighter, smaller business needs to recover the money to which it is entitled without delay.
2. If these funds are not to be payable to the government, there is no justifiable reason for requiring that such payments be held by the government for the entire year.
3. This provision would involve no loss of revenue to the government since it only speeds the recovery of funds to which the business entity is entitled.

B. Planned research into quick refunds:

1. Survey members of COSE with emphasis on:
   a. Extent and amount of estimated tax payments.
   b. Percentage of corporations who have filed in the past for quick refunds as of the close of their taxable year.
   c. Nature of the benefit that could have been achieved had early quick refund been available.
2. Inquire of the economic research department of the SBA as to the extent of small business estimated tax payments and the use by small business of the current quick refund provisions.

C. It is felt that this research will support the reasons small business wants quick refunds available before the end of the year. It will deomonstrate how early quick refunds are especially needed by the small corporations faced with income reductions brought about by business reversals which have resulted from a drop-off in business activity.

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IX. Rules Limiting the Deductibility of Business Search Expenses Need to be Liberalized

Allow the deductibility of expenditures incurred in search of a prospective business even though the proposed transaction was not consummated.

A. Why small business wants deductibility of expenditures for preliminary business investigation:

1. The inability to deduct such expenditures operates as a deterrent to the investigation of growth opportunities.

2. There is no equitable justification for conditioning the deductibility of such expenses on whether the transaction is actually entered into when it in fact may be later abandoned (Rev. Rule 57-418), and for not allowing a deduction when in fact the taxpayer incurs reasonable and necessary expenditures in a good faith investigation of a business investment.

B. Planned research into the deductibility of preliminary business investigation expenses:

1. Survey COSE members with emphasis on:

a. The extent and amount of such preliminary investigation expenses.

b. The percentage of time that such expenditures yield no new investment.

2. Inquire of the economic research department of the SBA as to the current amounts and trends of small business investment.

C. It is felt that this research will support the reasons why small business wants the deductibility of preliminary business investigation expenses by showing:

1. The significant amounts of such expenditures by small business.

2. That denying a deduction when in fact a good faith investigation has been made but the transaction not entered into works on unreasonable hardship on small business.

X. Restrictions on Section 303 of the Estate Tax Law Penalizes Small Business Concerns

A. Why small business wants to reduce requirements to meet the restrictions on Sec. 303.

1. If a corporation purchases (cancels or redeems) the stock from the estate of a former shareholder in such a way as to make the purchase (distribution) "equivalent" to a distribution of a dividend, the amount received by the estate, to the extent it is out of earnings and profits, will be treated as a taxable dividend at ordinary rates.

2. Whether a distribution in connection with a cancellation or redemption of stock is "equivalent" to a taxable dividend will depend on the facts in each case.

3. Basically, to avoid the "equivalent" of a dividend, the redemption must result in a meaningful reduction in the shareholder's proportionate interest in the corporation.

4. In addition, to obtain capital gain treatment on the redemption of stock, the redemption must have been made on time. The value of all the stock of the corporation which is included in determining the value of the gross estate is more than 35% of the value of the gross estate, or more than 50% of the taxable estate.

5. Sec. 303 is a special relief provision provided to owners of small closely held companies to obtain cash to pay "death taxes".

6. This provision (Sec. 303) is not adequate enough for owners of closely held stock. The restrictions of 35% and 50% should be reduced to 20% and 40%, respectively.

B. Planned research into lowering restrictions of Sec. 303.

1. Select cases from the files. Tax attorneys and CPA's who have been involved in Sec. 303 transactions to determine the effect of the lower restrictions.

2. To separate the Sec. 303 transactions into (3) categories.

a) Successful 303 redemptions
b) Nonsuccessful 303 redemptions
c) Redemptions which did not meet requirements of Sec. 303 and thus used another approach to obtain cash to pay "death taxes".

C. The results of the research should produce the following:

1. In cases where requirements of Sec. 303 were not met, such corporation stock was sold entirely to big business, thus eliminating one more small business entity. Lower requirements would have prevented the sale of a small business.

X. Restrictions on Section 303 of the Estate Tax Law Penalizes Small Business Concerns, Continued

2. The lower restrictions enable more estates to take advantage of capital gain tax treatment. In so doing, the requirement for cash is less. Thus, the corporation by such a liquidation need not be as liquid, or seriously impair their working capital.

3. The benefit of having more estates qualify for a Sec. 303 redemption is to maintain closely held companies. Small business concerns are healthy for the economy because of their great contribution to employment, gross national product and competition.

4. The lower restrictions on Sec. 303 redemptions should result in minimal tax loss to the treasury.

I would like to thank the members of the Senate Select Committee on Small Business for granting our organization the opportunity to testify at today's hearings. I would also like to extend thanks to the professional practitioners who comprise the Committee on Government Taxation and Regulation for their contribution to today's testimony.

Mr. RICHARD. Thank you.

There is a great deal of literature nowadays which suggests that many of today's economic woes are caused, to some extent, by a shifting of employment effort from tangible production of the nation's business concerns to nonproductive activities conducted by many governmental agencies.

We are not trying to imply that government regulation is unnecessary. We are, however, trying to demonstrate that much of the unproductive effort put forth by government is caused by needlessly complicated laws and regulations.

We only need to look at recent legislation. For example, the Employee Retirement Income Security Act, the Occupational Safety and Health Act, and the Tax Reform Act of 1969, for examples of laws which have imposed unreasonable burden on small business establishments.

The Employee Retirement Income Security Act lists over 30 different reports and notices which are required to be furnished annually or periodically.

We are critical of the laws—the administration of many of these laws—passed by Congress, not the objectives behind the legislation. We are calling for responsible legislation; legislation which considers impact from the point of view of both public and private sectors.

It is with this background that we have mobilized our resources to develop a program that will investigate and report on needed reform in areas of taxation and regulation. To accomplish our objectives, the Council of Smaller Enterprises has taken what we believe to be a unique step forward in information gathering. We have formed a committee in our area, composed entirely of volunteer professional accountants and lawyers, whose familiarity with the problems of small business is invaluable in getting at the roots of small business problems.

This committee, which is composed, as I said, entirely of professionals, will be reporting factually and gathering information; and has been charged with the responsibility for investigating and reporting on unfair tax laws which suppress the health of small business; developing meaningful tax reform measures which will provide small business with internally generated capital needed to support growth and provide jobs; and examine, what, in the opinion of the committee, will be unfair regulatory and reporting requirements imposed on small business accompanied by alternative plans of action.

We have asked our committee to identify key problems, present evidence supporting the existence of problems, recommend solutions to these problems, and develop specific information supporting the feasibility of the solutions.

Senator NELSON. May I ask, Mr. Richard, does this committee have any timetable? I assume it will be a continuing activity, but do you have a schedule for presenting, or concluding their evaluation of these various areas?

Mr. RICHARD. Yes. First, this will be a standing committee, so it will continually be monitoring and hopefully giving creative ideas.

Secondly, our initial phase—which I will give you the details of this morning—hopefully will be ready in time for your upcoming hear-

ings so that we may present you with factual research on the various areas we are talking about today. That, at least, is our goal.

We have developed a preliminary listing of tax reform targets. During the next few months, committee members will be conducting research studies—specific research studies—to support our tax reform and simplification proposals.

The prime goal of this research is to develop conclusive evidence that tax reform will provide small business with dearly needed capital, which may be reinvested in human and capital assets.

At the same time, the research data will attempt to determine that initial tax revenue losses will be eventually overcome by profits from a healthy, viable, small business community.

It is important to point out that this committee includes professors of accounting, professors of law, as well as practitioners. Preliminary input from our membership, coupled with initial investigation by our accounting and legal committee, shows the following target issues, among others, that require, in our opinion, immediate attention and action.

We again strongly recommend increasing the corporate surtax exemption to $100,000. We favor an increase in the surtax exemption for the following reasons:

The original logic that brought about the initial $25,000 exemption in 1938 continues to hold true today—small businesses grow almost exclusively through retained earnings. We are just not capable of relying on outside capital markets every time additional funds are needed in our business.

The only alternative course of financing is through debt. This, however, is not a reliable source of funds, as small businesses have traditionally paid the highest rates and have had the least success in obtaining loans.

This can be evidenced by the fact that over a 2-year period ending November 1974, small short-term loans fell almost 50 percent as a percentage of total corporate short-term loans.

Furthermore, small loans accounted for less than 2 cents of every dollar loaned in the long-term debt market despite the fact that small businesses of a size to need such loans account for over 50 percent of all corporate sales and corporate employment.

It is evident then that because small businesses do not have ready access to the external capital markets, we must rely on internal capital formation.

An exemption at the level of $25,000 is too low to allow for the needed internal capital growth of small businesses so that they can continue to expand and employ more people.

We have presented evidence to show that $25,000 in 1938, because of inflationary factors, based on the Wholesale Price Index, is worth $100,000 today. And, based on the Consumer Price Index, requires $98,000 now.

Other costs, such as social security costs, pension costs, Government paperwork, and importantly the removal of the multiple surtax exemption which was very helpful to many small businesses, makes this $100,000 even more urgent.

We note, with great appreciation, that Congress took the first step earlier this year by temporarily raising this to $50,000. However, it would be much more effective, in terms of its desired result and as a shot in the arm, for small business to recognize the full impact of inflation, and increase this permanently to $100,000, and consider the possibility of incremental increases as inflation occurs, or continues to occur.

We believe that this increased exemption would provide a necessary impetus to capital growth and continued expansion of small businesses. While there could be—and there probably would be—an initial revenue loss; in the long run, considering the reinvestment factor, improved profits, improved productivity, and improved employment, it is our firm opinion that the overall effect would be a revenue gain, and not a loss.

We are in the process of conducting specific research into the increase in the corporate surtax exemption, and will be reporting on this at your next hearing.

We are surveying our members on the earnings and retained earnings growth that would result from the increased exemption. We are going to examine, specifically, what use such savings would be put to.

We are going to be looking into the current availability of money to these corporations through loans. We will also be using the economic research department of the SBA to give us additional information for this survey.

We will be inquiring of the business administration departments of four of our local universities as to any research into the economic impact that an increased exemption would have. Also, area law schools will be assisting us and will be providing information to us in this regard.

We feel that research will support the reasons small business favors an increase in the corporate surtax exemption by showing: The dependence of small business on internally generated capital for growth; the savings that would result to these corporations as a result of the increased exemption; that such savings would most likely be put to (1) increasing or maintaining employment, or (2) purchasing new or used equipment. This means that savings from an increased exemption would be recycled into the economy compounding the benefits; and that any loss in revenues as a result of the exemption increase would be made up by the increased employment and productivity.

Many enlightened small businessmen—myself included—are perfectly willing to state that any money saved as a result of increasing the exemption would definitely be put back into our business, in terms of investment in employment, or investment in specific employment producing assets, rather than going into the pockets of the owners.

We suggest that depreciation regulations need to be revamped. Present depreciation accounting regulations should be overhauled. We recommend that traditional "useful life concepts" of depreciation be abandoned in favor of a less complex capital cost recovery program.

This program which we call "CCR," will provide the small businesses the flexibility to internally generate capital by employing a liberal, noncumbersome rapid depreciation writeoff which will maximize depreciation charges during periods when funds are needed for expansion.

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A second goal of the committee's depreciation reform measures is simplification. Tax depreciation regulations provide a larger potential for simplification than many other regulations.

Depreciation accounting is primarily concerned with the timing of depreciation deductions, not the avoidance of taxation. Accordingly, a logical assumption states that broad uncomplicated depreciation rules will enable the small business concern to simplify accounting procedures—reduce operating expenses—without a resulting negative impact on income tax revenues.

Finally, the committee is planning to investigate, as part of depreciation, the feasibility of permitting small business concerns to coordinate depreciation write-off periods with loan amortization periods where capital assets are being financed with debt instruments.

This proposal will help the small business borrower to better plan his cash flow requirements. We believe such a concept would be welcomed by lending institutions and would provide such institutions with a badly needed incentive for making funds available to small business enterprises.

We have specific proposals, as a part of our statement, that are highly technical. I will not read them this morning, but wish to have them made a part of the record. And we will be presenting further specific details on CCR at a later date.

We plan research into depreciation tax reform measures. The strength of the capital cost recovery theory lies in the assumption that reinvested tax benefits will result in improved company profits by employing the return on invested capital concept.

This concept follows the theory that the entrepreneur will not make a capital investment unless the investment earns a reasonable rate of return. Thus, the scope of capital cost recovery research projects will entail a series of studies geared to determine both short-term and long-term impact on tax revenues, determining if rate of return concepts will improve tax revenues on a long-term basis.

We believe the CCR program will demonstrate that reform of depreciation regulations will provide an effective source of capital to small business concerns. Also, reform should eliminate much of the compliance accounting caused by the complicated regulations.

The primary objective of the committee's research would lead to demonstrate that reform measures will be advantageous to small business concerns, to lending institutions, and will not adversely effect tax revenue.

We strongly suggest the increasing of the accumulated retained earnings credit. By allowing a greater accumulation of liquid assets, a cushion would be made available to small businesses enabling them to survive economic fluctuations. This would result in fewer business failures, fewer plant closings and fewer unemployed workers.

The excess of the accumulated earnings credit does not currently take economic fluctuations into account in the measurement of such excess. If the credit is increased, businesses would be in a better position to withstand business losses caused by economic fluctuations.

Small businesses are particularly affected by the current low limit on the accumulated retained earnings credit since a greater proportion of the total capital of a small business is internally generated—in many cases; with our members, over 90 percent is the figure.

Again, we are proposing specific research, which is underway at the the present time, and we hope to show that small business relies heavily on internally generated capital, much more so than bigger business; that a larger cushion of accumulated liquid assets would provide small businesses with a better chance of surviving economic fluctuations; with a negligible impact on revenue in relation to the benefits of business survival.

Small business urgently requires an enactment of an interstate taxation act, if tax simplification is to be achieved.

The current multiplicity of State taxing procedures requires a substantial duplication of general information. Certain items and procedures that are available for Federal purposes, such as LIFO, ADR and the capital gain deduction, may or may not be available for State purposes. This often means that small business must keep several sets of books, greatly increasing their costs and reducing their profitability.

Income apportionment formulae may differ so greatly from State to State that it results in double taxation. For example, sales factors may be allocated on either a destination or contract finalization basis. Property may be allocated on either a fair market value, net book value, or original cost basis.

Even cities within the same State may have a variety of modifications to Federal taxable income and vary the apportionment formulae which only serves to further compound the multiplicity of effort that must be expended by small businesses.

In this area, our research is actively pursuing the reasons why we think that an interstate taxation act is in order. We hope to show the current system results in unfair burden of double taxation on small business, and the multiplicity of this effort means great additional cost to small business people.

Our committee advocates the retaining of the Domestic International Sales Corporation provisions for small business. It has taken small business a long time to become aware of the DISC. And, now that we have many small businesses moving into the export market, entry into the export market via DISC provides an important avenue of growth for smaller enterprises.

For example, my firm just organized a DISC 3-months ago, even though the legislation has been on the books for several years. Increased growth tends to increase employment, while at the same time minimizing the exportation of jobs to foreign countries that often occurs when factories are built abroad.

The DISC provisions in general, even though in the opinion of our committee are unnecessarily complex, provide an incentive to improve the Nation's balance of payments. With small business engaged in exporting, the problem could be further helped.

Our research will include a combined project with the Cleveland World Trade Association—one of the most active, local world trade associations. We will ascertain whether the World Trade Association members feel that DISC and tax incentives provide, in general, a service and increase world trade.

We will ask what role the association sees for small business in world trade, and what impact the association foresees if DISC is repealed.

We will be contacting numerous agencies to determine, in tangible and specific ways that we feel the DISC should be retained, especially for small business.

It is felt that this research will show the tremendous impact on small businesses. It will show the growth of small business export trade, and its favorable effect on employment. Each new billion dollars of exports creates an estimated 60,000 jobs. The important role that small business can play in the Nation's balance-of-payments programs will be pointed out in the research.

Since the enactment of DISC, exports have increased $55 billion.

Subchapter S provisions should be revised. The following revisions of the subchapter S rules are needed: Increase the number of permissible shareholders from 10 to 15; allow certain trusts to be qualified shareholders; amend the termination provisions to provide for termination only by a majority or at least provide that a new shareholder's affirmative refusal to consent to the election is necessary so as to prevent inadvertent termination; allow additional investments by the shareholders so that any excess losses can be carried forward rather than forever lost; and allow for property distributions of previously taxed income.

Subchapter S has been of great benefit to both small business and the economy. Subchapter S is now being used by over 10 percent of small business enterprises that are corporations. The provisions allow new businessmen the opportunity to limit their liability to their investment in the enterprise.

Limited liability also makes raising additional capital from new investors easier, and it is very difficult today for small business to raise equity capital.

An additional benefit is that losses up to the extent of the investment are passed through to the individual shareholders. Subchapter S eases the flow of funds generated by profitable operations back to the shareholders for reinvestments in other enterprises to promote further economic growth.

In this area, as well, we have specific technical areas as part of our testimony, which I will not discuss today. We will also present specific research to show why we feel that subchapter S is so important and should be revised.

Regulations regarding overpayment of estimated tax needs amendment. We specifically suggest amending section 6425 to allow a corporate taxpayer to file for a quick refund of certain overpayments of estimated installments prior to the end of the taxable year. Presently taxpayers must wait until after their fiscal yearend to receive tax refunds.

The value of this is well illustrated by the current recessionary period. As business slackens and working capital becomes tighter, smaller business needs to recover the money to which it is entitled without delay.

If these funds are not to be payable to the Government, there is no justifiable reason for requiring that such payments be held by the Government for the entire year.

This provision would involve no loss of revenue to the Government since it only speeds the recovery of funds to which the business entity is entitled. We will be presenting specific research in this area, as well.

Rules limiting the deductibility of business search expenses need to be liberalized. This is an area that few people are aware of, and is so important to small business, especially to newly emerging entrepreneurs.

Allow the deductibility of expenditures incurred in search of a prospective business, even though the proposed transaction was not consummated. Ninety times out of 100, small business persons search for new businesses and these searches are not successful.

The inability to deduct such expenditures operates as a deterrent to the investigation of growth opportunities. There is no equitable justification for conditioning the deductibility of such expenses on whether the transaction is actually entered into when it, in fact, may be later abandoned; and, for not allowing a deduction when, in fact, the taxpayer incurs reasonable and necessary expenditures in a good faith investigation of a business investment.

Restrictions on Section 303 of the Estate Tax law penalizes small business concerns. If a corporation purchases—cancels or redeems—the stock from the estate of a former shareholder in such a way as to make the purchase or distribution "equivalent" to a distribution of a dividend, the amount received by the estate, to the extent it is out of earnings and profits, will be treated as a taxable dividend at ordinary rates.

Whether a distribution in connection with a cancellation or redemption of stock is "equivalent" to a taxable dividend will depend on the facts in each case.

Basically, to avoid the "equivalent" of a dividend, the redemption must result in a meaningful reduction in the shareholder's proportionate interest in the corporation.

In addition, to obtain capital gain treatment on the redemption of stock, the redemption must have been made on time. The value of all the stock of the corporation which is included in determining the value of the gross estate is more than 35 percent of the value of the gross estate, or more than 50 percent of the taxable estate.

Section 303 is a special relief provision provided to owners of small, closely held companies to obtain cash to pay "death taxes".

This provision is not adequate enough for owners of closely held stock. The restrictions of 35 percent and 50 percent should be reduced to 20 percent and 40 percent, respectively.

Mr. Chairman, and committee, the proposals that we have briefly discussed this morning are highly technical. As I mentioned to you, our committee is now actively engaged in research to back up these proposals.

In addition, we will be presenting other proposals of a highly technical nature, to you at your next hearings, backed up by facts and figures, as to why we feel you should act upon them.

The establishment of our working, professional committee, is a major step in obtaining useful information which will hopefully be of value to this Joint Committee, and small business in general.

We appreciate the opportunity of testifying this morning, and our committee—and our entire organization—is at your disposal for any information which we can supply to you in the future.

Thank you, Senator Nelson.

Senator NELSON. Thank you, Mr. Richard, for your very valuable testimony. The committee will be particularly interested in your working professional committee's technical recommendations.

I think one of the problems that we have always had in dealing with the special problems of small business is that we have not had adequate backup in the form of practical and technical information from professional people whose work is in the field of small business. Most of the time, when we are taking testimony, it is testimony from accountants or tax experts who are dealing with the problems of big business. As you have pointed out and has been pointed out in the last several days, the problems are quite different. We have not had the benefit of professional advice, technical advice from professionals who are dealing with small business problems. I think your working professional committee's recommendations could be of great assistance to both the Finance Committee and the Small Business Committee.

So, we thank you very much. When you do have those studies completed, we are going to have continuing, ongoing hearings on problems across the whole spectrum of small business issues. We will be very pleased to take testimony at that time when your committee has something to report.

Mr. RICHARD. Thank you.

If we are invited, and we certainly hope we will be, it is our intention that the testimony and the research that I have discussed with you this morning will be related to you by members of our committee so that you will be able to ask them the technical questions concerning the testimony.

Senator NELSON. Mr. Laxalt?

Senator LAXALT. Just a couple of questions, Mr. Richard.

I listened to your presentation with great interest, having been involved in a number of these problems myself. How feasible is the Interstate Taxation Act? Is it anticipated that the local taxing subdivisions would be preempted entirely?

Mr. RICHARD. It is going to be extremely difficult because no local city, State, or Federal agency likes to give up any jurisdiction. We think it will be difficult; but we think if it is simple and properly laid out, it will be workable. We suffer from no illusions, however. It is going to be a very, very tough, uphill battle, and we hope to be making some specific proposals to your committee in the fall that may be palatable. It would certainly help.

Senator LAXALT. You would not be seeking through the act to preempt the collection only and to make the procedures and principally the deduction side of it more uniform?

Mr. RICHARD. Exactly. We recognize that collection is something that the individual entities look on as their absolute right; but the regulations are so diverse now for those of us who operate in several different areas. This is what we are seeking to make more uniform.

Senator LAXALT. You mentioned quick refunds?

Mr. RICHARD. Yes, sir.

Senator LAXALT. How would that be practical without closing out the year?

Mr. RICHARD. Well, many small businesses today have become substantially more scientific in their accounting procedures and techniques and take relatively accurate monthly and quarterly statements. Some,

my own included, have their external auditors review their quarterly statements. We feel that small businesses would be in a fairly decent position to know whether they have been overpaying on their estimated taxes. Of course, this would perhaps require more accounting on the part of corporations to show they are justified in asking for a refund. I frankly feel, as a small business person, that small businesses should know, on a regular basis, how their business is doing.

Senator LAXALT. Do you think there is that degree of certainty in the situation?

Mr. RICHARD. Not at all.

Senator LAXALT. I do not think so either.

Mr. RICHARD. But I would think this would encourage small business to become substantially more businesslike in accounting records. This is our hope.

Senator LAXALT. But the theory is, I gather, say on a quarterly basis, if there is a strong indication that at the close of the tax year there is going to be a refund situation, upon the proper showing. The refund would be immediately payable.

Mr. RICHARD. Yes, sir.

Senator LAXALT. Has that been tracked through as to feasibility?

Mr. RICHARD. No. We are in the process of doing it. This was suggested by several of our accountants on the committee who work closely with small business and feel that they can set up a procedure that is feasible.

Senator LAXALT. I hope so. That could be very helpful.

Mr. RICHARD. It would be highly desirable to us.

Senator LAXALT. Certainly in tight cash flow areas could afford immediate relief rather than running to a bank, which is customarily the practice.

On the revisions of 303, have any of your people costed that out in terms of revenue loss?

Mr. RICHARD. No. But we will try to show you the impact in the fall of what 303 will do.

Senator LAXALT. Like the chairman, I will be anxiously awaiting the details, and I think if you have the data that can support it, it will be extremely helpful to this committee.

Mr. RICHARD. We are trying very hard to talk in terms of specifics that we can back up. We feel that this will be very helpful to us and hopefully will be helpful to you.

Senator LAXALT. One additional question.

The capital cost recovery program—what you are attempting to do is to simplify the depreciation situation.

Mr. RICHARD. Yes.

Senator LAXALT. What is the bottom line result? A shorter depreciation time for the writeoff.

Mr. RICHARD. There are two results to the CCR program. One is to enable us to take a shorter life, definitely. I was at a board meeting yesterday with Mr. Ray Watts, the counsel of your committee, and he asked me the same question. I explained that the corporation with which I am involved, because we are profitable, pays a relatively high amount of tax, and very little depreciation because we are on a straight line basis and we cannot take advantage of certain liberalized areas of the present depreciation law. Yet, we must grow. As a grow-

ing company, we have to go out and borrow the money to pay our taxes, when liberalized depreciation would enable us to not have to do that.

Senator LAXALT. Is not depreciation capital cost recovery?

Mr. RICHARD. It is. Yes; there is no question.

Senator LAXALT. I do not understand the difference in terminology.

Mr. RICHARD. Well, perhaps it is a catchy phrase used by our accounting committee.

Senator LAXALT. I expected that was the case.

Mr. RICHARD. We are interested in shorter depreciation lives and simplifying the whole depreciation regulations.

Senator LAXALT. Thank you, Mr. Chairman. That is all I have.

Senator NELSON. Thank you very much, Mr. Richard, for your very, very fine testimony.

Mr. RICHARD. Thank you, Senator.

Senator NELSON. We will now hear from the panel on venture capital and its significance to innovation and growth. It is a panel of Mr. Walter Stults, executive vice president of the National Association of Small Business Investment Companies; Mr. David Morgenthaler, president of Morganthaler Associates; and Mr. Richard Hanschen, president of New Business Resources.

Gentlemen, if you would identify yourselves for the reporter so the record will be kept straight on attribution of comments.

Mr. STULTS. Mr. Chairman, my name is Walter Stults; I am with NASBIC.

Mr. MORGENTHALER. Mr. Chairman, my name is David Morgenthaler. I am a senior partner of Morgenthaler Associates of Cleveland, Ohio, and I am appearing today to replace our Mr. Paul Bancroft of Bessemer Securities who was unable to attend.

Mr. HANSCHEN. Mr. Chairman, I am Richard Hanschen of Dallas, Tex., and president of Venture Capital Organization of New Businesses. Also, I am a director and chairman of the Incentives Committee for the National Venture Capital Association.

Mr. NOONE. Mr. Chairman, I am Charles Noone, general counsel of NASBIC.

Mr. LEWIS. I am Stewart Lewis, counsel to National Venture Capital Association.

STATEMENT OF WALTER B. STULTS, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, ACCOMPANIED BY CHARLES M. NOONE, GENERAL COUNSEL

Mr. STULTS. Mr. Chairman, we would like to proceed as a panel. I would like permission to file my complete statement with two appendices, if I might, and then summarize what I have to say.

Senator NELSON. Your full statement and whatever you have appended to it will be printed in full in the record.

Mr. STULTS. Thank you, Mr. Chairman.

[The prepared statement and attachments of Mr. Stults follow:]

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STATEMENT BY
WALTER B. STULTS, EXECUTIVE VICE PRESIDENT
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
before the
SENATE SMALL BUSINESS COMMITTEE
and the
SUBCOMMITTEE ON FINANCIAL MARKETS, SENATE FINANCE COMMITTEE

June 19, 1975

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Walter Stults, Executive Vice President of the National Association of Small Business Investment Companies, located in Washington, D. C. Our organization represents over two-thirds of all SBICs and MESBICs and our members control approximately 90% of all the assets committed to the SBIC industry. With me today is Charles M. Noone, NASBIC's General Counsel.

Let me begin my testimony by congratulating the members of the Senate Small Business Committee for their exemplary work earlier this year in making certain that the special needs of small business were recognized in the Emergency Tax Reduction Act. Your success in initiating the proposals -- and the support given to you by the members of the Senate Finance Committee -- brought about truly landmark legislation. It marked the first time since 1958 that significant Federal tax reforms were directed to independent business.

We are delighted that the Small Business Committee and the Senate Finance Committee are joining in holding these

hearings. We trust that they represent a continuing quest to bring equity in the Internal Revenue Code to all segments of the American business community.

OUTLINE

We have drafted this statement to cover several areas which we believe will be of interest to your Committees. First, I shall comment upon the provisions of the 1975 Emergency/Tax Reduction Act. Secondly, I shall summarize NASBIC's position on broader questions of small business tax reform. The third portion of the statement will cover the field of capital formation, since we do not believe that the question of business taxation has much significance unless it is viewed from the perspective of how our tax policies affect the ability of businesses to survive and grow. Fourth, I shall review the experiences of the SBIC program -- a pioneering partnership endeavor bringing together the Federal Government and the private sector in a jointeffort to solve a serious public policy goal, the provision of long-term credit and equity capital to new and small businesses. The fifth section of the statement will attempt to analyze the "equity gap" facing small business in 1975. Finally, I shall list several NASBIC-supported proposals to amend the Internal Revenue Code for the specific purpose of strengthening the SBIC industry and augmenting our ability to meet the demonstrated needs of our clientele.

I. Emergency Tax Reduction Act of 1975

As I said earlier, every American small business should convey its thanks to the two Committees you represent for your outstanding work several months ago in obtaining substantial tax breaks. The changes you drafted and enacted into law are meaningful and NASBIC believes strongly that they should be made permanent. We understand why the cuts in rates were restricted to 1975 and why the investment credit was limited to two years, but we urge the Congress to remove the temporary label. It is axiomatic that a businessman must make long-range plans, if he is to succeed, but convulsive changes in Federal tax laws rule out any rational effort at such planning.

Furthermore, the after-tax dollars which the independent businessman can retain in his business as a result of the 1975 law permit him to be a more efficient purveyor of goods and services and a more effective competitor.

For these reasons, we respectfully urge your Committees to recommend, and the Congress to pass, legislation making permanent the provisions contained in Public Law 94-12, approved on March 29 of this year.

II. Small Business Tax Reform

For a number of years, NASBIC has actively supported the evolving legislative proposals contained in the "Small Business Tax Simplification and Reform Act." Even though the various bills embodying the provisions of that legislation have contained few provisions relating directly to SBICs, our backing has not been completely unselfish. Stated most baldly: "SBICs will not and cannot succeed, unless the small businesses they invest in have a chance to grow and prosper." Furthermore, SBIC owners and managers are sincerely committed to the free enterprise system; they believe that our economic system is doomed, however, unless entrepreneurs are given the ability to start new businesses, to grow, to make profits -- and, perhaps unfortunately, they must be given the opportunity to fail, too.

NASBIC has worked with those Congressional groups actively pressing the cause of tax reform for small business and with the various small-business groups supporting that campaign. We believe that retained earnings are the absolutely essential elements for any small business.

Large corporations usually can draw upon the public securities markets or the major financial institutions for the dollars they need to launch a new product, to enter a new market -- or to weather an economic downturn. Small business, on the other hand, seldom has access to outside sources of funds and must rely on their retained earnings. Many of the 22 sections of Titles III, IV, V, and VI of the Bible-Evins tax bill were aimed at maximizing retained earnings and we believe your Committees should look with favor upon them as you consider the items to be included in your 1975 tax reform package for small business.

Perhaps this is an appropriate place to inject several personal thoughts which are based upon 25 years of close observation of taxes and small business.

First, I do not believe that it is rational, or realistic, to talk about a "neutral" Federal tax law. It is not realistic, because there are too many powerful interests which will reject the

concept of eliminating that special tax provision which applies to them. Furthermore, I do not believe it is rational to seek absolute neutrality. Let me explain: suppose we could get rid of every, single "loophole". Then we could raise ~~the neces~~sary revenue by taxing every individual and every business at a flat rate of, let's say, 15% of all income. I do not believe that would be either neutral or equitable, since both individuals and businesses differ greatly in their requirements and in their ability to pay.

Putting the same concept in another way, I would say that it makes no sense to strike out blindly and indiscriminately at tax provisions which become "loopholes" in the eyes of the beholder, but which may well be essential to the viability of a segment of our economy.

My conclusion, then, is this: the Internal Revenue Code is inevitably biased. It does, and probably should have, a differential impact on various types of economic activity. The eight, or ten, or twelve million small businesses ask only that Congress make certain that the Code is not biased against them -- and that it does recognize the realities of business life for the independent sector.

III. Capital Formation

No business can grow unless it has the ability to expand its capital. Indeed, in periods of inflation, the costs of replacing inventories and equipment rise so rapidly that a firm must increase its capital base merely to stand still.

For smaller firms, retained earnings represent almost the only avenue of capital formation. A concern without after-tax dollars to plow back into the business is an economic basket case. Suppliers may extend trade credits for a while and banks may furnish loans, but the typical independent business must become profitable and stay that way to have any hope of survival.

The Internal Revenue Service is usually the biggest partner in any small firm. SBA regulations provide that SBICs may not take control of a small business, but the Internal Revenue Code is not so well attuned to such niceties, so a "successful" firm soon finds itself paying out just about half its total income to Uncle Sam. As a matter of fact, when one adds in the social security levies - 5.85%, that business is paying over 50% of its profits to the Federal Government.

During certain periods in the past, many of the most successful growth firms were able to raise additional capital by selling some of their stock through a public underwriting. Although the number of businesses going public was never large in proportion to the total business population, these firms often represented the most innovative and most competitive factors in the entire economy. They were the ones who developed the new product or who provided the new service which brought the challenge to the well-entrenched major corporation. And profiting from this process were not only the entrepreneur and the investor who bought his stock, but also the consumer who received a new or more economical product or service. Others were major gainers from this classical Horatio Alger story, too: the additional workers who were employed by the growing business, and the Federal, State and local governments who feasted on the additional revenues and earnings of the expanding concern.

So what's new in this equation?

First of all, the impact of Federal taxation. Only in the last three decades has the Government drawn off such a high percentage of a firm's earnings. And, secondly, the public securities markets have all but closed down for most businesses during the past two years and it's hard to predict when, if ever, a small or medium size firm will be able to raise needed capital through a public underwriting.

Attached is a chart showing the number of new issues sold for firms with net worth of less than $5-million for the past seven and one-half years:

TABLE 1

NEW, SMALL STOCK ISSUES

Year	Number of Issues	Dollars Underwritten (millions)
1968	358	745.3
1969	698	1,366.9
1970	198	375.0
1971	248	550.9
1972	409	896.0
1973	101	205.3
1974	9	16.1
1975 (first 5 mos.)	0	0

Note: Above data represent firm underwritings for all companies with a net worth under $5 million. Issues of over $5 million were not included nor were Regulation A or best effort underwritings. The above data were compiled through the efforts of Greater Washington Investors and S.M. Rubel & Associes.

Small businesses were not the only ones who felt the cold wind of a dying new issues market. Data compiled by the Securities and Exchange Commission and published in the April 1975 issue of the Federal Reserve Bulletin show a similar trend for all corporations even though it is apparent that some of the major companies have still been able to tap the public securities markets during the past two years.

TABLE 2

TOTAL NEW ISSUES
(in millions of dollars)

Gross Proceeds Corporate Issues

Year	Total	BONDS Publicly offered	BONDS Privately placed	STOCK Preferred	STOCK Common
1971	32,123	24,775	7,354	3,670	9,291
1972	28,896	19,434	9,462	3,367	9,694
1973	22,268	13,649	8,620	3,372	7,750
1974	31,458	25,337	6,121	2,248	4,079

Gross Proceeds, major groups of Corporate Issuers

	Manufacturing		Commercial & Misc.		Transportation		Public Utility		Communication		Real Estate & Financial	
Year	Bonds	Stocks	Bonds	Stocks	Bonds	Stocks	Bonds	Stocks	Bonds	Stocks	Bonds	Stocks
1971	9,426	2,152	2,272	2,390	1,998	420	7,605	4,195	4,227	1,592	6,601	2,212
1972	4,821	1,809	2,645	2,882	2,862	185	6,392	4,965	3,692	1,125	8,485	2,095
1973	4,329	643	1,283	1,559	1,881	43	5,585	4,661	3,535	1,369	5,661	2,860
1974	9,832	546	1,863	968	983	22	8,854	3,964	3,707	217	6,228	617

IV. Small Business Investment Companies

I noted in the preceding section that retained earnings and the sale of securities to the public are two means of capital formation. I wish to discuss now another source of external funds to the ambitious and qualified owner-managers of smaller firms: the SBIC.

Privately organized, capitalized, and managed, SBICs hold Federal licenses which restrict them to investing in new or small businesses in return for the ability to borrow indirectly from the Small Business Administration through the sale of SBIC debentures guaranteed by the U. S. Government.

The program was established by the Small Business Investment Act of 1958; sixteen years later, the industry consists of more than 300 SBICs with private capital of about $400-million and total assets approaching the $1-billion level. These SBICs disburse almost $200-million a year to between 2,000 and 3,000 independent businesses. During the life of the program, SBICs have invested over $2.5-billion in the birth and growth of more than 45,000 small firms.

SBA requires annual reports from every SBIC and collates the figures from these reports. In Table 3, I show the number of active SBICs on March 31 of each year from 1960 through 1974 (the latest data available).

TABLE 3 SBIC FINANCIAL DATA

Date	Reporting SBICs	Private Capital (in millions of dollars)	Assets (in millions of dollars)
3/31/60	80	$ 39.7	$ 43.3
3/31/61	200	174.6	195.5
3/31/62	516	436.3	506.9
3/31/63	615	460.0	599.2
3/31/64	649	463.7	657.2
3/31/65	645	459.9	699.7
3/31/66	606	433.8	701.2
3/31/67	548	393.2	691.5
3/31/68	441	342.6	637.3
3/31/69	373	325.0	630.1
3/31/70	331	332.1	633.3
3/31/71	288	324.9	611.9
3/31/72	274	339.8	673.2
3/31/73	248	332.7	695.1
3/31/74	252	360.7	795.6

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It's immediately apparent that the SBIC industry has experienced a substantial shaking-out during the first 15 years of its life. The drop from 649 reporting, or active, SBICs in 1964 to the 248 licensees nine years later does show a major reduction. Many of the SBICs which disappeared were absorbed by merger with another licensee; an even larger number of companies disappeared because they were too small to afford the staff they required and to afford the time it would take for their investments to become profitable. Others left because their founders just did not understand the true nature of the venture capital/SBIC business before they got into it. Finally, a significant number lost a lot of money and surrendered their licenses. Incidentally, I shall digress to point out that the SBIC program is designed to assure that the shareholders of the SBIC lose every dollar they have invested in it before the Federal Government loses a nickel of its loans to the SBIC. For that reason, the losses to SBA have been minimal over the past 16 years: less than $29-million have either been taken or provided for and this is in contrast to the $6.3-billion dollar-years of financing to small business.

To get back to the record of SBIC financial assistance to small and new businesses: Table 4 shows the annual disbursements made by SBICs, both in terms of dollars and numbers of financings, as well as breaking down those totals among loans, debt securities, and stock purchases.

TABLE 4

SBIC ACTIVITIES DATA

ANNUAL DISBURSEMENTS

(in millions of dollars and numbers of financings)

Year Ending	Totals	Loans	Debt Securities	Stock
3/31/64	$220.0 (5,638)	$124.2 - 56% (3,787)	$74.1 - 34% (1,073)	$21.6 - 10% (778)
3/31/65	$186.8 (4,763)	$121.7 - 65% (3,403)	$45.7 - 24% (752)	$19.4 - 11% (608)
3/31/66	$221.1 (4,960)	$129.4 - 58% (3,334)	$52.6 - 24% (746)	$39.2 - 18% (880)
3/31/67	$164.2 (3,728)	$88.6 - 54% (2,425)	$47.9 - 29% (621)	$27.6 - 17% (682)
3/31/68	$143.2 (2,816)	$78.2 - 55% (1,683)	$30.4 - 21% (440)	$35.5 - 24% (693)
3/31/69	$182.4 (3,090)	$76.9 - 42% (1,555)	$53.7 - 30% (530)	$51.8 - 28% (1,005)
3/31/70	$187.0 (2,920)	$76.9 - 41% (1,406)	$51.9 - 28% (564)	$58.1 - 31% (950)
3/31/71	$156.0 (2,536)	$66.3 - 43% (1,305)	$45.5 - 29% (499)	$44.2 - 28% (737)
3/31/72	$168.9 (2,544)	$81.8 - 48% (1,428)	$43.7 - 26% (438)	$43.4 - 26% (676)
3/31/73	$175.2 (2,405)	$76.7 - 44% (1,260)	$47.8 - 27% (468)	$50.7 - 29% (677)
3/31/74	$197.6 (2,000)	$104.7 - 53%	$63.2 - 32%	$29.7 - 15%

Table 5 indicates the number of dollars outstanding in SBIC portfolios on the reporting dates for each of the last 15 years.

TABLE 5

OUTSTANDING BALANCES (as of)	
3/31/60	$ 9,900,000
3/31/61	79,400,000
3/31/62	233,700,000
3/31/63	386,937,000
3/31/64	490,533,000
3/31/65	536,562,000
3/31/66	552,294,000
3/31/67	535,843,000
3/31/68	448,707,000
9/30/68	439,419,000
3/31/69	437,082,000
9/30/69	447,599,000
3/31/70	470,317,000
3/31/71	472,923,000
3/31/72	502,355,000
3/31/73	500,400,000
3/31/74	569,400,000

The preceding three tables demonstrate that the SBIC program has disbursed a relatively large number of dollars to small business, but the question remains of how beneficial this financial assistance was to the firms which received the funds.

Data compiled by the Small Business Administration demonstrate that SBIC financing has been tremendously beneficial to the firms which received it. An SBA program effectiveness study showed that these SBIC-aided small businesses achieved the following annual growth rates: employment: 25%; revenues: 27%; profits: 27%; assets: 35%; and net worth: 37%. Obviously, these "portfolio companies" are growing far more rapidly than the averages for all U. S. businesses.

The owners of these companies were deeply grateful to the SBICs for financing their start-up or growth. Another recent SBA survey revealed that more than 90% of all portfolio companies had benefited from SBIC help, most of them to a major degree. Naturally, tensions sometimes arise between an entrepreneur wholly involved in the life of his business and the lender or investor advancing funds to that firm, but the true partnership nature of the relationship between the businessman and the SBIC is supported by SBA's findings that 87% of the owners were satisfied with their SBIC dealings and 87% said they "would use SBIC assistance again under similar circumstances."

While the SBA study proves that the SBIC program has been a boon for those businesses which have received capital, long-term loans, and management assistance from SBICs, the statistics concerning the returns received by the shareholders in those SBICs raise more questions. The unadorned rates of return on capital shown in Table 6 would seem to indicate that the program has been terribly disappointing to those who invested in SBICs. But a word of caution should be entered. First of all, the figures in Table 6 show only operating income and gains on the sale of portfolio securities, since SBIC financial statements were prepared on a "cost or value, whichever is less" basis through March 31, 1974. Table 7 adds another dimension to the profit picture, because it shows the amount by which SBICs have reported that their portfolios had a value above cost.

TABLE 6

SBIC FINANCIAL DATA

Profit Rates
(percentage return on capital)

Date	Total
3/31/60	.04%
3/31/61	(.08%)
3/31/62	(.7%)
3/31/63	(1.8%)
3/31/64	(4.0%)
3/31/65	(3.5%)
3/31/66	2.5%
3/31/67	2.4%
3/31/68	6.0%
3/31/69	9.5%
3/31/70	3.1%
3/31/71	(3.6%)
3/31/72	0.8%
3/31/73	(1.0%)
3/31/74	4.6%

TABLE 7

Unrealized Appreciation

Date	Total
3/31/65	$39.8
3/31/66	77.4
3/31/67	109.2
3/31/68	141.0
3/31/69	175.6
3/31/70	116.8
3/31/71	82.6
3/31/72	97.9
3/31/73	85.8
3/31/74	52.2

In addition to the distortion shown by the unrealized appreciation factor, several other items must be considered before one can judge whether or not the SBIC program has been a success from the viewpoint of those who invested in SBIC stock:

1. Bad-Debt Reserves: SBICs have been entitled to deduct as a business expense a significant portion of their pre-tax earnings as a reserve against losses on bad debts. On March 31, 1974, this amounted to almost $60-million, and, to the extent that reserve is in excess of anticipated losses, it detracts from indicated profits.

2. Distributions in Kind: A number of SBICs have distributed stock in successful portfolio companies to their stockholders rather than selling them for their own account. This action has eliminated the tax impact for the SBIC and has represented a reward to the stockholders who seldom receive ordinary dividend income. SBA kept statistics on such distributions only in 1971, 1972, and 1973. In those 3 years, portfolio securities with a cost of $2.2-million and a market or fair value of $17.2-million were given to SBIC stockholders. This represents a pre-tax income of $15-million which might otherwise have been shown directly by the SBICs.

3. State of the Securities Market: SBICs that hold stocks of publicly-traded companies are obviously affected by the general level of stock prices, particularly quotations on the over-the-counter market. Table 7 showed a drop in unrealized appreciation of about $125-million between March 31, 1969 and March 31, 1974. Should the market rebound to 1969 levels, SBICs would likely show a major gain in their asset values.

For inclusion in the hearing record as Appendix A is an article which appeared in the May 1975 issue of the SBIC Digest, entitled "Evaluating SBIC Performance". I believe this explanation of the various factors involved in analyzing the profit-and-loss statements of SBICs is a valid and useful treatment. Incidentally, it was prepared by officials of the Investment Division at SBA -- which publishes the SBIC Digest.

To conclude this treatment of SBIC performance: a number of SBICs have compiled outstanding investment records. They have been able to pick good small businesses to invest in;

they have worked well with those portfolio companies; and they have been able to exit from their successful investments with sufficient gains to overcome the inevitable losses and disappointments. On the other hand, the evidence indicates that the bottom-line profit figure is still not high enough to attract the additional hundreds of millions of dollars of private capital which are needed to fill the equity gap which we'll explore in the next section.

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V. Is There An "Equity Gap" For Small Business in 1975?

When Congress passed the Small Business Investment Act in 1958, it was convinced that small and new businesses in the United States faced an "equity gap" -- the lack of an institutional source of capital and long-term loans. The past 17 years have certainly proved that a gap did exist, because SBICs have disbursed more than $2.5-billion in those years. Good investment opportunities have existed for SBICs, and small businesses have shown themselves willing to bring outside partners into their firms in return for capital, long-term credit, and management counselling.

Other sources of such funds have existed during these years, notably the various venture capital funds. Other witnesses before this hearing will represent that segment of our overall industry and will give you specific information on their operations.

I believe the evidence is clear that, despite the existence of the $1-billion SBIC industry and despite the existence of a non-SBIC venture capital industry which is probably equally large, an "equity gap" still exists. Most SBICs report that they see more eligible investment opportunities than they are able to meet. Naturally, this fluctuates with the state of the economy and the state of the securities markets, but I am convinced that there are more potential entrepreneurs than our combined industry now finances. I am certain that many well-managed businesses have the capability to expand if they could attract the necessary financing. And, finally, I know that there are many areas in the United States which have very little, or absolutely no, venture capital. SBICs and other venture capitalists do range throughout the country in making investments, but it is unlikely that a qualified small businessman in an area without SBICs will even know about our resources. Furthermore, SBICs and venture capitalists are much less likely to advance funds in areas where no local co-venturer is located.

Earlier in this statement, I pointed out that small business raised $1.37-billion in new issues in firm underwritings

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in 1969. In 1974, that figure fell to $16-million. Even discounting the inflated values given to the stocks of some companies in a "go-go" era, it is obvious that the number of good firms did not drop so precipitously during that 5-year period. SBICs and venture capital companies have taken care of some of these growth companies, but certainly not all of them.

It is impossible to place any sort of a figure on the magnitude of the 1975 equity gap. One cannot merely tabulate the applicants who were refused financing by SBICs and venture capital companies, because of duplication and because some proposals were simply not realistic. Furthermore, in cities or areas where there are many well-publicized venture capitalists, the potential entrepreneur -- or the successful businessman who wants to grow -- knows that an institution is available to help him fulfill his goals. In other parts of the United States, such a man would not even give credence to such dreams.

The past 18 months have added more uncertainties to the picture. The escalating inflation of 1974 forced businessmen and venture capitalists alike to hoard their dollars and restrain their expansion plans. Almost every SBIC manager has reported that he saw far fewer investment opportunities in 1974 than in preceding years. During the past month or two, the trend has reversed and, once again, the innovative scientist trying to leave the major corporation to establish his own firm has come forward. Once again, the businessman who has been successful on a local scale has begun to think about taking his product or his service on to a larger stage.

I make these observations, which are undoubtedly obvious, merely to reinforce my general statement that it is possible to say, without fear of contradiction, that there is still an equity gap in the United States -- but it takes a venturesome person indeed who will attempt to ascribe specific dollar dimensions to the gap.

VI. SBIC Tax Proposals

If Congress agrees with my statement that the equity gap for small business persists, it is important that SBICs increase their assistance above present levels. To accomplish that goal, existing SBICs must be encouraged to increase their capital and new SBICs must be brought into the program, particularly in areas of the country where no licensees now operate. NASBIC has drafted two complementary bills to provide the incentives to bring added resources to present SBICs and to attract new licensees. One bill would amend the Small Business Investment Act of 1958 and will be considered by the Senate Banking, Housing and Urban Affairs Committee. The other relates to the tax aspects of the SBIC program and would go before the Senate Finance Committee and is more relevant to your current hearings.

Two distinct types of investors have purchased SBIC stock over the past 15 years. One group seeks capital appreciation and a return on their investment through long-term capital gains. For this group, our tax bill offers SBICs a 100% reinvestment credit which will defer payment of Federal taxes and would permit an SBIC to reinvest all of its earnings in additional small businesses. Obviously, the stockholders in this group will find the SBIC reinvestment credit a significant incentive.

The second group of investors desires regular dividends and will purchase the stock of SBICs which are income-oriented. The ability of these SBICs to pass-through their earnings on a regulated investment company basis would make them most attractive to this second category of investors.

In all, the SBIC tax bill has 7 provisions. They can be stated briefly as follows:

1. Permit Subchapter S Treatment for SBICs. (Sec. 2 of Bill)
2. Permit SBICs to be Shareholders in Subchapter S. Corporations. (Sec. 3 of Bill)
3. Allow 100% Reinvestment Credit for SBIC Earnings. (Sec. 4 of Bill)
4. Enact Statutory 10% Bad Debt Reserve. (Sec. 5 of Bill)
5. Provide that Dividends Paid SBICs by Portfolio Companies on Preferred Stock be Deductible as Interest. (Sec. 6 of Bill)

6. Liberalize the Diversification Requirements for SBICs Electing to be Taxed as Regulated Investment Companies. (Sec. 7 of Bill)

7. Permit Section 851 Pass-Through for Non-Public Companies. (Sec. 7 of Bill)

My statement has already covered #3, #6, and #7 in summary form, and #1 would also allow an SBIC to pass through its earnings to its shareholders without intervening corporate taxes.

Item #2 is designed for the benefit of specific small businesses. Under present tax law, only individuals and estates may be stockholders in a Subchapter S corporation which elects to be taxed as a partnership. When an SBIC takes an equity interest in such a small business, the firm loses its right to be a Subchapter S corporation. We believe this is counter-productive and harmful to the small business involved.

The 1969 Amendments to the Internal Revenue Code gave specific authority for SBICs to set up reserves for bad-debts, but the implementing regulations have never been promulgated by IRS. SBICs which have been in operation less than 10 years still are not certain how much they can place in such a reserve. We believe it would be helpful to establish a statutory reserve level, as provided in Section 4 of our bill.

The fifth item is the only innovative portion of our tax bill and we believe it could be extremely valuable for the small business which receives SBIC financing. At the present time, most SBICs face a dilemma in structuring their financing. They want their dollars to be most effective in helping the small business grow, but it must also consider the impact upon the portfolio company. For that reason, the usual SBIC financing takes the form of subordinated debt with the right to acquire stock. The small business can deduct its interest payments to the SBIC as a business expense. If that firm were able to charge off payment of dividends on preferred stock as a business expense, more SBIC deals would be structured as stock purchases, and thereby strengthen the capital position of the small business.

Mr. Chairman, I ask that a section-by-section analysis of the SBIC tax bill and the actual language of our proposals be included in the hearing record as Appendix B.

Variable Tax Rates on Capital Gains Income

Before leaving the subject of SBICs and taxes, I wish to refer briefly to one most important item, the taxation of capital gains. SBICs and venture capital companies deal every day with the "risk-reward ratio". That's only a short-hand way of saying that we weigh the potential gains from any investment against the chance that we will lose all the dollars we put into the firm. Congress recognized this factor when it provided that investors in SBIC stock could offset any losses on the sale of such stock against ordinary income, rather than as a capital loss.

In the same way, in 1958, Congress also added Section 1244 to the Internal Revenue Code which gave taxpayers the right to offset losses on securities defined as "Small Business Stock" against ordinary income.

As a further incentive for individuals, SBICs, and venture capitalists to invest in smaller firms, I recommend that your Committees explore the possibility of revising the present capital gains taxation rate to take into account the length of holding the securities, as well as the degree of risk involved in the investment. I realize that the latter element requires a rather subjective analysis, but I maintain that an SBIC which invests in a very small business and holds that investment for 10 years or longer should be taxed at a lower rate than the person who invests in the stock of a Triple AAA corporation and holds that investment for six months and one day.

Venture capital investments are invariably almost completely illiquid; that is, the SBIC cannot sell that security to anyone for a number of years. We usually acquire stock long before the business even goes public at all and we face tight SEC restrictions before we can sell the stock, even if there is a market for it.

I ask, then, that Congress recognize the sharp distinctions between different types of capital gains and provide an incentive for SBICs and others to make long-term investments in high-risk situations.

VII. Summary

The members of the National Association of Small Business Investment Companies maintain their strong belief that the economic system which has brought such a high level of fulfillment to the United States can and should be preserved. We can recite from our own experiences hundred of instances where an ambitious and imaginative entrepreneur has made that better mousetrap and has brought the world to his doorstep. We hold as a matter of faith the concept that competition is the touchstone of our free enterprise order and we have helped hundreds of small businesses compete successfully against the giants in their industries. We call upon all our logic, all our experiences, all our rhetoric to convince Congress and the Executive Branch of the Federal government that positive action must be taken quickly to guarantee the survival and vigor of the independent section of our economy.

SBIC managers are involved in the most exciting pursuit. The rewards of participating in the birth and growth of a successful business enterprise are a combination of the psychic and the financial. We are "at the jugular of the free enterprise system", as one of NASBIC's former Presidents put it.

In closing, we pledge our continuing cooperation in every possible way as your Committees pursue their efforts to shape an equitable Federal tax policy which will encourage, not inhibit, business growth and vitality.

APPENDIX A

Feature — Evaluating SBIC Performance

The purpose of this article is to discuss the evaluation of small business investment company (SBIC) performance and profitability, and to highlight the elements used in measuring that performance which do not readily lend themselves to analysis. In this age of emphasis on quantitative analysis and its obvious advantages of rigor and objectivity, it's sometimes easy and convenient to overlook or heavily discount the elements of profitability that can't be assigned a dollar quantity or a number of some kind.

In order to measure or evaluate the economic performance of an SBIC or to compare one SBIC to another we must consider all sources of economic return to the investment in the SBICs. These returns are both direct and indirect in that some lend themselves to straightforward quantitative analysis, while the others are implicit but nonetheless important.

Direct Returns. For the purposes of this discussion, the direct returns consist of the combined net income of SBICs which includes net income from operations (ordinary income) and net realized gains from the sale of investments (capital gains). The rate of return would be computed by dividing the combined net income by the equity capital invested.

Realizing that this is a controversial area and subject to much debate, we will for this article define an "adequate" rate of return as ten-percent simple per annum on equity capital invested. There have been $4.7 billion dollar-years of invested equity capital in the SBIC industry in the 13-year financial history of the industry. This has earned a total direct return of $23.8 million net, an historical rate of 0.5%. This doesn't come close to meeting the adequacy criteria described above.

This picture does however have a further dimension. The consensus of thought is that the portfolio cycle of an SBIC runs from 5 to 7 years and therefore, it is possible to characterize the first years of the industry's history as a start-up period. Taking the latter 7-year period (1967 throught 1973, inclusive), the direct rate looks somewhat different. During this latter period, $2.4 billion dollar-years of capital were invested in the industry and the

earnings were $58.8 million, a direct rate of return of 2.5%. The improvement can be attributed partially to the excellent performance of the capital markets overall during the second half of the decade of the 60s, enhancing the market value of SBIC investments, and enabling SBICs to convert their unrealized gains on investments to realized gains. Proof of this becomes evident when we look at the elements of the combined net income during that period. During the last 7 years of the industry's history (67 thru 73), there was a net operating loss of $61.2 million and net realized gains from the sale of investments of $120.0 million, thus the $58.8 million of combined net income for the period. A recap of these results is as follows:

SBIC FYs	Dollar-years Invested Capital (millions $)	Aggregate Combined Net Inc. (millions $)	ROR (%)
61 thru 66	2,231.2	(35.0)	(1.6)
67 thru 73	2,439.9	58.8	2.4
	$4,671.1	23.8	0.5

Notwithstanding the improvement in the direct rate of return in the last 7 years, that rate still does not meet the adequacy criteria.

In addition to the methods discussed thus far for computing the direct rate of return of SBICs, there is an alternate method, some say a preferable method, of computing the return. For this method it is necessary to include the change in the unrealized appreciation of the portfolio in the numerator of the return computation. Using this computation, the total return for the last 7 years would have been $219.7 million for a direct rate of 9.2%. Although this approaches the adequacy criteria, this writer does not feel that using the change in unrealized appreciation in the computation is entirely justified due to the nature of venture capital investments and their relative illiquidity and volatility.

Clearly, the direct returns computed by the more conservative method do not appear to be adequate to attract and retain capital in the SBIC industry. This leads then to the discussion of the indirect rate of return as an important supplement to the direct rate in evaluating the overall SBIC industry performance.

Indirect Returns. These returns consist of three elements: Dividends-In-Kind, Tax Benefits, and Residual Benefits. Each of these is discussed in turn below with examples of how they enhance the overall economic return to the capital invested in SBICs.

Dividends-in-Kind

The best way to describe this form of indirect return is by example. Let's assume that an SBIC has in its portfolio an investment consisting of the shares of common stock of a small business, such shares being registered (or exempted) by the SEC and traded in the market. Assume further that the SBIC has considerable unrealized appreciation in the value of these shares. When the SBIC determines that the time has come to realize such appreciation and liquidate its holdings in the shares, it has a choice of several alternative actions. First, it may sell the appreciated shares in the market, realize the gain, pay the tax, and retain or pay out the earnings.

The second choice available to the SBIC would be to declare a dividend-in-kind. Here's how this technique operates. The SBIC would declare the dividend in the amount of the cost of the appreciated shares and then ratably pass out to its stockholders those appreciated shares at their cost not their market or appreciated value. As far as the SBIC is concerned, there would be no earnings, no taxes and no cash effect. What occurs in this case is that the SBIC as a corporation chooses not to realize the gains but instead passes the appreciated shares (at cost) to its stockholders via the dividend-in-kind technique. This leaves to the discretion of the recipient stockholders the timing of the actual sale of the shares and resulting realization of gain. In this case, the direct return of the SBIC would not be effected while the actual return to its stockholders could be considerable.

There is no historical record for the aggregate SBIC industry, except for the years 1971, 1972, 1973, of the amount of such dividends-in-kind. In those 3 years, dividends-in-kind with a cost of $2.2 million and a market or fair value of $17.2 million have been distributed to SBIC shareholders. On the other side of the issue, that's $15.0 million of pre-tax realized gain ($17.2 million minus $2.2 million) that has not

been available for the SBIC direct rate of return and therefore never considered in evaluating SBIC profitability and performance.

It is evident that this disguised rate of return, if that's an appropriate description, must be taken into consideration when evaluating the adequacy of the SBIC industry performance.

Tax Benefits

There are certain tax benefits available to SBICs and to the owners of SBIC shares which must be considered when making the final decision as to the returns available on capital invested in SBICs. In this area, it is especially difficult to quantify these returns since the records containing such information are confidential and thus not available. There seems to be little doubt however that tax savings realized by SBIC shareholders, whether those shareholders are corporate or individual, are and can be considerable. Many SBICs are wholly owned subsidiaries of financial and non-financial companies, and therefore, when filing consolidated tax returns, the parents of these SBICs many times realize considerable tax savings. If these tax savings were attributed to the investment in the SBICs, the returns to that investment would be enhanced.

Residual Benefits

As mentioned above, SBICs are owned by different types of financial and non-financial corporations. Among these are banks, commercial finance companies, financial holding companies, wholesale distributors, franchisors, manufacturers, real estate companies, etc. In these situations, the SBIC becomes a complement to the overall corporate objectives of the parent.

Consider first the situation of a bank which wholly owns an SBIC. The SBIC can become an extension of the full service concept in banking while at the same time providing the bank with potential customers for its banking services. In many cases where a bank may not make a particular small business loan because of risk considerations or because the small business needs equity or subordinated debt, or because the term required is too long for the bank; the bank may refer the applicant to its SBIC subsidiary which can make such a

non-bankable financing, thus retaining the good will of the business. Also, there is no prohibition against an SBIC and its parent bank making a simultaneous financing in different forms to a small business concern. The SBIC may become a source of business for its parent bank. Any additional services that the bank may be able to sell the investees of its SBIC would of course generate earnings for the bank, a portion of which would be attributed to the ownership of an SBIC subsidiary.

Another example would be SBICs owned by franchisors or wholesale distributors. The SBIC subsidiaries may finance the capital requirements of the franchises or customers of such parents, thereby creating and/or perpetuating the market for the product(s) of the SBIC parent. At present, there are about 15 SBICs which are owned by food wholesalers or franchisors which finance their customer small businesses. In these cases, the SBIC, though profit seeking, has the additional role of complementing the operations of the parent, thus enabling the parent to enhance its profits. It is evident that some portion of the profits of these types of parents should be attributed to the investment in their SBIC as well.

<u>Summary</u>. The five elements of return which must be considered before the final decision can be made as to whether an SBIC or the SBIC industry has had an "adequate" performance record are as follows:

. . . Net Operating income

. . . Realized gains

. . . Dividends-in-kind

. . . Tax benefits

. . . Residual benefits

The first two are considered the direct returns, while the latter three are indirect.

It is appropriate to mention to the analyst and layman alike, that the inability to quantify the indirect returns does not justify overlooking or heavily discounting them. It is entirely possible, indeed probable, that the indirect returns are more significant than the direct and that the total economic returns to the capital invested in the SBIC program has in fact been more than "adequate".

APPENDIX B

INTERNAL REVENUE CODE

1. Permit Subchapter S Treatment for SBICs. (Sec. 2 of Bill)

Outline of Problem:

Subchapter S permits qualifying corporations to avoid federal corporate income tax. The principal requirements for qualification are that the corporation be a domestic corporation with not more than one class of stock issued and outstanding, that it have not more than 10 shareholders, all of whom are individuals or estates, and that not more than 20% of its gross receipts be from "passive investment income" which is defined to include dividends, interest and gains from sales or exchanges of "stock or securities".

It is this latter passive income test which prevents many closely-held SBICs (10 or fewer shareholders) from achieving "pass-through" treatment. While it was reliably reported some three years ago that Treasury was prepared to recommend the elimination of this test for Subchapter S corporations generally, it has not done so.

Recommended Solution:

Amend Section 1372 (e)(5) of the Code to exempt SBICs from the 20% passive income test.

2. Permit SBICs to be Shareholders in Subchapter S Corporations. (Sec. 3 of Bill)

Outline of Problem:

As noted under the preceding topic, only individuals or estates can be shareholders in a Subchapter S Corporation under present law. Corporate shareholders are not permitted.

Permitting SBICs to be shareholders would accomplish two beneficial results, namely enlarging the potential market for SBIC financing, particularly venture capital financing, and potentially increased yields for SBICs on successful investments by virtue of the avoidance of federal corporate income tax on earnings of their portfolio Subchapter S corporations.

Recommended Solution:

Amend Section 1371 (a)(2) to permit SBICs to be shareholders in Subchapter S corporations.

3. Allow 100% Reinvestment Credit for SBIC Earnings. (Sec. 4 of Bill)

Outline of Problem:

SBICs with net taxable income generally are subject to federal corporate income tax the same as any other domestic corporation. The payment of such taxes

reduces the funds available to an SBIC to provide financing to small business concerns.

Recommended Solution:

Add a new Section 251 to Part VIII of Subchapter B of Chapter 1 of the Code (relating to special deductions for corporations) to exempt SBICs from corporate income tax on earnings and profits to the extent that such earnings and profits are utilized for additional loans and investments not later than the close of the taxable year following the year of realization of such earnings and profits.

The SBIC would become subject to tax on any earnings or profits paid out to shareholders as dividends or upon dissolution of the SBIC.

In addition to generating additional funds for expanding SBIC financing activities, an obvious benefit of such a change in the law presumably would be the attraction of additional private capital to the SBIC program.

IRS has already recognized the basic principle by its promulgation of Income Tax Reg. 1.533-1(d) which exempts SBICs from the surtax on accumulated earnings provided such earnings are utilized for additional loans to and investments in small business concerns.

4. Enact Statutory 10% Bad Debt Reserve. (Sec. 5 of Bill)

Outline of Problem:

SBICs were formerly permitted to establish bad debt reserves in the amount of 10% of outstanding loans pursuant to Revenue Ruling 64-48 effective for a ten-year period beginning in 1959. Despite strenuous industry and SBA efforts to persuade Treasury to extend the ten-year period, Treasury insisted that it expired December 31, 1968.

Section 586 of the Code, enacted as part of the Tax Reform Act of 1969, established a new method for computing additions to bad debt reserves of SBICs. Essentially, it permits SBICs to add to existing reserves on an extremely conservative six-year moving average method related to realized losses.

SBICs assert that the Section 586 formula is unrealistic and totally inadequate in terms of providing reasonable reserves for bad debts for SBICs which are engaged in extremely risky financing.

Recommended Solution:

Amend Code Section 166, pertaining to bad debts, to provide a specific bad debt reserve for SBICs in the amount of 10% of outstanding loans, and amend Section 586 to delete references to SBICs.

5. Provide that Dividends Paid SBICs by Portfolio Companies on Preferred Stock be Deductible as Interest. (Sec. 6 of Bill)

Outline of Problem:

Under present law, interest paid by a borrower on business indebtedness is a deductible business expense for purposes of computing taxable income. Dividends on stock paid to shareholders, whether on common or preferred stock, are not deductible and thus must come out of after-tax income.

In his tax plan submitted to the Congress late in 1974, President Ford proposed to allow companies to deduct the dividends they pay on preferred stock just as they already deduct the interest they pay on bonds. In keeping with President Ford's announced support for small business and the need to provide additional sources of equity capital for small concerns, his proposal should be made applicable to SBICs even if not supported for corporations generally.

Recommended Solution:

Amend the Internal Revenue Code to provide that interest paid by small concerns to SBICs on their preferred stock shall be deductible as an ordinary business expense in computing taxable income.

6. **Liberalize the Diversification Requirements for SBICs Electing to be Taxed as Regulated Investment Companies. (Sec. 7 of Bill)**

Outline of Problem:

Subchapter M of the Code permits the "pass-through" of earnings and profits to shareholders of regulated investment companies without federal corporate income tax provided the company pays out to its shareholders quarterly at least 90% of its investment income.

But to qualify for this election, the corporation must meet rigid diversification requirements on its investments. Specifically, a Subchapter M corporation must be able to show at the end of each quarter of its taxable year that it has at least 50% of its assets in cash, Government securities or in loans or investments representing not more than 5% of its assets nor more than 10% of the outstanding voting securities of portfolio concerns.

It is the latter 5% and 10% tests that prove most troublesome for SBICs seeking to qualify under Subchapter M.

Historically, SBICs which have succeeded in qualifying under Subchapter M have been the most successful in

terms of attracting additional private investment. This being a prime goal of the Congress, steps should be taken to facilitate qualification of additional SBICs under Subchapter M.

Recommended Solution:

Amend Section 851 of the Code to conform the diversification requirements for SBICs to those contained in the Small Business Investment Act of 1958.

This same proposal was contained in S. 2629 and H.R. 14788, both introduced in the 93rd Congress. It should be noted that Treasury strenuously opposed the proposal in letters to the tax committees in August, 1974.

7. Permit Section 851 Pass-Through for Non-Public Companies. (Sec. 7 of Bill)

Outline of Problem:

Another requirement for qualification under Subchapter M (see above re diversification) is that the company be registered under the Investment Company Act of 1940 at all times during its taxable year.

Problems created for SBICs under the 1940 Act are well documented elsewhere.

Recommended Solution:

Amend Section 851 of the Code to permit SBICs to be taxed as regulated investment companies whether or not registered under the Investment Company Act of 1940.

94th CONGRESS
1st SESSION

A BILL

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of small business investment companies and shareholders in such companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.--This Act may be cited as the "SBIC Tax Reform Act of 1975".

(b) AMENDMENT OF 1954 CODE.--Except as otherwise expressly provided, whenever in this Act an amendment is expressed in terms of an amendment to a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

(c) EFFECTIVE DATE.--Except as otherwise specified, the amendments to the Internal Revenue Code of 1954 made by this Act shall apply to taxable years beginning after the date of enactment of this Act.

SECTION 2. EXEMPTING SBICs FROM THE PASSIVE INVESTMENT INCOME TEST UNDER SUBCHAPTER S.

Subparagraph B of Section 1372(e)(5) (defining passive investment income) is amended--

(1) By striking the period at the end of Subsection 1372(e)(5)(ii) and substituting in lieu thereof"; or"; and

(2) By inserting after Subsection 1372(e)(5)(ii) as thus amended the following new subsection:

"(iii) the electing small business corporation is a small business investment company licensed under the Small Business Investment Act of 1958."

SECTION 3. PERMITTING SBICs TO BE SHAREHOLDERS IN SUBCHAPTER S CORPORATIONS.

Section 1371(a)(2) (defining eligible shareholders in a subchapter S corporation) is amended to read as follows:

"(2) have as a shareholder a person (other than an estate or a small business investment company licensed under the Small Business Investment Act of 1958) who is not an individual;"

SECTION 4. ALLOWING A DEDUCTION FOR SBIC EARNINGS AND PROFITS DISBURSED IN ADDITIONAL LOANS AND INVESTMENTS.

Part VIII of Subchapter B of Chapter 1 (relating to special deductions for corporations) is amended by adding at the end thereof the following new section:

"SEC. 251. EARNINGS AND PROFITS OF SMALL BUSINESS INVESTMENT COMPANIES.

"(a) ALLOWANCE OF DEDUCTIONS.--

"(1) IN GENERAL.--In the case of a small business company licensed under the Small Business Investment Act of 1958, there shall be allowed as a deduction the earnings and profits of such small business investment company up to the amount of such earnings and profits disbursed in new loans or investments pursuant to Section 304 or Section 305

of the Small Business Investment Act of 1958.

"(2) CONDITIONS FOR ALLOWANCE.--No deduction shall be allowed under this section unless such earnings and profits are disbursed by the close of the taxable year following the taxable year in which such earnings and profits are realized.

"(b) DENIAL OF DEDUCTION.--The deduction provided by Subsection (a) shall not apply to dividends paid to shareholders from earnings or profits of a small - business investment company whether payable in cash or in kind or upon dissolution of the small business investment company."

SECTION 5. PROVIDING 10% STATUTORY BAD DEBT RESERVE FOR SMALL BUSINESS INVESTMENT COMPANIES.

(a) Section 166 is amended by adding at the end thereof the following new subsection:

"(h) RESERVE FOR SMALL BUSINESS INVESTMENT COMPANIES.--In the case of a small business investment company licensed under the Small Business Investment Act of 1958, the reasonable reserve for bad debts allowed under Subsection (c) shall be not less than 10 percent of outstanding loans at the end of the taxable year."

(b) Section 586 (relating to reserves for losses on loans of small business investment companies and business development corporations) is amended by deleting therefrom all references to small business investment companies.

SECTION 6. ALLOWING A DEDUCTION FOR DIVIDENDS PAID TO SMALL BUSINESS INVESTMENT COMPANIES ON PREFERRED STOCK.

Part VIII of Subchapter B of Chapter 1 (relating to special deductions for corporations) is amended by adding at the end thereof the following new section:

"SEC. 252. DIVIDENDS PAID TO A SMALL BUSINESS INVESTMENT COMPANY ON PREFERRED STOCK.--

"In the case of a corporation having preferred stock outstanding to a small business investment company, there shall be allowed as a deduction 100 percent of the dividends paid to the small business investment company on such preferred stock."

SECTION 7. AMENDING THE DIVERSIFICATION REQUIREMENTS FOR SMALL BUSINESS INVESTMENT COMPANIES ELECTING TO BE TAXED AS REGULATED INVESTMENT COMPANIES.

Section 851 (relating to definition of regulated investment company) is amended by inserting after subsection (e) the following new subsection:

"(f) SPECIAL RULES FOR SMALL BUSINESS INVESTMENT COMPANIES.--For purposes of this title--

"(1) In lieu of meeting the requirements of subsection (b)(4) of this section, a small business investment company licensed under the Small Business Investment Act of 1958, as amended, may elect in the alternative to be considered a regulated investment company under this subtitle provided that at the close of each taxable year--

"(A) at least 50 percent of the value of its total assets is represented by--

(i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and

(ii) other securities for purpose of this calculation limited in respect of any one issuer to an amount not greater in value than 20 percent of the private capital of the small business investment company and not more than 50 percent of the outstanding voting securities of such issuer.

"(B) not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary or his delegate, to be engaged in the same or similar trades or businesses or related trades or businesses. For the purposes of this subsection, the term 'controls' means the ownership of more than 50 percent of the total combined voting power of all classes of stock entitled to vote."

"(2) Notwithstanding the provisions of subsection (a)(1) of this section, the provisions of this section shall apply to a small business investment company which is licensed by the Small Business Administration under the Small Business Investment Act of 1958, as amended."

54-397 O - 75 - 27

Mr. STULTS. Let me begin my testimony by congratulating the members of the Small Business Committee for their exemplary work earlier this year in making certain that the special needs of small business were recognized in the Emergency Tax Reduction Act. Your success in initiating the proposals, and the support given to you by the members of the Senate Finance Committee, brought about truly landmark legislation. It marked the first time since 1958 that significant Federal tax reforms were directed to independent business.

I was amused when Chairman Long of the Finance Committee spoke of small business advocates being a pressure bloc, and I think that is one of the most hopeful signs that the small business community has seen in the last 25 years.

My statement will cover several areas. I have already commented on the provisions of the Emergency Tax Reduction Act. I would like to summarize NASBIC's position on the broader questions of small business tax reform; third, over the field of capital formation, since we do not believe that the question of business taxation has any significance unless it is viewed from the perspective of how our tax policies affect the ability of businesses to survive and grow. Fourth, I shall review the experiences of the SBIC program. Fifth, I will try to analyze whether or not there is an equity gap today. Finally, I shall list several NASBIC-supported proposals to amend the Internal Revenue Code for the specific purpose of strengthening the SBIC industry and augmenting our ability to meet the demonstrated needs of our clientele.

One further comment only on the 1975 Tax Act. We urge Congress to make those changes permanent as soon as possible. It is axiomatic that a businessman must make long-range plans if he is to succeed. But convulsive changes in Federal tax laws rule out any rational effort at such planning.

In the field of small business tax reform, I would point out that our association has consistently and actively supported the Small Business Tax Simplification and Reform Act as it has developed over the years. We are not doing that in an unselfish manner, I must admit. Stated most boldly, SBIC's will not and cannot succeed unless the small businesses they invest in have a chance to grow and prosper.

We believe that retained earnings are the absolutely essential element for any small business. Most of the provisions of the Bible-Evins tax bill were aimed directly at that point; and we hope that the new Nelson-Evins bill this year will also be attuned most directly to the retention of earnings.

One personal comment here. I would say that I do not believe it is rational or realistic to talk about a neutral tax law. It is not realistic because there are too many powerful interests around who will be strong enough to defeat the abolishing of that special tax provision which applies to them.

Furthermore, I do not believe it is rational to seek absolute neutrality.

Later in my statement I will mention capital gains tax. Today the act is neutral on capital gains. You get the same amount of tax impact if you have invested in General Motors stock today, sell it on December 20, or if you invest as venture capitalists, and SBIC's do, in busi-

nesses, stick with them for 14, 15, and 16 years, put lots of money, sweat, blood and tears in them, and you have the same tax consequence.

I feel that that is a presumed neutrality which is completely irrational.

I would also point out that there is great frustration in the small business community. The first comprehensive set of field hearings held by the Senate Select Committee on Small Business were held in 1952. We went around the country in eight different cities at that time. We made a report to the Senate—the committee did—on June 18, 1953. Lo and behold—I have reviewed that report in getting ready for this statement. The Senate Small Business Committee, June, 1953, said, increase the surtax from $25,000 to $100,000; make depreciation allowances a more rational way of retaining earnings for small business; and allow corporations to be taxed as partnerships.

Gentlemen, 22 years later you have heard a whole panoply of witnesses saying increase the surtax, amend Subchapter S, make a better capital recovery or depreciation plan. 22 year—that is a long time to wait. We hope that the new power group which has formed in the Senate will help us out.

In capital formation, I would point out here that within the small business community of 10 million people, there is a vast range of business enterprise in size and type. The ones that the venture capitalists and the SBIC are supporting tend to be more in the medium size. Here we believe that present climate is very difficult. Profitable firms immediately get in the 48 percent tax bracket when they begin making some money, and that halves retained earnings.

The new issues market is almost completely closed. I included a table on page 7 of my statement showing that almost 700 small businesses raised $1.4 billion in new issues in 1969. In the last 10 months, not a single business with net worth of under $5 million has been able to sell a public issue. Now, this indicates to me, unless we say that in the last 6 years the small business community has not given birth to any growth businesses, it shows a net equity gap. We believe that Congress must be aware of it and must do everything it can in a coordinated way to attack the problem.

Senator LAXALT. What do you think the reason is that there have been no issues recently?

Mr. STULTS. Obviously, the performance of the over-the-counter market, the quotation of the companies that went public in the 1968 to 1970 period, are down 80 percent or so. So that is one reason.

Another reason is that it takes a pretty venturesome person to invest in a relatively small business, a high-risk situation, when he can get Government agency paper paying 10 or 12 percent, get CD's at 12 percent. Senator, this is a real problem.

SBIC's have been in business now for 16 years. Beginning on page 9 of my statement, I show some data on the size of the industry today. There are fewer SBIC's than there were 10 years ago, but the assets at this point are the highest in history. SBIC's have roughly $1 billion in assets at this point, and we are disbursing approximately $200 million a year to small businesses. Between 2,000 and 2,500 small businesses divide up this $200 million.

At the end of March 1974, the latest date for which we have data, the SBIC's had some $600 million outstanding in small business.

Senator LAXALT. What percentage of the market does that represent, potential market? It is minimal, is it not?

Mr. STULTS. If we say that 1969 represented any kind of a benchmark in terms of new issues, that was $1.4 billion, obviously that was abnormal. But I will go on here in the statement, Senator, and say that I believe that there are tremendous unfilled needs out in the countryside. Your State does not have a single SBIC, for example. I do not think that it has a single organized venture capital company.

Senator LAXALT. No; it does not.

Mr. STULTS. We had one small SBIC there, but it was too small to do the job. We are proud of the fact that the SBIC's have been able to pick up those small businesses which have made a mockery of the statistical tables showing that 80 percent of the small businesses will not survive the first 3 years of their life. We have been able to pick up better firms than that.

As a matter of fact, SBA has done a program effectiveness study and has shown that SBIC-aided small businesses have achieved the following annual growth rates: In employment, 25 percent; in income revenues, 27 percent; in profits, 27 percent; an annual growth rate of 37 percent in net worth.

Obviously, these portfolio companies of ours are growing far more rapidly, and not surprisingly, the owner-managers of those small businesses like the assistance they have received from SBIC's. More than 90 percent of all of them reported to SBA that they had benefited, and most of them said they had benefited to a major degree.

And despite the fact that we have made loans to them, and making a loan is supposed to be the way to lose a friend, 87 percent of the small businesses that we helped said they would go back to an SBIC again, that their relations were such that they would be willing to bring in a partner because in most cases we take an equity interest in the small business. So for the first time here is a sole proprietor or a partnership, a limited group of insiders, and we come in from outside and take a piece of the action and they still like us.

I submit that this indicates that Congress was very wise in 1958 when it passed the Small Business Investment Act. The SBA data show that our program has been very helpful to the small businesses. I am not certain that the statistics are equally clear in terms of what it has done for the shareholders in the SBIC.

On page 13, I show some financial data on the profit rates of small business investment companies. In fiscal 1973, there was a net return on capital, a loss of 1 percent. In 1974, a plus 4.6 percent return, not very large, but I go on to point out on page 14 that there are distinctions which should be made between the bottom-line figure as shown on our financial statement and the actual results.

Senator HASKELL. Mr. Chairman, could I ask a question just for clarification?

I thought I heard you say that SBIC's profit had grown at an annual increase of 27 percent.

Mr. STULTS. Small business concern profits, Senator Haskell.

Senator HASKELL. I see.

Mr. STULTS. The people we have helped. They have grown about 25 percent a year. We have, unfortunately, not had that kind of growth.

Senator HASKELL. I see. Thank you.

Mr. STULTS. To conclude this treatment of SBIC performance, a number of SBIC's have compiled outstanding investment records. They have been able to pick the good small businesses. They have worked well with them, and they have been able to exit from their successful investments with sufficient gains to overcome the inevitable losses and disappointments.

On the other hand, the evidence indicates the bottom-line profit figure is still not high enough to attract the additional hundreds of millions of dollars of private capital which are needed to fill the equity gap which still exists. On pages 16 and 17, I try to give you a rather subjective analysis of why I believe there still is an equity gap and point out that despite the existence of the $1 billion SBIC industry and the non-SBIC venture capital industry, which is probably the same size, that gap still exists. We believe that it is impossible to place any sort of a figure on the magnitude of this gap because we just cannot tabulate the number of applicants who were refused financing because there is duplication, because a number of proposals were simply not realistic.

As I pointed out to Senator Laxalt, there are areas of the country where there are no SBIC's and no venture capital firms. We are certain that in that part of the country a successful businessman who wants to grow just cannot even give any credence to his dream because there is not the ability to tap outside sources of capital.

NASBIC has, in a sense, put its dollars where its mouth is on this. Our officers have directed the staff to devote a major share of our time and resources to recruiting and working with prospective and potential licensees. We are not afraid of more competition. We believe that there is room for much more money in the venture capital industry. We believe that each time a new, well-managed SBIC or venture capital company is set up, we are able to attract more local businessmen who want to grow. We are able to attract management teams who are frustrated by the corporate bureaucracy which keeps them from trying out new products and new services. They want to break loose.

Right now we are seeing something very interesting. A major source of deals now are the anticonglomerators. Those who were taken in during the late 1960's, the independent businessmen who were merged with conglomerates. They were unhappy there; they were unable to perform well in a corporate structure. They are now coming to SBIC's and venture capital companies, saying, "Give us some money. We want to buy ourselves out from under this great conglomerate. We can be more effective; we can be more efficient; we can make more money."

So obviously, all of the talk about economies of scale comes a cropper when a man says, "My company made $1 million as an independent and when nowhere as a division of a major corporation. We think we can make $1 million again as an independent corporation." That is pretty hard evidence. I think that there is a role for the independent sector.

If Congress agrees with my statement that the equity gap for small business persists, it is important that SBIC's increase their assistance above present levels.

To accomplish that goal, existing SBIC's must be encouraged to increase their capital, and new SBIC's must be brought into the program.

We have drafted two complementary bills to provide the incentives to bring these people into it. One would amend the Small Business Investment Act and will be considered in mid-July by the Senate Banking Committee, and the other relates to the tax aspects of the SBIC industry. I summarize the seven provisions of that bill in my statement. We hope to have it introduced in the House, and we hope that it will be considered as a part of the House tax reform hearings, and that it will be over here in front of the Senate Finance Committee in the near future.

Variable tax rates on capital gains income is a subject I have already touched upon. I wanted to point out that we are in long-term investments. Congress should recognize that. One of your witnesses yesterday gave you a graphic example of how capital gains were really taxing only inflation. There was no real gain at all and showed how the price level had changed so much that the man who had worked in his business for 10, 12 years came out with less buying power when he sold out 10 years after the formation of a very successful business.

To summarize, the members of the National Association of Small Business Investment Companies maintain their strong beliefs that the economic system, which has brought such a high level of fulfillment to the United States, can and should be preserved. We can recite from our own experiences hundreds of instances where an ambitious and imaginative entrepreneur had made that better mousetrap and has brought the world to his doorstep.

We hold, as a matter of faith, the concept that competition is the touchstone of our free enterprise order, and we have helped hundreds of small businesses compete successfully against the giants in their industries. We have called upon all of our logic, all of our experiences, all of our rhetoric, to convince Congress and the executive branch of the Federal Government that positive action must be taken quickly to guarantee the survival and vigor of the independent section of our economy.

SBIC managers are involved in the most exciting pursuit possible. The rewards of participating in the birth and growth of the successful business enterprise are a combination of the psychic and the financial. We are at the jugular of the free enterprise system, as one of NASBIC's former presidents put it.

In closing, we pledge our continuing cooperation in every possible way as your committees pursue their efforts to shape an equitable Federal tax policy which will encourage and not inhibit business growth and vitality.

Thank you.

Senator NELSON. Thank you very much.

If the committee members would not mind, perhaps we would finish the presentations, and then have questions.

Mr. Morgenthaler?

[The prepared statement of the National Venture Capital Association follows:]

STATEMENT ON BEHALF OF THE
NATIONAL VENTURE CAPITAL ASSOCIATION
TO THE
SUBCOMMITTEE ON FINANCIAL MARKETS OF
THE SENATE FINANCE COMMITTEE
AND THE
SENATE SELECT SMALL BUSINESS COMMITTEE
ON THE
CAPITAL NEEDS OF SMALL BUSINESS

June 19, 1975
Washington, D. C.

Mr. Chairman, and members of the Subcommittee on Financial Markets and the Select Small Business Committee:

My name is Richard Hanschen. I am a resident of Dallas, Texas, and President of New Business Resources, Inc., and appear here today accompanied by David T. Morgenthaler from Morgenthaler Associates, and our counsel on behalf of the National Venture Capital Association -- NVCA. I serve as Chairman of NVCA's Incentives Committee and my colleague, Mr. Morgenthaler, is Secretary. I have also submitted a supplemental statement which is appended to this testimony.

NVCA was formed as a result of our members' awareness of the same set of concerns respecting the nation's economic and industrial health which are the source of today's very vital hearings. Our goals are the fostering of a broader understanding of the importance of venture capital to the vitality of the United States economy and the encouragement of the free flow of capital to young companies.

NVCA concurs completely with this Committee's recognition, in its public announcement of these hearings

of "the indispensable role of small business promoting healthy competition in our economy," and "creating jobs for a growing work force and developing innovative ideas and products." We are also very concerned, as we believe this Committee to be, that unless our nation's tax and financial laws and regulations are structured so that they are receptive to, and, when possible, affirmatively stimulate the attraction of capital to small, high-risk enterprises, America's worldwide industrial and economic leadership will be irretrievably lost, and its standard of living -- for all the people -- will be inevitably lowered.

So that this Committee may fully appreciate the tremendous impact which the venture capital industry has had, and will continue to have, upon the daily lives of Americans, we offer these pertinent examples. Everyone is familiary with pocket calculators. Today, literally millions of these indispensable devices are being sold at prices which the man on the street can afford. Pocket calculators are solely the product of American technology.

A venture capital enterprise funded by risk investments developed the know-how for miniaturized semiconductors, called MOS's. With this know-how and technology, an entire new industry was created and America still leads the world in the field. The total initial risk capital investment was relatively small, especially when compared to recent total industry sales.

Digital wrist watches are another example. They are also a product of MOS technology. Today they are worn by only a few people because of the relatively high prices. Tomorrow, I predict -- and I am proud to say that the development will come from the City of Dallas, soon to be the watch capital of the world -- absolutely accurate digital wrist watches will be produced in mass quantitites at reasonable prices.

The relevance of this Committee's interests to the business of the membership of NVCA may be readily demonstrated. Our typical member is a supplier of risk capital. This may constitute a pension trust or a syndicate of investors. It is in each case a pool of capital, established by an operating business managed by persons trained to evaluate new and untried enterprises which show exceptional promise for development of new capabilities -- the advancement of a new generation of technology, for example, or the formation of an entirely new industry such as pocket calculators.

To justify the commitment of capital in ventures of this nature, the investing organization must be able to assure itself -- while at the same time recognizing that some losses are inevitable -- that the enterprise in which the investment is to be made will ultimately return the invested amounts and also produce a profit commensurate with the risk. The returned capital, together with the profits, can thereafter be recycled in other enterprises.

Only if such a climate is maintained and sustained can the multiplier effect on the nation's economy be felt on those who ultimately serve it in terms of jobs, new products and newly needed services.

To sustain this process of inflow of capital, realization of gain and future reinvestment, our tax and financial laws must be so ordered that:

(1) The tax burden to be met when enterprises are sold is not excessive, as it is today;

(2) This tax burden must attach only at such time as the venture capital enterprise generates the funds with which to pay the tax;

(3) Losses, when realized by the business in which funds are invested, are available to offset income from other sources when realized, or as ordinary -- not capital -- losses so that the venture capitalist may accurately anticipate the net after-tax cost of making the initial venture capital investment; and

(4) The operating enterprise in which the venture capital investment has been made must be able to foresee steady and hopefully exponential growth of its own business with opportunity for the managers as well as the owners to realize upon its own capital yield potential. Thus, key and other employees, particularly those who are highly trained technical personnel with intense, but short-lived creative and applied scientific capacities, must have the opportunity for reasonable equity participation in

the enterprise.

In light of these concerns, NVCA has sought to determine trends with respect to the amount and direction of venture capital inflow.

In a study prepared for NVCA by Professor Aharon R. Ofer of Northwestern University, this pertinent data was obtained:

Although 143 venture capital companies made investments from $210-$233 million per year during 1971 through 1973, less than half of this -- $118 million -- was made in the first nine months of 1974. Thus, it appears that the amount of dollars available for new venture capital projects is precipitously declining. Doubtless, the general state of economic health in the United States contributed to this decline, but there are other causes which NVCA wishes to bring to the Committee's attention.

The first of these is the unintended adverse impact of recent general legislation. For example, important and useful as is the Employee Retirement Income Security Act of 1974 -- the so-called ERISA law -- it contains what appear to be very serious side effects, because a provision in that statute, Section 404(a)(1), requires that persons managing pension funds be subject to specified fiduciary standards. As a consequence of these tighter controls, the potential resources of pension funds for risk enterprises has been virtually eliminated.

While we are hopeful that a clarification of the regulations of the new section can be effected promptly, and unless this occurs, or amelioratory legislation is promptly enacted, a major source of risk capital -- already in short supply -- will be permanently lost to the nation's economy. All that is necessary is that the clarifying regulations (or legislation), as the case may be, establish that a pension fund may make a full range of investments including those of high risk, so long as the portfolio is reasonably balanced.

Other laws and regulations have also had a serious negative effect upon the availability of the risk capital for venture enterprises. For example, under the Securities regulations, when a venture capital enterprise is mature for sale of its shares to the public, such a sale may not be affected in the absence of a costly registration -- because of the strictures of Rule 144 issued pursuant to the Securities Act of 1933 -- except in shares of unduly limited quantities with sales stretched over an unacceptable limitation of time. Although NVCA recognizes the need for full disclosure in normal circumstances and the filing of registration statements, simplified registration forms are a necessity. Exceptions keyed to the special needs of venture capital enterprises are also appropriate. Similarly, in the case of many venture capital enterprises, which are by their very nature small in size at their conception, existing costly registration requirements add unacceptable costs to the burdens of launching such new

ventures.

There are other areas of equal concern to NVCA and, we believe, to this Committee, in which new legislation is sorely needed so that the restrictive rules of present law can be modified and a climate for the formulation of venture capital enterprises be continuously created.

NVCA has these specific recommendations:

1. The Association believes that a vital ingredient to encouraging venture capitalism is obtaining the necessary individual genius with which to develop the new products and technology that are the sine qua non of venture capitalism. To do this requires the cooperation and genius of an individual or group of individuals working in a new field. Venture capital organizations, are as previously was mentioned, high risk businesses and the individuals required to make a venture capital operation succeed are in great demand by major established industries. In order to persuade such individuals to take a chance on a venture capital business, as opposed to the security of an established corporation, some direct incentives for that individual are necessary. To that end we have developed a proposal, which we have entitled the Incentive Stock Option Proposal, which would permit reasonable individual equity participation in the business. A copy of this proposal, with a memorandum of detailed explanation, is attached to this testimony. The essence of the proposal is not to create a new loophole but simply to provide fair and equitabile treatment for those who wish to have a stake in the corporation for which they

work.

Under existing law stock options are essentially treated in one of two ways. Either the option is a qualified option under the Internal Revenue Code and thereby entitled to certain favorable tax treatment or it is a nonqualified stock option and not entitled to that special tax treatment. Qualified options have become the subject of increasing demand for repeal and the future of such options is highly uncertain. In addition, such options are largely inflexible and have many disadvantages attached to them, as has become especially apparent in recent years. Nonqualified options, on the other hand, are subject to special tax rules which can in fact have disincentive effects. Employees receiving options subject to nonqualified stock options may in fact be forced to sell their stock in order to pay taxes due on receipt of the stock in question. In many cases the stock may be largely unmarketable and the employee may in fact be put in a disadvantageous position.

Our proposal is simply to match the taxation with the disposition of the stock in question. That is, if an individual exercises a stock option and receives stock the individual will only be taxed at such time as he in fact disposes of the stock and otherwise realizes gain. This relies on the old and fundamental tax principle that income taxes should be paid out of the funds which generate the income. In this way the individual has the choice to continue his equity participation in the company until such time as he wishes to sell for economic or other reasons, or at such time as he dies. At that time and only at that time will the individual be taxed on his investment. The taxation so imposed will be at ordinary

income rates, subject to certain averaging provisions designed to take into account the period over which the individual has held the stock.

Further explanation of this proposal would be inappropriate at this time. The details are described more fully in the memorandum attached. We feel that this would be an important means of providing realistic and fair taxation of individuals who receive an equity investment in their company. We have had informal discussions with the Treasury Department on this matter and have been assured that Treasury has no objections to the proposal.

2. One of the important hinderances in accumulating the capital necessary for venture capitalism is the tax imposed when an investment in a venture capital operation is withdrawn. An important method for increasing the capital available for venture capitalism would be to defer the tax on a realized venture capital investment if the capital in question is reinvested within a stated period into a new venture capital business. In the Internal Revenue Code there exists considerable precedent for this type of deferral, which is usually referred to as a rollover provision. By postponing the collection of the tax on the amounts reinvested in venture capital businesses, the United States economy will undoubtedly be economically ahead in that the new capital invested will over the years probably generate

more revenue collections from the business created than the United States would have received had it fully taxed the capital in question and thereby decreased the amount of private capital available for venture capital reinvestment. The roll-over in question could be implemented either by a provision simply deferring the tax for amounts reinvested or by the adoption of a special credit measured by the amount of a realized investment which is reinvested.

3. In addition to the rollover provision just discussed a reduction should be made in the capital gains tax applicable to venture capital investments. Such investments are high risk investments and are usually relatively long-term investments. New businesses just developing are generally unmarketable for a period of several years until they have produced a developed product which can be sold and which allows the company to "go public." The problem previously eluded to, i.e., the drain of private capital sources due to the tax on realization of a single venture capital investment, can also be alleviated by simply reducing the capital gains tax applicable on the realization of such an investment. A reduction in this tax to reflect the importance of and the need for venture capital would be entirely appropriate and in the best interest of the United States economy.

In this connection, I should add that the Association supports Senator Bentsen's proposal for a graduated capital gains rate. Increasing the fludity of capital by reducing taxes would be beneficial both to the economy as a whole and to the venture capital business.

4. Under the Internal Revenue Code the shareholders of certain types of corporations can elect to be taxed directly on all corporate income and not pay separate corporate taxes. Such corporations are referred to as Subchapter S Corporations. NVCA is concerned that the rules regarding which corporations can qualify for this treatment are overly restrictive. Corporations and trusts cannot be shareholders of Subchapter S Corporations. The number of permissable shareholders cannot exceed 10. The corporation is only allowed to issue one class of stock. These restrictive rules severely limit the use of Subchapter S Corporations without serving any valid goal. They were initially added to limit the use of Subchapter S Corporations when they were in the "experimental" stage. Since Subchapter S Corporations are now an accepted and widespread form of business operations these unduly restrictive provisions should be deleted or modified. If, for example, corporations and trusts could be shareholders then Subchapter S Corporations would be much more usable as venture capital businesses.

54-397 O - 75 - 28

5. The final provision which the Association would like to bring to the attention of the Senators concerns a question of corporate taxation. Under current law corporate net operating losses can generally be carried forward for only a limited span of years, usually not more than five. The Association cannot understand the logic or wisdom of this artifical time limitation. New venture capital businesses typically lose money in their very early stages but grow into profitable businesses as the years progress. The effect of the capital loss carry forward limitations in many cases is simply to deny full equalization of the tax burden on the corporation for losses sustained in their development periods. The Association would strongly back any provision to remove the limitation on corporate loss carry forwards or to at least extend the carry forward provisions to a period of at least ten years. Many other provisions in the Internal Revenue Code applicable to carry forwards have no limitation or have limitations beyond five years. We feel that this modification would improve the equitable taxation of venture capital businesses and would thereby stimulate their growth.

Conclusion

The Association has tried to present a general description of the industry and an explanation of the importance of the health of venture capitalism to the United States generally.

The Association also wishes to make it clear that venture capitalism is at a crossroads today and any threats on its existence could have serious and unfortunate effects for the United States.

STATEMENT OF DAVID T. MORGENTHALER, MORGENTHALER ASSOCIATES, A DIRECTOR OF THE NATIONAL CAPITAL VENTURE ASSOCIATION

Mr. MORGENTHALER. Thank you, Mr. Chairman. It is a pleasure to have the opportunity to appear before your committee today.

My name is David Morgenthaler. I am a resident of Cleveland, Ohio, and I am senior partner of Morgenthaler Associates, which is a private investment firm specializing in venture capital. My firm supplies capital and active direction to a number of new ventures, usually high technology oriented companies, located throughout the United States. An example of such companies is a mini-computer company which we, among others, financed from a start in 1970. Today this company is the largest employer in Broward County, Fla., with a total of about a thousand employees, and just recently has been selected to furnish the computers for the NASA Kennedy space program because of its advanced technology. These are some of the accomplishments of a company that did not exist 5 years ago and had some initial difficulties in raising risk capital.

Another was a company in which we financed two men 6 years ago, and this company is now the leading producer of computer-assisted programing for numerically controlled machine tools. It has made American industry considerably more efficient. Its effectiveness is such that its programs are now going to Europe, running on American-based computers and will both bring revenue and greater efficiency to American business.

I am a director of the National Venture Capital Association and a former national officer, and my colleague, Mr. Hanschen, is chairman of our inventives committee.

I have come to this meeting directly from a particularly interesting experience, in that I have just spent 3 days at the International Seminar for Entrepeneurship and Economic Development in Cincinnati, a conference of more than 300 people with representatives from more than 40 countries. The subject was a discussion of entrepeneurship and the formation of new companies. And a very strong point made by the delegates from these more than 40 countries was that the lack of a venture capital industry in their countries, the lack of anything corresponding to venture capital firms and SBICs and so on was a very major factor in a lack of stimulation, lack of help, and a lack of capital for their potential new enterprises, and this, among other factors, resulted in these countries continuing to fall behind the United States in terms particularly of the new, highly innovative, technology-oriented companies.

It was a very interesting experience in that these foreign delegates appreciated, I think, our industry more than we did.

Our National Venture Capital Association was formed as a result of our members' awareness of the same set of concerns about our economic and our industrial health, which are the source of your hearings today.

The goals of our association along with NASBIC and others are the fostering of a much broader understanding of the importance of venture capital to the vitality of our economy in the United States and the encouragement of the free flow of capital to these young companies.

Our association concurs completely with this committee's recognition in its public announcement of these hearings of the indispensable role of small business in promoting healthy competition in our economy and in creating jobs for a growing work force and developing innovative ideas and profits.

I might submit, as an example, the entire minicomputer industry—a billion-plus dollar business today, where the leading company in the field was formed and financed by venture capital about 15 years ago. The industry has been primarily formed by and financed by venture capital firms, and very few of these important developments have come from the larger computer companies, and most of the large computer companies are not real factors in the industry today—this industry which is contributing so much to automation and to lower costs in American industry.

Our association is also very much concerned, as we believe your committee to be, that our tax and financial laws and regulations be structured so that they are more receptive to, and when possible, affirmatively stimulate the attraction of capital to the smaller, high-risk enterprises. If we are unable to accomplish this, we certainly will lose a great deal of our technological and industrial leadership, and inevitably this simply means that business will go overseas and our standard of living will be lower.

The members of NVCA and the SBIC's have provided a disproportionate amount of the risk capital for the high technology companies that have provided the high growth in very exciting companies in recent years, those such as I alluded to, the minicomputer industry, the computer peripheral industry, and the field in which my colleague, Mr. Hanschen is an expert, the semiconductor industry. My colleague tells me that Dallas, Tex., as a result of semiconductor development, will become the watch capital of the world. And others independent of Mr. Hanschen have told me that Switzerland is finished in the watch field, despite their preeminence, as a result of American semiconductor development.

The relevance of your committee's interest in the business of the membership of NVCA is easy to demonstrate. A typical member of our 70 members is a supplier of risk capital. This money may come from a pension trust. It may come from a syndicate of investors, banks or other institutions, private individuals. In each case it is a pool of capital, established by an operating business. The pool is managed by people who are trained to evaluate new and untried enterprises which show exceptional promise for development of new capabilities and to work with these enterprises and nurture them through the early and difficult stages that practically all new companies go through.

For example, we are normally working in the advancement of a new generation of technology or the formation of an entirely new industry such as the pocket calculator industry. To justify the commitment of capital to ventures of this kind the investing organization has to be able to assure itself—while nevertheless recognizing that some losses are absolutely inevitable—that the enterprise in which the investment is to be made has a good chance of ultimately returning the amount which has been invested and will also produce a profit commensurate with the very high risk experienced in these ventures.

The returned capital, then, together with any profits can therefore, when the enterprise is mature and stable enough to be suitable for lower risk investors, be recycled to other enterprises. And only if such a climate is maintained can the multiplier effect on the Nation's economy be felt on those who ultimately serve it in terms of jobs, new products, and newly needed services.

Our association would suggest that to sustain this process of inflow of capital, realization of gain and future reinvestment in such enterprises, that our tax and financial laws should be so ordered that, first, the tax burden that must be met when such enterprises are sold is not excessive, as we feel that it is today. Second, that this tax burden must attach only at such time as the venture capital enterprise generates the funds with which to pay that tax.

Third, that losses, when realized by the business in which funds are invested, are available to offset income from other sources when such income is realized, or as ordinary losses as opposed to capital losses, so that the venture capitalist may accurately anticipate the net after-tax cost of making the initial venture capital investment. And finally, the operating enterprise in which the venture capital investment has been made must be able to foresee steady, and hopefully exponential, growth of its own business with opportunity for the managers as well as the owners to realize its own capital yield potential. Thus, key and other employees, especially those technically creative personnel that have intense but very short-lived creative capacities, must have the opportunity for reasonable equity participation in these enterprises if they are to be persuaded to leave the safety and stability of the larger organizations where their ideas are not being recognized and to form the new enterprises to bring the new products to market which their own companies are unwilling or unable to do.

In light of these concerns, our association has sought to determine trends with respect to the amount and the direction of venture capital inflow.

In a study prepared for our association by Prof. Aharon R. Ofer, of Northwestern University, this pertinent data was obtained:

Over 143 venture capital companies made investments averaging from $210 to $233 million per year during 1971 throughout 1973. Less than half of that amount—$118 million—was invested in the first 9 months of 1974.

I would respectfully call to the committee's attention that though those amounts do not seem large, this is the early pioneer investment and it has a multiplier effect out of all proportion to the number of dollars in that lower risk capital will follow this capital in and ultimately bank capital, institutional capital, and so on so that the multiplier effect is tremendous.

From the numbers, then, we see that the amounts of dollars available for new venture capital projects was precipitously declining by the fall of last year and has, if anything, decreased further in the spring of 1975. Doubtless, the general state of the economic health in our country contributed to this decline but there are some other causes which NVCA would like to bring to the committee's attention.

The first of these is the unintended adverse effect of recent general legislation. For example, important and useful as is the Employee Re-

tirement Income Security Act of 1974—the so-called ERISA law—nevertheless it has what appears to be some very serious side effects which we feel sure were not intended because a provision in that statute, section 404(a)(1), requires that persons managing pension funds be subject to specified fiduciary standards. As a consequence of these tighter controls, the potential resources of pension funds for risk enterprises has been virtually eliminated.

While we are hopeful that a clarification of the regulations of this new section can be effected promptly, and unless this does occur, or unless ameliatory legislation can be promptly enacted, a major source of our risk capital will be permanently lost to our Nation's economy at a time when this risk capital is already in short supply.

All that is necessary to correct this situation is that the clarifying regulations (or the legislation) as the case may be, establish that a pension fund may make a full range of investments, including those of high risk, so long as the portfolio is reasonably balanced and these percentages are not allowed to exceed a reasonable number.

Other laws and regulations have also had a serious negative effect on the availability of risk capital for venture enterprises. For example, under the securities regulations, when a venture capital enterprise is mature enough for sale of its shares to the public, such a sale may not be effected in the absence of an extremely costly registration—because of the strictures of rule 144, issued pursuant to the Securities Act of 1933—except in the case of extremely limited quantities with sales stretched over an unacceptably long time period.

Senator HASKELL. Excuse me, Mr. Chairman; may I just ask a question?

What is rule 144?

Mr. MORGENTHALER. It is an SEC rule which states that a control investor may sell without an S. 1 registration provided he——

Senator HASKELL. Oh, yes.

Senator BENTSEN. One-half of 1 percent every 6 months; is that not it? I remember that one.

Mr. MORGENTHALER. That is correct. There is a limitation as to both the percentage of the volume of the trading, or as a percentage of the shares of the company's stock.

Now, our association obviously must recognize the need for very full disclosure in normal circumstances, and in no way have we a desire that immature investments be brought to the public. We do very much need simplified registration forms and a lower cost and lower burden on these companies of making such sales, subject to reasonable, well-controlled restrictions.

Our association separately has made proposals to the SEC in regard to this rule 144, and has discussed it with the Commissioners.

Senator HASKELL. As I remember it, at one time rule 144, now that you refresh my memory, was considered a giant step forward.

Mr. MORGENTHALER. Yes, sir.

Senator BENTSEN. It depends on whom you ask, Floyd.

Mr. MORGENTHALER. Similarly, in the case of many venture capital enterprises, which are by their very nature small in size at their conception, existing costly registration requirements add unacceptable costs to the burden of launching such new ventures. We have had

some relief in this area with rule 146. We would like to see it go further. But it certainly has the advantage of clarifying the provisions of the act.

There are other areas of equal concern to NVCA and, we believe, to your committee, in which new legislation is sorely needed so that the restrictive rules of present law can be modified and the climate for the formation of venture capital enterprises be continuously created.

NVCA has these specific recommendations.

First, the association believes that the vital ingredient to encouraging venture capitalism is obtaining the necessary individual genius with which to develop the new products and technology that are the sine qua non of venture capitalism. Our most important raw materials, without any question, gentlemen, are the people who give up comfortable jobs in comfortable situations and so on to go out and to work very long hours, to take very high risks at very much lower salaries, attempting to conserve initial capital in the hope of building up an enterprise in which their stock will become worth a great deal more than they paid for it.

In order to persuade such individuals to take a chance on a venture capital business, as opposed to the security of the large organization, some direct incentives for that individual are necessary. To that end, NVCA has developed a proposal which we have entitled "The Incentive Stock Option Proposal," which would permit reasonable individual equity participation in this business.

A copy of the proposal, with a memorandum of detailed explanation, is attached to our testimony. I will not take your time by going into it here, gentlemen.

The essence of the proposal is definitely not the creation of a new loophole, but simply trying to provide fair and equitable treatment for those who wish to have a stake in the corporation for which they have left the security of other positions to form.

Under existing law, stock options are treated in one of two ways: either the option is a qualified option under the Internal Revenue Code and thereby entitled to certain favorable tax treatment, or it is a nonqualified stock option and not entitled to that special tax treatment.

Qualified options have become the subject of increasing demand for review, and the future of such options is highly uncertain at this point.

In addition, such options are largely inflexible and have many disadvantages attached to them, as has become especially apparent in recent years. Nonqualified options, on the other hand, are subject to special tax rules which can, in fact, have distinctive effects in the kinds of enterprises that we are talking about. Employees receiving options subject to nonqualified stock options rules may, in fact, be forced to sell their stock in order to pay taxes due on receipt of the stock in question. In many cases, in our kinds of companies, the stock may be very largely unmarketable, and the employee will then be put in a very disadvantageous position of having to sell his stock at a very low price or being unable to sell it and having to borrow or find the money separately under very adverse circumstances.

Our proposal on this is simply to match the taxation with the disposition of the stock in question. That is, if the individual exercises a stock option and receives stock, the individual will only be taxed at

such time as he in fact disposes of the stock and otherwise realizes gain. This relies on the old and fundamental tax principle that income taxes should be paid out of the funds which generate the income. In this way, the individual has a choice to continue his equity participation in the company until such time as he wishes to sell, for economic or other reasons, or until such time as he dies. At that time and only at that time will he be taxed on his investment. Such taxation will be imposed at ordinary income rates, subject to certain averaging provisions designed to take into account the period over which the individual has held the stock.

I will not take your time with further explanations of the proposal. The details are described fully in the memorandum which we have attached.

And we have had informal discussions with the Treasury Department on this matter and we have been assured in these discussions that they have no objection to the proposal.

Second point: One of the important hindrances in accumulating the capital necessary for venture capitalism is the tax imposed when an investment in a venture capital operation is withdrawn. As I am sure you are aware, in recent years the capital gains tax revisions have increased the amount of tax paid on such capital gains by about 50 percent. An important method for increasing the capital available for venture capital would be to defer the tax on a realized venture capital investment if the capital in question is reinvested within a stated period into a new venture capital business.

In the Internal Revenue Code, there exists considerable precedent for this kind of deferral, which is usually referred to as a rollover provision. By postponing the collection of the tax on the amounts reinvested in venture capital businesses, the U.S. economy will undoubtedly be economically ahead, in that the new capital invested will, over the years, generate more revenue collections from the business created than the United States would have received had it fully taxed the capital in question and thereby decreased the amount of private capital available for venture capital reinvestment.

Obviously, of course, the venture capitalist must be required to reinvest, and the profits are not available to him for other things, if he is to receive this favorable tax treatment.

The rollover in question could be implemented either by a provision simply deferring the tax for amounts reinvested or by the adoption of a special credit measured by the amount of a realized investment which is reinvested.

Third, in addition to the rollover provision just discussed, a reduction should be made in the capital gains tax applicable to venture capital investments.

As my colleague has just commented here, in these kinds of investments we receive exactly the same treatment, from a tax standpoint, if one invests in the very large stable security; holds it for 6 months and 1 day, and gets a capital gain, as he does in going into a small, high-risk venture which may be completely unmarketable for many years.

These investments are high risk and are usually relatively long-term investments. New businesses just developing are generally unmarketable for a period of at least several years.

My firm, in making a venture capital investment, uses a rule that we will not make an investment in a company unless we are fully prepared to have our capital committed and no hope of selling any of it for a period of 5 to 7 years. We would like to do better, obviously, but it usually just does not become liquid at any earlier time than that, even if the business is quite successful.

These new businesses will just be unmarketable until they have produced a developed product which can be sold and which possibly allows the company to go public and attract other investors who cannot and should not invest in the early high-risk stages.

Another way of possibly alleviating this problem of the drain of private capital sources due to the tax levied on the realization of a single venture capital investment could also be alleviated by simply reducing the capital gains tax applicable on the realization of such an investment. A reduction in this tax to reflect the importance of venture capital to our economy, the need for it, the shortage of it, would be entirely appropriate and would very much be in the best interest of our economy.

In this connection, I should add that our association supports Senator Bentsen's proposal for a graduated capital gains rate. Increasing the fluidity of capital by reducing taxes would be beneficial both to the economy as a whole and to the venture capital business.

I am very nearly through, gentlemen.

Under the Internal Revenue Code, the shareholders of certain types of corporations can elect to be taxed directly on all corporate income and not pay separate corporate taxes.

You have had comments earlier this morning in regard to Subchapter S corporations. NVCA is also concerned that the rules regarding which corporations can qualify for this treatment are overly restrictive. Corporations and trusts cannot be shareholders of subchapter S corporations. The number of permissible shareholders under present regulations cannot exceed ten. The corporation is allowed to issue only one class of stock. These restrictive rules severely limit the use of subchapter S corporations without serving any really valid goal. They were initially added to limit the use of these corporations when they were in the experimental stage. Since they are now an accepted and widespread form of business operations, these restrictive provisions should be deleted or modified.

If, for example, corporations and trusts could be shareholders, then subchapter S corporations would be much more usable as venture capital businesses.

The final provision which we would like to bring to the attention of the Senators concerns a question of corporate taxation.

Under current law, corporate net operating losses can generally be carried forward for only a limited span of years, usually not more than 5. Our association does not understand the logic or the wisdom of an artificial time limitation. Our new venture capital type businesses typically lose money in their very early stages but grow into profitable businesses as the years progress. But one of the very important functions which venture capital firms such as those represented at this table perform is working with these new corporations to provide additional capital to them and to sustain and council them through the sometimes

long period of years that are necessary before these corporations become profitable. If this period stretches out much longer than we expect—and believe me, it certainly does at times—we would like to see a provision to remove the limitation on capital loss carryforwards or at least extend this capital loss period up to at least 10 years, so that the losses incurred in the early years will not become irrecoverable because of the 5-year limitation. Many other provisions in the Internal Revenue Code applicable to carryforwards have no limitation or have limitations beyond 5 years. We feel that this modification would improve the equitable taxation of venture capital businesses and would thereby stimulate their growth.

In conclusion, we have tried to present to you a general description of the venture capital industry and an explanation of the importance of the health of venture capitalism to the United States generally. As the numbers show, the flow of venture capital to new business today is substantially reduced, and further reduction in the capability and incentives of this industry to provide risk capital to new ventures will have a serious and disproportionate effect on the formation and growth of the new and innovative companies that give America its technological lead and many of the dynamic qualities of our economy.

Thank you, gentlemen.

Senator NELSON. Thank you very much, Mr. Morgenthaler.

Our next witness is Mr. Richard Hanschen, president of New Business Resources.

Mr. Hanschen?

[The prepared statement and attachments of Mr. Hanschen follow:]

SUPPLEMENTAL STATEMENT BY RICHARD J. HANSCHEN, PARTNER, NEW BUSINESS RESOURCES—VENTURE CAPITAL PARTNERSHIP

In 1969 we started Mostek, a new company based on the introduction of a new chemical-processing technology, ion implantation, for the processing of a new type of semiconductor. Since that time, Mostek has paid $11 million in corporate taxes and created new jobs. Mostek, through ion implantation, was the first company to put all of the circuits on one chip for the hand-held calculator.

This single technological advance sharply reduced the labor content of calculators and other electronic equipment and was the steppingstone for the United States industry to marshal their forces and reestablish their dominant picture in the worldwide electronics industry.

Going back in time, most of you are familiar with the contributions of a then new company to electronics, Texas Instruments, in bringing the transistor from a Bell Labs experimental level to a commercial reality. The impact of the transistor during the 1950's for making possible the large central computer industry and the military instrumentation industry is a well-established fact.

The further invention by TI of the integrated circuit has caused electronics to pervade all of industry, and the resulting new industry of minicomputers made by new companies such as Digital Equipment, Data General, Computer Automation, and possibly as many as 20 other companies, has not only provided jobs and taxes, but has also been the major factor in improving the productivity of industry.

In addition to calculators and electronic watches, the MOS–LSI technology has spawned the new intelligent terminal industry. This new industry has new companies such as Datapoint, Linolex, Sycor, Incoterm, Vydec, and Data 100. The impact of intelligent terminals is being felt more in the front office and will be a key factor in increasing productivity by automation of the white collar functions of industry.

You'll all agree that there has never been a question in these past two decades about the competitiveness of free enterprise in the electronics industry. The enclosed article from "Business Week" describes the impact of the U.S. The competitiveness is brought about by the introduction of new companies highly motivated to make their own contribution in their industry. My terminology for this is *distributed competitive free enterprise.*

Although you may classify our activities as small businesses because of size at the start, I want to stress that the capitalization required is such that we have to be prepared to finance a company that can do $50–100 million annually within the first five years of existence. In the case of Mostek, approximately $5 million of private capital and $15 million of public money was raised, and to date Mostek has retained earnings of $12 million. With debt leverage and by turning assets into revenues at a 1:2 ratio, they have enough capital to grow from their current $60 million level to $100 million.

My purpose in being here today is to tell you that a series of random changes have combined to make it almost impossible to duplicate the building of a Mostek in the U.S. today. Last month we sold Linolex to 3M solely because the capital formation structure that enabled us to create Mostek has been decimated.

My concern stems from the fact that the venture capital community five years ago was starting between ten and fifteen new companies a year. To the best of my knowledge, there was only one such high technology company initiated in 1974 in the U.S. This trend continues in 1975. We have several proposals that we would like to have you consider to assist in new company formation and in the capital formation of these companies.

The first proposal that is attached considers incentives for the young entrepreneurs to leave the security of large industry and take the risk of entering into the fragile environment of a new company, utilizing new technology to create products for markets that do not yet exist and must be created by aggressive market development techniques.

If one reviews history, he can quickly see that these creative contributions originate with young men between the ages of 25 and 35. In most cases they have no capital to invest and may still be in debt from their college educations. The opportunities to position them in what was previoulsy known as founders stock has been eliminated by the introduction of the bargain purchase tax that was introduced when Knudson left General Motors and received bargain purchase in Ford Motor stock.

Young men building companies in their own image and principles rather than in some other industrial leader's image is the cornerstone to building new companies. It is imperative that these young men have ownership positions in the companies in order to commit the decade of time that is necessary to grow an organization from start-up to a major contributor of jobs and taxes in our economy. If Tom Watson had not left NCR to create IBM, would we have our computer industry today?

The other major impact we need is that of continued capital formation. The recent fiduciary responsibility requirements in the last pension fund bill has broken the continuity of financing for such new companies as I've described. We believe that Senator Bentsen's bill allowing a pension fund management the discretion of investing 1% of his assets in new companies in industry will greatly alleviate the present stalemate in capital formation.

We believe that private capital would be willing to invest in start-up organizations and in restricted securities if there was increased motivation for the risk that they take in having their capital committed in these venturesome acivities for a five to ten-year period.

Our proposal is that capital committed from here on directly into companies during their capital formation period up through their first public offering not be taxed if it is "rolled over" and re-invested in a similar capital formation of a new company. The details of this is enclosed in the accompanying literature.

[Editorial from Business Week, Apr. 20, 1974, p. 124]

Competition Makes a Boom

Anyone who thinks the U.S. economy is drifting helplessly into senility should take a look at the extraordinary boom in the semiconductor industry (page 64). Achieving a 60% increase in sales last year, semiconductors have hit the U.S.

market with a deluge of new products and new applications. In the world market, U.S. companies have captured a two-thirds share, with the percentage running even higher in the high-technology lines.

A large measure of the industry's success depends on rapidly advancing technology. With innovation piling up on innovation, the industry has been opening new markets even faster than it can serve them. U.S. industry executives estimate that they are at least two years ahead of foreign competition in technology.

But that is not all. The industry has followed an aggresive pricing policy, both in the U.S. market and overseas. It has sought a stronger market position rather than a maximum profit. Access to the industry has been relatively easy. Plenty of money has been available in the form of venture capital and bank loans. And so the pacesetters have been hungry, young companies with hot ideas and great expectations. The older, bigger producers have responded to the challenge with new development and vigorous marketing of their own.

If this picture seems hauntingly familiar, that is because it closely resembles the economic world as described by Adam Smith and Ricardo. The semiconductor industry has managed to tap the power generated by free competition and open access.

It is undoubtedly true that not all U.S. industry can expect to follow the path of semiconductors, where access is easy and capital requirements are moderate. But it would be interesting to see some of them try. If the U.S. is going to hold its own in a hotly competitive world, it needs more industries than can learn a lesson from the semiconductors.

Summary—Incentive Stock Option Proposal

Accompanying this document is a proposal for modification of the statutory rules governing the federal income tax treatment for certain types of employee stock options. This proposal is designed to achieve greater equity participation by employees in their employing corporation while providing a balanced and fair law that taxes recipient employees in an appropriate manner at an appropriate time.

Under current law employers wishing to provide employees with employer stock have numerous alternative methods available. Two of the most popular methods are qualified stock options and nonstatutory stock options. These two alternatives represent widely diverse approaches to this subject. For qualified stock options, taxation of the employee is generally deferred until a disposition occurs and any gain is usually taxed at capital gains rates. For nonstatutory stock options, taxation is at ordinary income rates and in many cases will occur before the employee is actually able to dispose of the stock. Consequently, in the latter case an individual is taxed on income before he can effectively generate funds from that income with which to pay the tax.

Due to the liberal treatment afforded to qualified stock options, efforts have recently been made to repeal this provision. Such a measure was approved by the House Ways and Means Committee in the 93rd Congress. This repeal would provide too drastic an alternative for the treatment of stock options. The need for a more balanced proposal suggests the adoption of the attached as a more appropriate method of taxing employee stock options.

The goal of the incentive stock option proposal is to encourage equity participation by employees through the use of stock options. This is achieved by modifying the harsh rules applicable to nonstatutory stock options to provide that the employee is not taxed until such time as an actual disposition of the stock occurs. However, unlike qualified stock options, which provided for capital gains treatment of any gains, the incentive stock option proposal recognizes that any amounts received on disposition are taxable as compensation (i.e., ordinary income) to the employee. Consequently, while the employee does not generally recognize income until a fund is generated with which to pay the tax, at the same time any amounts received are taxed in the same manner as other compensation.

In short, if fairer and more appropriate tax treatment is provided for employee stock options such options will probably be utilized more fully with a resulting benefit to all involved. Employees will receive a greater stake in the free market system without the cost of such compenstaion being unduly borne by the federal treasuries.

Memorandum—Incentive Stock Option Proposal

This memorandum presents a proposal which responds to current national needs for capital formation. The proposal presented involves the use of the Federal income tax laws. This has been formulated in a manner, however, which harmonizes the principle that income is generated when a "gain or profit" is realized, with the doctrine that the payment of tax attributable to the realization of the income should be imes (i.e. measured) by the receipt of actual economic capacity (the funds) with which to pay the tax. As formed, these proposals would enable an employee to receive stock as compensation for his commitment to an enterprise, but the defer the burden of ordinary income tax until such time as the stock (at its then value) is disposed of by the employee. In this manner, the government is assured of receiving the tax due at ordinary income rates, but the employee is spared the burden of payment on illusory gain (if the stock declines) and on value not realized when the stock is sold or disposed of.

I. Background

The Internal Revenue Code has for many years employed various structural mechanisms to encourage businesses to allow employees to participate in the ownership of the company.

The principal methods of encouraging such equity participation have traditionally been so-called "qualified" stock options and "nonqualified" stock options. Qualified stock options, defined under section 422 of the Code, have been granted special tax treatment under section 421. The special treatment granted includes both (1) deferral of any tax on the exercise of the option, and (2) taxation of all gain (in an otherwise taxable transaction such as a sale) at long-term capital gains rates. Nonqualified stock options are governed by section 83. A more recent provision, this section generally assumes that the stock (if not subject to restrictions on transfer) is taxable at ordinary income rates, and imposes the tax at the time of exercise of the option. If, however, the stock is subject to certain restrictions described in section 83, the value of the stock remains taxable at ordinary income rates, but the imposition of the tax is deferred until such time as the restrictions expire.

Thus, qualified options receive both deferral of tax and capital gains rates, while nonqualified options possess neither favorable attribute. It is only in the case of a qualified option that the taxable event (realization of income) is tied to the time of taxable capacity, i.e., the time at which the employee receives funds from the transaction, and thereby is in a position to pay the appropriate tax.

Section 83, added to the Internal Revenue Code in 1969 as part of the 1969 Tax Reform Act, was designed to correct certain perceived abuses in the tax laws. Congressional concern focused both on the deferral of tax (in certain situations) and on the conversion of ordinary income (from compensation) into capital gains.[1] Section 83, which applies to all transfers and covers all classes of "restricted property" (i.e., not just stock), was enacted in conjunction with the continuation of the qualified stock option provisions and assured full taxation of the ordinary income element in stock transfers, but did not adequately deal with the problem of the timing of the tax. Thus, under section 83, taxable income arises when an option to acquire property, including stock, is exercised, whether or not the stock is, or can be disposed of—that is, whether or not the option holder has the economic capacity to pay the tax. It is this rather punitive, and certainly burdensome, aspect of section 83 to which the attached proposals are particularly related.

In the last Congress, the House Ways and Means Committee in its deliberations concerning major tax reform legislation, proposed the repeal of the existing provisions under section 422 of the Internal Revenue Code establishing qualified stock options. If this repeal occurs in the 94th Congress,[2] section 83 of the Code would become essentially the governing provision for all categories of stock options. This change, if enacted, would seriously hamper equity participation, especially in high risk businesses.

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[1] See Staff of Joint Committee on Internal Revenue Taxation, general explanation of the Tax Reform Act of 1969, 109–113.

[2] See sec. 311, H.R. 1040 (94th Cong., 1st sess.). (This provision of Congressman Corman's bill would repeal the qualified stock option provisions.)

II. GENERAL REASONS FOR THE PROPOSED AMENDMENTS

One of the long recognized goals of this country has been the encouragement of equity participation in business by employees. This has been reflected in numerous provisions of the tax law as well as in other areas of the law.[3] A repeal of the qualified stock option provisions would remove a major incentive used to encourage such equity participation. The application of section 83 to all such transactions would, in many cases, actually discourage employee stock ownership since the employee may not be able to afford the tax on the relatively unmarketable stock of a closely held corporation or other corporations with no established market for their stock. In addition, even in the case of a relatively marketable stock, a positive value is achieved by encouraging equity participation by employees.

For these reasons, it is proposed that new section 84 be added in accordance with the attached proposal. This proposal is designed to insure that stock received through employee stock options will be taxed at ordinary income rates but that the tax will not be imposed until he employee generates the cash with which to pay the tax. This modification will serve both the goals of preventing tax avoidance and encouraging equity participation by employees.

III. DETAILED EXPLANATION OF PROPOSED AMENDMENT

The proposed new section 84 provides that a special election may be made with reference to stock received pursuant to an incentive stock option. This election would permit the optionee to defer any taxation (1) on the receipt of a stock option, or (2) on the exercise of the option, until the date on which the stock in question is disposed of. At that time, the full amount of profit then realized becomes taxable as ordinary income (unlike the current treatment of qualified stock options which grants capital gains treatment). The tax would be computed under an income averaging method similar to that applied to lump-sum distributions under the Employee Retirement Income Security Act of 1974 (P.L. 93-406). The individual would at such time have in hand the funds with which to pay the tax imposed. Gain at the disposition would thus be computed as the difference between the amount received (or the fair market value of the stock, if higher) over the amount paid for such stock. Using the higher of the proceeds or the fair market value to measure the amount of compensation will prevent unjustified avoidance of income taxes through transfers by gifts and other non-compensatory and inadequately compensated transfers. On the other hand, the clear hardship which it obtains under preset law is avoided. No longer would an employee be taxed on the illusory paper value of stock at date of exercise, because if such stock declines in value before disposition, income is never realized. In addition, the Internal Revenue Service in most situations will not be faced with the difficult, and administratively burdensome, requirement of valuing stock whose value may be unclear.

The term "incentive stock option" is defined in such a way as to limit the applicable stock to common stock of the employing corporation or its parent. Since the purpose of the proposal is to encourage equity participation by employees, an employee must continue with the company for at least ten years after receiving the incentive stock option in order to realize the full benefit of this provision. If, for some reason, the employee's services are terminated within that ten year period, the incremental right to exercise the option must not have accrued at a rate faster than 20 percent per year. Also, the employee must not by virtue of his option acquire more than a 10 percent interest in the company (when his other holdings at the time of receipt of the option are considered).

The election would be made in accordance with regulations prescribed by the Secretary or his delegate, it being intended that such election would be made at the time the property would otherwise be taxable in accordance with subsection (a) of section 83. If an election is made under proposed new section 84, an election under existing section 83(b) would not be permissible. If an election under section 84 were made and a loss were eventually incurred on the property due to forfeiture or worthlessness, such loss would be treated in accordance with existing tax principles. Any loss allowed would accordingly be limited to the employee's basis in the property.

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[3] Recently this has been dramatically reflected in legislation encouraging the use of employee stock ownership plans, which encourage employees to adopt such plans and consequently provide equity participation by employees. See, e.g., Tax Reduction Act of 1975 (Public Law 94-12), § 301; Trade Act of 1974 (Public Law 93-618), § 273.

The proposal also allows the employer a deduction at the time and in the same amount as the employee has income. This achieves a matching of deductions with income. No gain or loss would be recognized to the corporation, however, pursuant to section 1032.

The proposal makes no reference to whether options themselves are marketable, i.e., readily tradeable. The intention is that the receipt of the incentive stock option, whether or not marketable, would not generate income. This avoids the extremely difficult problem (especially in light of increased trading in options) of determining when an option is marketable. If an option is in fact traded, however, such an event would generate income under section 61 and this provision would not prevent recognition of such income.

The stock acquired pursuant to this election would be separately identified and would not lose its identity due to stock splits or other changes in the character of the stock. Any stock dividends received on such stock would not be subject to the section 84 selection.

The term "disposed of" is defined to include all transmittals of the property except that in a case of transmission at death no disposition is deemed to have occurred except as provided in section 691. Section 691 deals with income with respect to a decedent. This provision is generally consistent with the disposition provisions found in section 453(d) dealing with dispositions of installment obligations.

IV. REVENUE EFFECTS

No detailed estimates have been made of the revenue effect that would result from the accompanying proposal. Since new section 84 grants a tax deferral when compared with section 83 some initial revenue loss might be expected. However, in reality the revenue impact should be positive since the presence of section 84 would provide an incentive to new industry. This should induce more venture capital, create more jobs and generally enhance the economy. In addition, since all gains are taxed eventually, even without any induced effect a revenue balance should be realized after a few years.

PROPOSED STATUTORY LANGUAGE

Add new section 84 as follows: "Section 84. *Incentive stock option election*—

(a) *General rule.*—Any person who performs services for a corporation and receives an incentive stock option in return for such services may elect to include in gross income for the taxable year in which the stock received pursuant to the exercise of the option is disposed of the amount determined in accordance with subsection (b). If such an election is made, section 83 shall not apply with respect to either the receipt of the option or the receipt of stock pursuant to the option.

(b) *Amount of tax*—

(1) The tax for any taxable year is an amount equal to ten times the tax which would be imposed by subsection (c) of section 1 if the taxpayer were an individual referred to in such subsection and the taxable income were an amount equal to one-tenth of the excess of—

(A) The amount received or the fair market value of the stock at the time of disposition whichever is higher, over

(B) The sum of (i) the amount (if any) paid for such property, and (ii) the minimum distribution allowance.

(2) In the event that employment is terminated within ten years from the date the incentive stock option was issued, then in lieu of "ten" and "one-tenth" in paragraph (1) there shall be substituted the number and fraction corresponding to the number of full years of active employment.

(c) *Minimum distribution allowance.*—For purposes of this section, the minimum distribution allowance for the taxable year is an amount equal to—

(1) The lesser of $10,000 or one-half of the total taxable amount on the disposition for the taxable year, reduced (but not below zero) by

(2) 20 percent of the amount (if any) by which such total taxable amount exceeds $20,000.

(d) *Terms defined*—

(1) *Incentive stock option.*—For purposes of this section, the term "incentive stock option" means an option for common stock of the employing corporation, or its parent, if

(A) The option would not, if fully exercised when received, confer upon the optionee ownership of more than ten percent of the corporation's outstanding stock,

(B) The option provides that, in the event of termination of employment within five years after the date the option is received the option will be exercisable only with respect to the percent of the total shares covered by the option that correspond to the ratio of the number of years of active employment over five.

(2) *Disposition.*—For purposes of this section, a disposition will be deemed to have occurred when the stock is sold, exchanged, transmitted by gift or otherwise disposed of, except that no disposition will be deemed to have occurred on transmission at death other than as provided in section 691.

(e) *Deduction by employer.*—In the case of transfer of stock pursuant to subsection (a), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such stock was transferred, an amount equal to the amount included in the gross income of the person who performed the services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performs such services.

(f) *Election.*—An election under subsection (a) shall be made in such manner as the Secretary or his delegate prescribe and may not be revoked except with the consent of the Secretary or his delegate."

STATEMENT OF RICHARD J. HANSCHEN, PARTNER, NEW BUSINESS RESOURCES—VENTURE CAPITAL PARTNERSHIP, DALLAS, TEX.

Mr. HANSCHEN. Thank you, Mr. Chairman, and Senators.

My remarks, I hope, will not duplicate too much of Dave's, and they are more aimed at the specific cases of my own activities in venture capital.

In 1969, we started Mostek as a new company based on the introduction of new processing technology, ion implantations, for manufacturing and processing a completely new form of semiconductors. Since that time, Mostek has paid $11 million in corporate taxes, has created 2,640 jobs in the United States, and those employees pay over $4 million in income taxes.

It takes, in our company, approximately $16,000 of assets per employee to generate the volume of business that we do. During that same time, no dividends have been paid to any of the stockholders, and I think probably 90 percent of the original private-placement stockholders are still intact and have not realized any gains on their positions.

And as a specific way of amplifying Dave's remarks that you must be very patient investors in venture capital, these are not quick opportunities to do what we call a rollover type of investment. Probably more important, Mostek, through this process, was the very first company in the world to put all of the circuits necessary for a calculator on one single little chip of silicon.

This technological advance sharply reduced the labor content of calculators and other similar electronic equipment and was the keystone for the U.S. industry to marshal their forces and reestablish their dominant picture in the worldwide electronics industry.

If you will recall, in the beginning of the 1970's, there was a great concern that we were losing our industry to other countries of the world that had lower labor, and I can say, I think, that we have had a significant contribution.

Now, if you go back to technology and its impact—I will just review in time a little bit. Lee DeForest, with his invention of the vacuum tube, and Milo T. Farnsworth innovating into the cathode ray tube,

created the TV industry, and of course, the tube created the radio industry—that is quite well known.

Some of you are familiar with the contributions of what was then a new company in the early 1950's, Texas Instruments, a company I spent a dozen years with, in bringing the transistor from a laboratory experimental level to commercial reality. The impact on industry during the 1950's created the central computer industry and the military instrumentation industry, which was known then as the black box industry. And they put these instruments together to form avionics packages and missile packages, made possible things like the Minuteman Missile.

Then the further invention by Texas Instruments of the integrated circuit brought about the electronics being simplified so it pervaded all of industry.

But new industry such as Dave has been mentioning, the minicomputers, made by new companies, names that were not heard of before—Ken Olson starting Digital Equipment, Data General, Computer Operation, Modular Computer, SEL, possibly as many as 20 other companies that I could mention in the United States who have not only done the same thing that we talk about in Mostek, creating jobs and taxes, but minicomputers are probably the major factor in improving the productivity of our industry.

One of the most exciting things in medical electronics just introduced is based upon minicomputer technology, and it is this new brain scanner and body scanner through X-ray techniques that put it all in electronic equipment, so that a surgeon can quickly survey a patient. It is probably the most radical advance in medical aids for surgeons that has taken place in the last two decades.

Senator BENTSEN. Mr. Chairman, may I interrupt for a moment?

One of the frustrations of a Senator is having to be at two places at one time.

Mr. HANSCHEN. I understand, sir.

Senator BENTSEN. I am going to have to go, although I find your statement and the others most interesting. I am going to take them with me and study them. I appreciate your comments about my legislation. And let me say further that Senator Nelson and I and the rest of us did a tremendous amount of work on that pension bill, and I have a deep concern with respect to your point about the prudent man rule. I think you are going to find people just feeling free to invest in very major corporations where they think no one would question them if they have a failure, and be reluctant to go into "Widget Corporation" that no one ever heard of. I think we are going to have to make some changes to try to see that venture capital is available, and I certainly will put myself to work to see if we cannot make that a more workable provision than it is.

Senator NELSON. Thank you, Senator Bentsen. Mr. Hanschen, please go ahead.

Mr. HANSCHEN. Now, in going on into these new technologies such as the MOS-LSI that I mentioned. In addition to calculators and watches, the technology has spawned a completely new industry, starting up—these industries, almost all of them—when I talk about the new emerging companies, they are all—you can trace them back exclusively to being financed by venture capital organizations.

This new industry is called the intelligent terminal industry, and companies such as Datapoint, Linolex, Sycor. Incoterm, Vydec, and Data 100 have spawned, in the United States. They are growing companies. The impact of their product can be felt more in the front office and will be a key factor in increasing the productivity by automation of the white collar functions.

An example is GSA here in the Government has just prepared, I think, about 300 intelligent terminals for the purchasing function that allows them to cut the processing time of a purchase order down from 17 days to 5 days, period of time. And their goal is to bring it down to 1 day.

Another function of this is being worked in the Library of Congress to put in every Congressman's office an intelligent terminal that would allow him to communicate directly with the Library of Congress without having to have people go over there and do the research for him. This is in the test stage over at the Library of Congress.

But I think many of the Government agencies are taking the leadership role in using this new equipment. One of the key things that we want to make a point is that I do not think there has ever been a question in the last several decades of my association with electronics industry about the fierce competitiveness of this portion of the free enterprise. I have included here an article from Business Week, printed in April of 1974, and it says that if the United States is going to learn to hold its own in a hotly competitive world, it needs more industries that can learn semiconductors. There are some concluding statements and other points in there.

My point is that competitiveness comes from having distribution, so I tend to call this distributed competitive free enterprise, as compared to either concentrated industry or concentrated nonmobile capital. In our discussions here, we may be kind of classified as small businesses because we start these things sometimes as one man, but it is never our intention to have a small business, as defined by the SBA terms. We have to prepare for capitalization to finance a company into $50 million to $100 million revenues annually within the first 5 years of existence.

Let me take the case of Mostek. We have raised $5 million of private capital to start the company and had enough success to raise $15 million in two issues of public money. We have retained earnings of $12 million. This $32 million, properly leveraged, in turning our assets efficiently into billings on a 1-to-2 ratio, will allow us to grow from our current $60 million to $100 million. This is kind of the goal of every investment we take a look at. Can it be a $100-million company carry the overhead to contribute back and grow. Below this level, you take a chance of a company's being quite vulnerable.

Now, one of my key purposes in coming here to talk to you today is that a series of random changes have taken place that make it impossible, almost impossible, at least, to duplicate the building of Mostek in the United States today. On April 15 of this year, we sold our Linolex Co. to Minnesota Mining, solely because the capital formation structure that enabled us to create Mostek in the early 1970's no longer exists today.

Now, further than that, our venture capital community 5 years ago was starting between 10 and 15 new such companies in the United

States. To the best of my knowledge, there was only one new high technology company that capitalized in 1974 in the United States, only one. This was down in San Antonio, Tex. They tried to raise $3.5 million, and were undercapitalized by a third, but went ahead on the risk. It is a very treacherous way to do it.

Senator NELSON. To what do you specifically attribute that?

Mr. HANSCHEN. Well, the question was asked earlier. I attribute it to the breakdown of the chain—what you have in the strategic plan of financing our organization—that is, that you start with private capital, fellows like ourselves, putting up our money and taking the risk. This was backed up by what we call second-level investors that might be industrial organizations or it might be wealthy families or might be SBIC's. Now, when they put the money—they are confident that an investment banker will, when this achieves a certain maturity, will take it to the public and raise more capital—because these things are in continuous need for capital, if they are going to grow. You can only grow a company from retained earnings at about a 15- to 20-percent rate per year, if you retain all of the earnings. But these companies, because of their size, demand 100-percent growth rates, 50-percent growth rates as they mature. It is very seldom you want to be under 30 percent, so there must be an infusion of capital.

Coming back to the investment banker, he will not take it out to the public unless he can get the venturesome funds to invest. We might call these the hedge funds, or the venturesome mutual funds. They will not invest unless they see down the road the possibility of further capital coming in for the pension funds. Now, that is where the chain has been broken, just in the last six months, so that the confidence factor reflected all the way down this chain has just been decimated, and you cannot get the investment banker, and there have been two in the United States that are outstanding in taking high quality things. It is Tommy Unterberg of Unterberg-Towbin in New York, and Hambrecht and Quist in San Francisco have had an outstanding track record in bringing these things to the public, and with the public getting a very good return on their investment over a period of time. I do not think either one of them have in their plans a new issue to bring out, and I do not think they have—Dave, do you know of anything they have brought out in a brand new issue in the last year?

Mr. MORGENTHALER. Little or nothing.

Senator NELSON. When you made reference to the investment bankers and their connection with the pension funds. What did you mean by that?

Mr. HANSCHEN. I am saying here that the investment bankers will underwrite, buy the stock, and sell it to the mutual funds. As the company grows, the mutual fund will want to see money come into the company to further investment banking activities, when it becomes mature enough from the pension funds. Right now, a pension fund manager, the man who invested really in Mostek, Morris Ruggles, says when he invested in it, and it was about a $7 million company—today it is $70 million—he says that he, because of these new regulations, that he cannot even put it on a list to study, because of the fiduciary implications of the new pension law. So that he cannot consider an investment into a company that is an order of magnitude larger

and has grown. In other words, the pension fund managers today will not look at a company doing less than $100 million a year. Many of them will not go under $250 million a year. They just will not even review them.

Senator NELSON. And that is because of the——

Mr. HANSCHEN. Fiduciary responsibilities.

Senator NELSON. The fiduciary responsibilities are so tight, and the responsibility is so great?

Mr. HANSCHEN. Right, so, you know, if you cannot get this flow of capital to the corporation coming down if your whole strategic plan that has been set up is just eliminated, and you are down to the point where you do not even want to start, because you do not see the flow of capital coming in.

Senator NELSON. And there is a substantial percentage of that kind of capital that has come from pension plans in the past, for that kind of a company?

Mr. HANSCHEN. When they get up to that state of maturity, you have to bank on the fact that some time along the line they are going to get mature enough so that at that time, they can come in. And pension funds have been the major source of capital in mature organizations of equity capital—I think if we take it percentagewise over mutual funds, I have been told it ranks about eight times as much capital—that comes from pension funds as comes from mutual funds for equities of this nature. So again you are close to an order of magnitude of difference there. And the lack of confidence is the factor that has broken the chain, because they do not see those fellows being able to come in, and believe me, we hear an awful lot about IBM competing with them. I personally have no fear of IBM, except their capital strength—the fact that they sit there with all of that hard cash to invest in anything, and they do not have to raise capital, and that they can rent their equipment on a 30-day basis. But we do not need to break them up to compete with them, or any of these things that are being talked about. We just have to have the same capital advantages that they have been able to concentrate and get hold of.

As a result, they can use marketing techniques of rental that a company such as we are talking about here just cannot possibly do—is rent on a 30-day basis without a good capital base.

Going back to some things the fellows were asking on extending the tax loss carried forward more than 5 years, there is no way you can build a company within 5 years that has to rent its product out. It takes about a 12-year time from startup until you have that rental stream big enough to cover your operating losses, especially when you are down on low-cost rental. So some of these things, I think—you know, there has been a change in the times, as far as marketing techniques and using rentals rather than direct sales, and I think they are a real necessity. I would not any more start a company today that had to rent its product in competition particularly with IBM, and only because of rental, not because of technology and marketing a better product or any other thing. It is just because of this problem of capital formation.

Senator HASKELL. Mr. Chairman, may I pursue this a little bit?

Senator NELSON. Let us save the comments, because I was just advised that the Senate has adopted a rule we cannot meet past 12:30. So we are going to have to conclude with Mr. Rohde and the next panel within the next 60 minutes, because of the floor debate.

Senator HASKELL. All right. Maybe I can talk to you afterward.

Mr. HANSCHEN. Certainly.

Senator NELSON. I think we are going to have to move on with the other witnesses. I did not know they were going to adopt that rule, but because of the pending business on the floor, they are going to require people to be there, so we cannot be meeting.

Thank you very much. We found the testimony very valuable, and I assume, if any of the members have questions, you would be willing to submit answers to them.

Mr. MORGENTHALER. Mr. Chairman.

Senator NELSON. Yes.

Mr. MORGENTHALER. Might I ask that we introduce a statement which we have available on behalf of Mr. Stanley Rubel, who is executive director of the National Venture Capital Association. Mr. Rubel was not able to be here today, but we would like to introduce his statement into the record. I would also like to introduce into the record the name of our attorney, Mr. Leonard Silverstein.

Senator NELSON. Thank you very much.

Mr. MORGENTHALER. And Mr. Stewart Lewis.

Senator NELSON. Mr. Rubel's statement will be printed in full in the record.

[The prepared statement of Stanley M. Rubel follows:]

June 19, 1975

JOINT HEARING

SENATE SMALL BUSINESS COMMITTEE
AND
FINANCIAL MARKETS SUBCOMMITTEE OF
SENATE FINANCE COMMITTEE

STATEMENT BY

STANLEY M. RUBEL

President, Capital Publishing Corporation
Executive Director, National Venture Capital Assocation

I am delighted at the opportunity to present my views to this important joint hearing today. Strangely, I am in a rather unique position to talk about the problems of capital formation in the country and the present condition of the venture capital industry. My firm, Capital Publishing Corporation has been publishing the professional journal for the industry "Venture Capital" since 1961. You might say that we have been the historians of the industry for the past decade and a half. We also publish the only directory and text on the venture process, "Guide to Venture Capital Sources", and I co-authored the only book thus written on the SBIC industry, "SBICs: Pioneers in Organized Venture Capital."

I have provided consulting services to a variety of Federal Agencies on these issues such as the Small Business Administration, National Science Foundation, National Bureau of Standards, as well as others and was a founder and am presently Executive Director of the National Venture Capital Association. The NVCA represents 70 of the nation's leading venture capital firms and I am enclosing the membership roster for your records.

Perhaps it is first appropriate to define the term venture capital and to describe the process by which a small growth company raises financing. Although there is no exact definition

of the term and it tends to mean different things to different people, my definition is the assumption of a major investment risk on a smaller sized business venture in anticipation of the firm growing to substantial proportions. Thus venture capital is interested in businesses with major growth potential which hopefully will only be small for a few years.

Venture capital can mean investing in an entirely new venture, or one that has been in operation for some time, but where a major expansion is taking place that could jeopardize the viability of the entire business. In the past most companies were in a loss position when venture capital was invested. I tend to use some arbitrary size standards in defining venture capital, such as investing in a business that has a net worth of $5 million or less and where the total financing is $5 million or less. While there are a few notable exceptions to these size levels, they tend to describe about 80% or more of the industry's activities.

Up until the past few years, the financing to get a business started would typically come either from organized venture capital companies, or from relatives, potential customers, suppliers and wealthy friends. The first major input of capital would come a year or two later from organized venture capital sources, often in combination with wealthy families and friends. Perhaps the second input would also come from these sources. By then the company would be expected to be profitable and use other institutional sources of capital such as banks, insurance companies, pension funds, and subsequently public underwritings.

RECENT HISTORY OF VENTURE CAPITAL

In the period of the 1950's a number of businesses were started, primarily through funds provided by wealthy individuals, partners and clients of investment banking firms, and the other informal sources of venture capital previously described. The first organized venture capital firm, American Research and Development Corp. had been formed in

1946 and was active through this period, as were certain well known wealthy families that had formal venture capital operations.

In 1958 Congress passed the Small Business Investment Act which created the small business investment company, SBIC. SBICs were special financial companies independently owned, but licensed by the Small Business Administration, to invest in smaller sized companies generally described as having less than $5 million in total assets, under $2.5 million in net worth and average profits of under $250,000 after taxes for the past two years. SBICs could borrow from SBA at a rate of twice their own capital (borrowing power has since been increased to three to one) and SBIC shareholders receive special treatment of losses should they be incurred when the SBIC stock is sold.

At first there was little interest in forming new SBICs, but in the early 1960's the stock market became enamored with smaller sized technologically based companies. As prices skyrocketed, many people formed SBICs to take advantage of this "new phenomenon" of investing in small technology based companies. Also many real estate developers and commercial lenders formed SBICs to obtain the special incentives provided.

The peak was reached in 1964 with 722 licensed SBICs with a net worth of about $500 million. During the 1959-1962 period some 50 publicly held SBICs were organized with capital of about $330 million and many of the large big city banks also organized SBIC subsidiaries. However a variety of problems developed in the SBIC industry due to errors in the original legislation, indiscriminate licensing by SBA, rapid change of SBA administrators and policies, the Investment Company Act of 1940 which was poison to publicly owned SBICS, and the fact that many of the people forming SBICs had little experience in this demanding business.

The SBIC program fell into disfavor during the mid 1960's and the number of SBICs began to shrink noticeably as many left the field or were asked to leave by SBA.

At the same time, though a number of technology based companies showed major growth and the increasing number of wealthy investors, brokerage firm clients, insurance companies and others who were investing in these companies were beginning to show large profits. This performance reached a peak in the late 1960's when the stock market fell in love with the small company and prices again skyrocketed. Again it looked like an easy business and many institutional investors concluded they needed to have some capital employed in ventures in order to properly balance their more conservative holdings.

Some insurance companies, pension funds and bank trust departments decided to hire their own managers to make venture investments and again like in the early 1960's with the SBICs, inexperienced people were brought in to make investment decisions. Others decided to back a new breed of firm, the professional venture capital company. Led off by Ned Heizer who formed the $80 million Heizer Corp., some 55 other venture corporations and partnerships were formed in 1969 through 1973. In all these companies raised about $650-$700 million from large institutions-pension and profit sharing funds, insurance companies, universities, large corporations, wealthy families, bank trust departments and others. In the main these new firms were directed by men who had previous experience in investing in venture capital through the existing venture firms, SBICs, investment bankers or others that had been operating through this period.

These companies have full time professional staffs who screen new investment proposals, perform thorough investigations, negotiate terms and subsequently work closely with the the firms they back. These venture groups provide a variety of management services ranging

from helping to raise additional capital and providing other investment banking services, to being involved in the important decisions of the businesses as they grow, helping develop and monitor financial controls, etc.

The National Venture Capital Association recently commissioned a study performed by Professor A. R. Ofer of Northwestern University. Based on his statistics on 57 members of the NVCA (71% of the total) and an extrapolation by myself to include the 150 organized venture capital firms in the country, I estimate that total assets of the organized venture community is currently $2 billion and that the industry is about 78% invested, which leaves only 22% of its capital for new investments. Since most venture firms like to maintain reserves of 15%-20% of their capital to finance existing holdings, these figures suggest that the industry tends to be fully invested at the present time. Of the 2,738 investments made by the industry, 346 were to companies that are now publicly held.

That isn't to say that there aren't venture funds interested in making new investments, and a number are, but many others would only be interested in new commitments only if they could roll over existing holdings or raise more capital.

The venture industry appears to invest $200-$250 million per year during normal periods (1970-1973) but in 1974, only some $118 million had been invested through September 30. A significant amount of this capital probably was employed in companies in which other venture firms were involved, rather than totally new projects. The average size of investment per venture firm has risen continuously and is now in excess of $500,000.

It has been estimated that the venture capital community normally funds 20 or more new companies in any given year, yet in the past few years only one or two new companies per year have been started by venture capitalists.

The availability of funds from public underwritings has also declined drastically in the past few years as per the following data from "Venture Capital."

	Total Underwriting for Small Companies	
	Number of Issues	Amount Raised (Millions)
1968	358	$ 745.3
1969	698	1,366.9
1970	198	375.0
1971	248	550.9
1972	409	896.0
1973	101	205.3
1974	9	16.1

The above data represents only firm offerings and does not include Reg A or Best Efforts underwritings. Only companies with a net worth before the financing of under $5 million were included and any financing over $5 million was excluded from the tabulation.

So far in 1975, there have been only a few new issues for a total of about $3 million, thus the current rate of activity is much like in 1974.

CAUSES FOR THE DECLINE IN VENTURE FINANCING

There seem to be a number of reasons why venture capital investments have declined so precipitously in the past few years.

1. There has been a general reduction in all forms of funding for the emerging growth company. Venture firms are more reluctant to invest, because if the company is successful, it will have difficulty

in raising the capital it needs from the later stage institutional investors and subsequently from the public. This means that venture capitalists have to make much larger investments and the rate of return declines correspondingly. Also it increases the risk of loss on projects that aren't successful.

2. There has been far more economic uncertainty in the past few years due to inflation, recession, the oil crises, etc. This is discouraging to an investor who must wait 5 to 10 years before he will be able to re-cycle all his capital and profit.

3. There is no new money coming into the venture capital business and the industry tends to be fully invested. Pension fund managers have become very concerned about the new rules of the Pension Reform Law of 1974 and they and other investors are leary of the venture field as an attractive vehicle to make money because of the problems enumerated in 1 and 2 above.

4. To complicate the issue, the tax on capital gains has been increased by more than 50% in the past few years. The old Federal rate of 25% has been increased to 37.5% for large gains and a number of states now tax capital gains between 2% and 5%. Thus it is possible to pay as much as a 42.5% capital gains tax on such profits. This reduces the return to venture investors, yet if anything their risk of loss has been increased. This isn't exactly an incentive to make high risk venture capital investments requiring ever increasing amounts of money.

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To provide further discouragement, a few years ago the SEC promulgated new restrictions on public sales of unregistered stock. Under what is called Rule 144, after two years a venture investor can sell an amount equal to only 1% of the outstanding shares every six months of a company in which it has an investment. Thus if a venture firm has a 25% equity interest in a fast growing company, it may well take 12 1/2 years to sell its position. The alternative is a costly and usually price depressing registered secondary offering, which again reduces the profit on the transaction, without reducing the risk. Of course the small company could sell out to a large corporation and this and many other laws encourage this action.

BENEFITS FROM VENTURE CAPITAL INVESTING

It is difficult for most people to realize that at one time or another, most of our large corporations needed venture capital in order to deal with a critical problem. The NVCA also asked Professor Ofer to study the 138 publicly held companies that the NVCA members had backed over the past 5-6 years by average. The following statistics show the truly amazing growth of 70 of these companies that responded to the questionnaire: —

	Data Just Before Receiving Venture Financing	Data In The Last Reporting Year-Usually 1974
Total Assets	455 Million	1.5 Billion
Total Employees	1,911	6,223
Total Sales	$328 Million	$1.6 Billion
Total (Losses) or Profits	($27.3) Million	$102 Million
Total Federal Corporate Income Taxes Paid	$6.8 Million	$66 Million

A total of $168 million in venture capital had been invested and these companies had paid a total of $140-$150 million in corporate income taxes. Since many were still using up tax losses incurred in earlier years, their corporate tax payments are very likely to show dramatic increases in coming years. Yet the average amount of venture capital required by these companies increased in each succeeding year and reached over $3 million in the latest year reported.

As a further illustration of the impact that venture capital has on the growth of a business, the following data was developed for four leading companies that the industry has founded and helped grow over recent years, Damon Corp., Fotomat Corp., Measurex and MSI Data Corp. These companies just by themselves now employ over 11,000 people, yet these firms would not have been started were it not for venture capital. It is highly unlikely that a Damon Corp. or a Fotomat or the others could get formed or financed in the current environment.

Another way to illustrate the impact of the venture function is to note its effect on any number of high growth industries such as semiconductors, minicomputers, all kinds of other computer related products, hand held calculators, automatic editing typewriters, CATV, hi-fi, new medical instruments, and a wide variety of others in recent years. Even frozen orange juice was developed through venture capital. A great many jobs have been brought back to the U.S. from Japan through the development of the small chips that are used now in hand held calculators and this type of advance is now being applied to electronic watches. These were developments by small companies that weren't subject to the restrictions of a large company environment and could attract the bright young scientist, production manager and marketing people to move the product into the marketplace. And it was also the result of venture capitalists who were willing to risk their capital to build new companies to better serve the public.

Name of Company MSI Data Corporation

Data Submitted by Brentwood Associates Date April 1, 1975

($ 000 omitted - columns 2 thru 7)

1 YEAR Fiscal Year Ending 3/31	2 INVESTMENT			3 SALES	4 EARNINGS BEFORE TAX	5 PROVISION FOR TAXES	6 NET INCOME	7 TAX CREDITS	8 NUMBER OF EMPLOYEES
	2a VENTURE CAPITAL	2b PUBLIC	2c OTHER						
1968			100*	28	(98)	-	(98)	-	10
1969	350			1,072	(45)	-	(45)	—	75
1970	1,400			3,177	(285)	-	(285)		181
1971	500			6,680	245	129	116	114	228
1972				9,484	797	417	381	92	375
1973		4,100		13,489	1,272	639	633		486
1974				20,188	2,242	1,083	1,158		929
1975 - 9 months				25,680	2,372	1,158	1,214		1,222

Total Venture Capital Invested $ 2,250,000

Total Investment, All Sources $6,450,000

Total Sales $79,798,000

Total Provision for Taxes net of Tax Credits $ 3,220,000

Total Present Employees 1,222

*Founders Investment

Name of Company MEASUREX CORPORATION

Data Submitted by BSC Date 3/24/75

($ 000 omitted - columns 2 thru 7)

1 YEAR Fiscal Year Ending 11/30	2 INVESTMENT			3 SALES	4 EARNINGS BEFORE TAX	5 PROVISION FOR TAXES	6 NET INCOME	7 TAX CREDITS	8 NUMBER OF EMPLOYEES
	2a VENTURE CAPITAL	2b PUBLIC	2c OTHER						
1968	864		63	9	(465)	-	(465)		16
1969	1,288		771	2,357	463	177	413	(177)	59
1970			4,745	5,828	1,251	625	626		125
1971			8,018	8,613	1,974	940	1,579		225
1972		10,859	1,711	16,336	2,887	1,160	1,727		364
1973			15,808	27,123	4,234	1,675	2,559		667
1974		9,915	16,967	42,086	4,915	950	3,965		947

Total Venture Capital Invested	$ 2,152,000
Total Investment, All Sources	$71,009,000
Total Sales	$ 102,352,000
Total Provision for Taxes net of Tax Credits	$ 5,350,000
Total Present Employees	947

Name of Company FOTOMAT CORPORATION

Data Submitted by BSC Date 3/24/75

($ 000 omitted - columns 2 thru 7)

1 YEAR Fiscal Year - Ending 1/31	2 INVESTMENT			3 SALES	4 EARNINGS BEFORE TAX	5 PROVISION FOR TAXES	6 NET INCOME	7 TAX CREDITS	8 NUMBER OF EMPLOYEES
	2a VENTURE CAPITAL	2b PUBLIC	2c OTHER						
1968	409		400	600	(211)	-	(211)		-
1969	1,012			7,300	60	8	52		1,372
1970	4,000	9,210	6,134	17,000	(7,013)	120	(7,133)		2,098
1971	5,300		1,450	27,300	(5,990)	-	(7,998)		2,776
1972	2,000		2,755	34,500	(3,282)	-	(3,702)		3,019
1973	(510)		545	45,800	2	226	2,078		2,847
1974	(510)		1,971	64,000	3,704	-	3,504		3,350
1975	(510)		(16,778)	89,070	7,147	3,750	6,857		4,360

* Restated for years prior to 1973 due to major accounting change.

Total Venture Capital Invested	$ 11,191,000
Total Investment, All Sources	$ 16,878,000
Total Sales	$ 285,570,000
Total Provision for Taxes net of Tax Credits	$ 4,104,000
Total Present Employees	4,360

Name of Company DAMON CORPORATION

Data Submitted by BSC Date 3/20/75

($ 000 omitted - columns 2 thru 7)

1 YEAR Fiscal Year Ending 8/31	2 INVESTMENT			3 SALES	4 EARNINGS BEFORE TAX	5 PROVISION FOR TAXES	6 NET INCOME	7 TAX CREDITS	8 NUMBER OF EMPLOYEES
	2a VENTURE CAPITAL	2b PUBLIC	2c OTHER						
1961	435			0					
1962				104	(178)		(178)		
1963				600	(37)		(37)		20
1964	214			853	91	33	58	(33)	30
1965				1,240	141	59	82	(59)	60
1966				1,542	180	68	112	(15)	80
1967			425	3,137	561	264	297		160
1968		860	1,670	15,709	2,089	1,044	1,045		400
1969		5,527	1,362	24,708	3,719	1,818	1,901		850
1970			4,543	34,543	5,037	2,200	2,837		1,498
1971			4,814	55,635	7,472	3,250	4,222		2,530
1972			2,993	93,519	12,692	5,641	7,051		3,529
1973			17,794	118,566	16,889	7,550	9,339		4,700
1974			(121)	141,311	14,485	6,358	8,127		4,500

Total Venture Capital Invested	$ 649,000
Total Investment, All Sources	$ 40,516,000
Total Sales	$ 491,467,000
Total Provision for Taxes net of Tax Credits	$ 28,178,000
Total Present Employees	4,500

CONCLUSION

It seems likely that the capital shortage in the U.S. coincided with the major increase in the capital gains tax, which simply made risk taking less attractive. Things have come so easily to us in America that we all tend to take the efficiency and effectiveness of the capitalistic system for granted. Very few people seem to realize that the system only works if someone is willing to risk significant sums of capital to create a new enterprise, or improve on an existing product or service, in order to produce growth and increased employment.

If we are to re-introduce any significant degree of dynamics back into the system we must create an environment in which investors are not discouraged but rather encouraged to risk their capital to build a significant enterprise.

Actually, there are very few venture capitalists I know who wouldn't willingly trade places with the Federal government....and receive untaxed 50% of the pre-tax profits of the companies they finance. I suspect that the government would collect far more in corporate income taxes if many new companies would be started, as during the 1960's, and the cost of future capital gains taxed at a lower rate would be far below this amount.

Incentives must be restored for both the investor and the executives of the small company who are essential if it is to achieve major growth. If the qualified stock option is made completely ineffective, as is presently being contemplated by the House Ways and Means Committee, it will make it almost impossible to provide incentives to induce executives in larger companies to leave comfortable jobs and take the personal risk (and usually a lower salary) entailed in building a smaller entity.

Proper incentives to both the entrepreneur and the investor go to the heart of providing a resurgeance of interest in starting new companies and providing venture capital.

The National Venture Capital Association has some specific suggestions on these subjects which will be presented by Richard Hanschen, a V.P. of the Association and a noted venture capitalist.

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Senator NELSON. Mr. Hanschen, you mentioned Mostek. Do you have an annual report, or something similar?

Mr. HANSCHEN. Yes; I can send it to you.

Senator NELSON. All right, we will appreciate it.

Thank you very much, gentlemen. Our next witness is Mr. Gilbert Rohde, president of the Wisconsin Farmers Union.

The committee is very pleased to have you here today to comment on the small business problems of the farmer, who constitutes a substantial segment of the small business community in the whole country. As a matter of fact, most farmers are small business.

Go ahead, Mr. Rohde.

STATEMENT OF GILBERT C. ROHDE, PRESIDENT, WISCONSIN FARMERS UNION

Mr. ROHDE. Thank you, Mr. Chairman and members of the committee.

For the record, Mr. Chairman, I am Gilbert C. Rohde, president of the Wisconsin Farmers Union. I appreciate the invitation to testify at these joint hearings on capital needs of small businessmen, farmers, and ranchers of this country.

Senator NELSON. As you know, the national president of your organization is a constituent of Senator Haskell's.

Mr. ROHDE. Yes; I am well aware of that.

I am representing the Wisconsin Farmers Union as well as the National Farmers Union.

As an official spokesman of a general farm organization, I wish to confine my testimony to the tax and capital problems of agriculture.[1]

First, we must recognize at the outset that the traditional concept of the owner-operated, wholly self-sufficient, debt-free family farm is being drastically altered by the forces of change. Except for a few isolated instances, the days of the essentially independent farm with a team of horses, a few simple implements, and highly unsophisticated management inputs are a thing of the past. The development of new technology and the quest for optimum efficiency have made the family farm much more competitive and committed to much higher degrees of specialization.

Today's family farm cannot readily change from one type of operation to another because the capital and risk involved are too high. He cannot, as did his forebears, pull up stakes and move to a new piece of land because the investment is prohibitive. The flexibility and freedom of the frontier psychology of the homesteading family farmer that spread west from New England across the continent is largely nonexistent today.

According to a report issued April 28 by the U.S. Department of Agriculture, farms with product sales of $20,000 or more owned over 70 percent of total farm assets and owed 77 percent of the farm debt in 1973. These are the farmers, presumably, who are large enough to provide the operations with the levels of income comparable with those of nonfarm people. Their average investment per farm, according to the USDA, is about $390,000 and rising rapidly. USDA studies further

[1] See article, "The Credit Crunch Moves Down on the Farm," Appendix XI.

show that most gains in efficiency have been achieved by farms large enough to utilize the labor and management of one or two well-equipped full-time men.

In the Midwest, the USDA says this means a capital investment of about $610,000 per farm. We personally know that this statistic is in the ball park, so to speak, because we have consistently heard the rule-of-thumb figure that it takes a half-million-dollar investment to own and operate a well-equipped, optimum dairy farm in Wisconsin today.

However, we also are aware that there are very few, especially young farmers, who are operating at this level of investment in Wisconsin. Debt free owners of half-million-dollar farm enterprises are as scarce as the proverbial hen's teeth in Wisconsin. Farms under the electronic farm record program at the University of Wisconsin averaged a total investment of $181,000 in 1974.

Senator NELSON. Does the University have a computer system?

Mr. ROHDE. Yes; they do.

Senator NELSON. When you say those in the computer system are they all in it?

Mr. ROHDE. No; I am sure the computer system records those farmers that are in—a few such as the Wisconsin Farm Management Association, of which I am a member, too. And our income and our production records are computerized through that.

Senator NELSON. What I was trying to get at is what kind of a sample is on the computer—is this supposed to be a representative sample of dairy or hogs of what types of farming?

Mr. ROHDE. I think predominantly dairy records, but I am sure that there are a number of specialized hog farmers and beef feeders in the southern part of the State who are also under the system.

Senator NELSON. Would this $180,000 be a representative sample, a median, or average?

Mr. ROHDE. Only when we consider that it may be understated, because the figures, relative to land are recorded at the purchase cost, rather than the market price today. I could only assume that those figures of $181,000 would be appreciably higher as a result of the market price of that land.

Senator NELSON. Then you could not buy a 200-acre farm, with 50 cows at less than $200,000 to $250,000 could you?

Mr. ROHDE. That is about the way I understand the figure.

It is important to examine what has been happening to farm real estate values in recent years to gain a better understanding of the capital requirements of today's farmer.

In Wisconsin, the value of land and buldings increased 73 percent in the past 5 years, rising from an average of $232 to $401 per acre. In the aggregate, the value of farmland and buildings in the United States rose from $152.1 billion in 1964 to $324 billion in 1974. The investment more than doubled in one decade. Farm real estate value increased $48 billion or 21 percent in 1973, alone.

Of course, farm debt shows a similar recent history. Farm mortgage debt increased to $34 billion in 1973—more than a threefold jump in 15 years. Currently, total farm debt, including operating loans, is in the neghborhood of $100 billion.

What is the significance of these skyrocketing farm capital and farm debt figures? It is this. Increasing farm capital is being supplied by off-farm sources to the detriment of family farming.

The ratio of debt to total assets in U.S. agriculture more than doubled from 1950 to 1970 and is now increasing at a much greater pace. In addition to an increasing ratio of debts to assets, there is also the phenomenal expansion of investments in farmland by nonfarm people and corporations. In 1969, nonfarmers owned about a third of all farm real estate. The 1975 census, undoubtedly, will show that this percentage is considerably higher today.

Senator NELSON. Now when you say nonfarmers, are you or are you not including banks, by way of loans or actual investments? You do not count that?

Mr. ROHDE. No; I am not.

Senator NELSON. You are counting outside investors with their own capital?

Mr. ROHDE. Outside investors' risk capital.

Absentee investor capital is readily used to shelter nonfarm income, commonly called "tax loss" farming. A recent USDA study shows that the large farm losses in 1970 were concentrated in two basic income classes: those with negative basic income and those with $25,000 or more.

Nonfarm income was substantially higher for the farm loss group than for the group reporting farm profits. Also, the size of the nonfarm income increased substantially with the size of the farming operations for the loss group while the level of nonfarm income remained relatively constant for the group reporting farm profits.

It is apparent from the study, that much of the investor capital is used to gain a competitive advantage over family farmers rather than to give the family farmer an added dimension of flexibility in his choice of managerial alternatives.

It is the tax-loss farmers who retain the flexibility and mobility to take their capital elsewhere to greener pastures while the family farmer's alternatives are severely restricted. If hard pressed financially, he has the options of selling out completely, becoming a part-time farmer if circumstances permit or relinquishing managerial control to outside capital and becoming the hired hand of absentee management.

The Tax Reform Act of 1969, though it addressed itself to the abuses perpetrated by "tax loss" farming did not go far enough in remedying the situation. Tax shelters for nonfarmers still exist in agriculture and must be dealt with legislatively.

Nonfarm investors buying up agricultural land also creates another tax problem for farmers. A newspaper headline we recently saw sums up the farmer's predicament. "Raw Land the Hottest Thing on the Market," the headline read.

The columnist wrote:

> Little question about it, millions of acres of land on the fringe of metropolitan areas are going for increasingly higher prices each year and thousands of speculators, from small fry to giant corporations are aware of it.

This situation, accurately described by the newspaperman, is resulting in higher and higher assessments on agricultural land for tax purposes. Since our local governments and school systems must rely predominately on the property tax for support, the added tax burden on farmers, especially those near metropolitan areas, becomes unbear-

able and they must sell out to these same speculators, be they small fry or giant corporations. State governments, including that of Wisconsin, have addressed themselves to this problem but thus far there is little indication that it is being satisfactorily resolved anywhere in the United States.

In the meantime the land rush goes on. I am personally acquainted with a situation in Wisconsin in which a realty firm is willing to pay as high as $500 per acre for as much land as they can acquire in western Wisconsin. This is considerably above the $363 per acre that farmland averaged in sales in Wisconsin in 1973.

Another phenomenon which I am sure is being repeated throughout the country is that of the commuting suburbanite who now is becoming the commuting "rurbanite." Airline pilots, as an example, and others are purchasing farms, comfortably removed from the hubbub of urban living. They commute to their occupation centers with light planes. The luxury of such rural living often comes out of the unfortunate hides of their farmer-neighbors in higher property taxes.

Our inheritance tax laws are also literally killing a farm family's chances of economic survival. Payment of estate taxes on inherited farmland often obligates the family to sell part of the farm to pay the taxes. The $60,000 exemption, established in 1943, is completely out of date in view of the kind of capitalization figures I recited here today. Legislation has been introduced to raise the deduction from $60,000 to $185,000, a much more realistic figure in regard to current economic conditions. Possibly Congress should also consider extending the period over which the inheritance tax is paid by the heirs.

And, incidentally, Senator, these are not the only alternatives to be considered. Our organization is studying the Saskatchewan land bank plan, which might be considered as an alternative.

I know specifically that at the University of Wisconsin, the chairman of the Department of Agriculture and Economics has long considered alternatives to this kind of a problem.

Unfair taxation was a root cause of the rebellion of the colonies against the King of England 200 years ago. We are not preaching any revolutionary doctrine here, today, but we wish to impress upon the Members of Congress, that the farmers are the victims of discrimination under our tax laws.

In addition to changing our tax laws, Congress is properly concerned about providing low-cost capital to farmers, especially young, beginning farmers. What are the chances of a farm boy starting out from small beginnings and becoming a debt-free owner of a $500 million farm enterprise in his lifetime. Not very good at best. Not very good at all if the institutions of Government through Government programs, credit agencies, and educational assistance are not available to give all the aid possible.

I would like to conclude with a quotation from a recent speech by Don Paarlberg, director of agricultural economics with the U.S. Department of Agriculture. He asked these pertinent questions: "Will the young men now starting out in farming be willing to stint themselves on the good things of life for 30 years or so in order to amortize an enormous debt? If they themselves were willing, would they be able to persuade wife and children to share that kind of life? How

satisfying is it to postpone living until one is ready for dying? Of what avail is it to be the richest man in the cemetery? Will our farmers be only those who inherit their farms or marry them? And even so, how can one buy out the other heir?"

This concludes my testimony, Mr. Chairman. I would be happy to answer any questions.

Senator NELSON. The committee appreciates very much your taking the time to come and testify this morning. And I appreciate your very fine statement, which highlights the problems of the family size farm.

[The prepared statement of Mr. Rohde follows:]

Statement by
Gilbert C. Rohde, President
Wisconsin Farmers Union
and
Member, Executive Committee,
National Farmers Union

Presented to
a Joint Hearing of the
Senate Finance Subcommittee on Financial Markets
and
the Senate Select Small Business Committee

Concerning
Tax and Capital Problems of Agriculture

June 19, 1975

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STATEMENT BY GILBERT C. ROHDE, PRESIDENT, WISCONSIN FARMERS UNION

BEFORE THE SUBCOMMITTEE ON FINANCIAL MARKETS AND THE SENATE SMALL BUSINESS COMMITTEE

JUNE 19, 1975

Mr. Chairman and Committee Members. I am Gilbert C. Rohde, president of the Wisconsin Farmers Union. I appreciate the invitation to testify at these joint hearings on the capital needs of small businessmen, ranchers and farmers. I am representing the Wisconsin Farmers Union and the National Farmers Union. As an official spokesman of a general farm organization I wish to confine my testimony to the tax and capital problems of agriculture.

First, we must recognize at the outset that the traditional concept of the owner-operated, wholly self-sufficient, debt-free family farm is being drastically altered by the forces of change. Except for a few isolated instances, the days of the essentially independent farmer with a team of horses, a few simple implements and highly unsophisticated management inputs are a thing of the past. The development of new technology and the quest for optimum efficiency have made the family farm much more competitive and committed to much higher degrees of specialization. Today's family farm cannot readily change from one type of operation to another because the capital and risk involved are too high. He cannot, as did his forebears, pull up stakes and move to a new piece of land because the investment is prohibitive. The flexibility and freedom of the frontier psychology of the homesteading family farmer that spread west from New England across the continent is largely nonexistent today.

According to a report issued April 28 by the U.S. Department of Agriculture, farms with product sales of $20,000 or more owned over 70 percent of total farm assets and owed 77 percent of the farm debt in 1973. These are the farmers, presumably, who are large enough to provide the operations with the levels of income comparable with those of nonfarm people. Their average investment per farm, according to the USDA, is about $390,000 and rising rapidly. USDA studies further show that most gains in

efficiency have been achieved by farms large enough to utilize the labor and management of one or two well equipped full-time men. In the Midwest, the USDA says this means a capital investment of about $610,000 per farm. We personally know that this statistic is in the ball park, so to speak, because we have consistently heard the rule of thumb figure that it takes a half million dollar investment to own and operate a well equipped, optimum sized dairy farm in Wisconsin today.

However, we also are aware that there are very few, especially young farmers, who are operating at this level of investment in Wisconsin. Debt-free owners of half million dollar farm enterprises are as scarce as the proverbial hen's teeth in Wisconsin. Farms under the electronic farm record program at the University of Wisconsin averaged a total investment of $181,000 in 1974. However, this is an understated figure because land is valued at the purchase cost rather than market price.

It is important to examine what has been happening to farm real estate values in recent years to gain a better understanding of the capital requirements of today's farmer. In Wisconsin, the value of land and buildings increased 73 percent in the past five years, rising from an average of $232 to $401 per acre. In the aggregate, the value of farm land and buildings in the United States rose from 152.1 billion dollars in 1964 to 324 billion dollars in 1974. The investment more than doubled in one decade. Farm real estate value increased $48 billion or 21 percent in 1973, alone.

Of course, farm debt shows a similar recent history. Farm mortgage debt increased to $34 billion in 1973 - more than a three-fold jump in 15 years. Currently, total farm debt, including operating loans, is in the neighborhood of $100 billion.

What is the significance of these skyrocketing farm capital and farm debt figures? It is this. Increasing farm capital is being supplied by off-farm sources to the detriment of family farming. The ratio of debt to total assets in U.S. agriculture more than doubled from 1950 to 1970 and is now increasing at a much greater pace. In addition to an increasing ratio of debts to assets, there is also the

phenomenal expansion of investments in farm land by nonfarm people and corporations. In 1969, nonfarmers owned about a third of all farm real estate. The 1975 census, undoubtedly, will show that this percentage is considerably higher today.

Absentee, investor capital is readily used to shelter non-farm income -- commonly called "tax loss" farming. A recent USDA Study shows that the large farm losses in 1970 were concentrated in two basic income classes -- those with negative basic income and those with $25,000 or more. Non-farm income was substantially higher for the farm loss group than for the group reporting farm profits. Also, the size of non-farm income increased substantially with the size of the farming operations for the loss group while the level of non-farm income remained relatively constant for the group reporting farm profits.

It is apparent from the study, that much of the investor capital is used to gain a competitive advantage over family farmers rather than to give the family farmer an added dimension of flexibility in his choice of managerial alternatives. It is the tax loss farmers who retain the flexibility and mobility to take their capital elsewhere to greener pastures while the family farmer's alternatives are severely restricted. If hard pressed financially, he has the options of selling out completely, becoming a part-time farmer if circumstances permit or relinquishing managerial control to outside capital and becoming the hired hand of absentee management. The Tax Reform Act of 1969, though it addressed itself to the abuses perpetrated by "tax-loss" farming did not go far enough in remedying the situation. Tax shelters for non-farmers still exist in agriculture and must be dealt with legislatively.

Nonfarm investors buying up agricultural land also creates another tax problem for farmers. A newspaper headline we recently saw sums up the farmer's predicament. "Raw Land the Hottest Thing on the Market," the headline read.

"Little question about it," the columnist wrote, "millions of acres of land on the fringe of metropolitan areas are going for increasingly higher prices each year and thousands of speculators, from small fry to giant corporations are aware of it."

This situation, accurately described by the newspaperman, is resulting in higher and higher assessments on agricultural land for tax purposes. Since our local governments and school systems must rely predominately on the property tax for support, the added tax burden on farmers, especially those near metropolitan areas, becomes unbearable and they must sell out to these same speculators, be they small fry or giant corporations. State governments including that of Wisconsin, have addressed themselves to this problem but thus far there is little indication that it is being satisfactorily resolved anywhere in the United States.

In the meantime the land rush goes on. I am personally acquainted with a situation in Wisconsin in which a realty firm is willing to pay as high as $500 per acre for as much land as they can acquire in western Wisconsin. This is considerably above the $363 per acre that farm land averaged in sales in Wisconsin in 1973.

Another phenomenon which I am sure is being repeated throughout the country is that of the commuting suburbanite who now is becoming the commuting urbanite. Airline pilots and others are purchasing farms, comfortably removed from the hub-bub of urban living. They commute to their occupation centers with light planes. The luxury of such rural living often comes out of the unfortunate hides of their farmer-neighbors in higher property taxes.

Our inheritance tax laws are also literally killing a farm family's chances of economic survival. Payment of estate taxes on inherited farm land often obligates the family to sell part of the farm to pay the taxes. The $60,000 exemption, established in 1943, is completely out of date in view of the kind of capitalization figures I recited here today. Legislation has been introduced to raise the deduction from $60,000 to $185,000, a much more realistic figure in regard to current economic conditions. Possibly Congress should also consider extending the period over which the inheritance tax is paid by the heirs.

Unfair taxation was a root cause of the rebellion of the colonies against the king of England 200 years ago. We are not preaching any revolutionary doctrine here

today, but we wish to impress upon the members of Congress that farmers are the victims of discrimination under our tax laws.

In addition to changing our tax laws, Congress is properly concerned about providing low cost capital to farmers, especially young, beginning farmers. What are the chances of a farm boy starting out from small beginnings and becoming a debt-free owner of a half million dollar farm enterprise in his lifetime. Not very good at best. Not very good at all if the institutions of government through government programs, credit agencies, and educational assistance are not available to give all the aid possible.

I would like to conclude with a quotation from a recent speech by Don Paarlberg, director of agricultural economics with the U.S. Department of Agriculture. He asked these pertinent questions:

> Will the young men now starting out in farming be willing to stint themselves on the good things of life for 30 years or so in order to amortize an enormous debt? If they themselves were willing, would they be able to persuade wife and children to share that kind of life? How satisfying is it to postpone living until one is ready for dying? Of what avail is it to be the richest man in the cemetery? Will our farmers be only those who inherit their farms or marry them? And even so, how can one buy out the other heirs?

-30-

Senator NELSON. The committee intends to go into the whole question of the family size farm and its problems during the course of the next year. And I would hope that out of that inquiry, we can develop some consensus on a number of the proposals, and others that you have made here. There is not any doubt in my mind that we will drive the family farmer out of business because of what is happening in land values and outside investors. This is so despite the fact that in dairying, which I am familiar with, and the agricultural economics studies in our own ag-econ department at the University of Wisconsin demonstrate that there is not anybody who is as efficient in producing milk and getting it to the market as is the family size farmer. No big corporation can compete with it. And yet the family farmer cannot cope with the competition of corporate investors who can pay $100 an acre more for land than it is worth.

And, as you well know, the hearings we conducted way back in 1967, looking into events then going on as far east as Minnesota and all the way into the west, where corporations were paying $100 or more an acre above the value of that land for agriculture. We learned that such investors could write off their expenses as a tax loss and hold on to the farm, fully confident that given a few years of tax losses, which they can stand, writing it off against other profitable operations, the land will achieve the value they paid for it—and above that. So it makes such an investment profitable for them. But no farmer can afford it.

Do you have any questions, Senator Haskell?

Senator HASKELL. No, I do not have any questions.

Well, I have just one. Would you say that the average investment in Colorado would be about the same as Wisconsin, or would you know?

Mr. ROHDE. I think it would be larger. It is a completely different type of agriculture. I am not thoroughly familiar with the value of land, as it is considered in a wheat farm.

However, the requirements of personal property are completely different. I think in some areas where you have highly concentrated and specialized farming, such as your potato farmers, their investments are considerably higher.

Senator HASKELL. Thank you.

Senator NELSON. Does the U.S. Department of Agriculture have a breakdown by State of farm values?

Mr. ROHDE. I cannot answer that. I believe they do.

Senator NELSON. We will have staff check that.[1]

Thank you very much for your very helpful testimony.

Mr. ROHDE. Thank you, Mr. Chairman, and Mr. Haskell.

Senator NELSON. Our final two witnesses are Mr. Roland Bixler, president of J–B–T Instrument, Inc., chairman of the Task Force on Small Business Tax Policy of the National Association of Manufacturers; and Cliff Massa, director of taxation, National Association of Manufacturers, who will be testifying on new techniques of revenue estimating.

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[1] See Appendix XII, booklet entitled "Farm Real Estate Market Developments," published by the Economic Research Service, U.S. Department of Agriculture.

I am sorry that you are at the end of the hearing and had to wait so long.

But, you will have 35 minutes before the Senate rule goes into effect. So, you may present your testimony however you desire.

STATEMENT OF ROLAND M. BIXLER, PRESIDENT, J-B-T INSTRUMENTS, INC., CHAIRMAN, TASK FORCE ON SMALL BUSINESS TAX POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. BIXLER. Thank you, Mr. Chairman and members of the committee.

My name is Roland Bixler. I am the president and cofounder of J-B-T Instruments, Inc., which is a small closely held independent business, manufacturing electrical instruments and electronic components located in New Haven, Conn. Our company employs about 225 people, which certainly qualifies us as a small business, though that seems like quite a lot when you get to payday. And in an industry where there are many much larger companies, I am at least glad to say that our company has demonstrated its ability to survive in every kind of economic climate because we observed our 35th anniversary just recently.

Some of the discussion this morning by Mr. Richard, for example, was of great interest to me because I also happen to be chairman of the State Taxation of Interstate Commerce Committee of the National Association of Manufacturers and this subject does have a heavy impact on small business. As you know, jurisdiction over this complex problem lies with the Senate Finance Committee.

At another time I hope there also might be opportunity to discuss the capital cost recovery system which was mentioned this morning, because that also is of prime importance.

My primary focus is as a small manufacturer, but I have helped to direct or operate 6 or 7 other small businesses, including a Subchapter S corporation. J-B-T is just about ready to start a DISC corporation—at the very time there is discussion about whether DISC corporations will be permitted to continue. Thus, I have a deep and continuing interest in the policies and actions of the Federal government, as they affect the ability of all sizes of businesses to produce the goods and services which our economy requires.

Speaking today specifically as the chairman of the Task Force on Small Business Tax Policy of the National Association of Manufacturers. I represent the NAM, as a broad-based trade association with approximately 13,000 member companies. Many persons are not aware that over 85 percent of all NAM manufacturing members are small businesses, in that they have fewer than 500 employees.

While recognizing that distinctions between the interests of large and small companies often are more illusory than real, since all are interrelated as suppliers, customers, or competitors, our Task Force on Small Business Tax Policy does study Federal tax policy and recommend changes in the light of small business problems. We are especially concerned with the ability of small firms to generate and retain internal capital which is needed for modernization and for the expansion of their business and their payrolls.

In recent years, the task force and the NAM have been active in the effort to increase the corporate surtax exemption as one simple, efficient and equitable means for providing much needed tax relief to small companies.

We are pleased that the Congress took an important first step in this area, by providing for a 1-year increase in the exemption to $50,000 in the Tax Reduction Act of 1975.

Our task force has a number of other tax policy items, which we feel should be considered by the Congress in the very near future. While they would improve the capital formation prospects, for business in general, they would be especially helpful to small firms. We understand that your committees will be holding additional hearings at a later date on a number of topics. And, therefore, I will just mention a few of the specific items which our Small Business Task Force feels ought to be included.

One is to make permanent the increase in the corporate surtax exemption; also, to consider at least $100,000 as the proper amount, taking into account the inflation which has occurred and the other arguments that we have heard this morning.

The second part of our program is a reduction in the corporate tax rate, both normal and surtax, but without creating additional notches or graduation.

The third is a stable and permanent investment tax credit of at least 10 percent, such as we have now, but, as you know, for only 1975 and 1976, coupled with liberalized rules for applying credit to structures and for extending the carry-over periods.

And, fourth, the creation of a capital recovery allowance system to replace an outdated "useful life" depreciation system, which inhibits adequate internal capital formation.

Each of these items certainly should be considered by the Congress and included in a true tax reform package. But, the invitation to appear today was essentially to discuss an NAM taxation committee study, which is so new, it was just released on Monday of this week. It is called the *Tax Impact Project Report*. And it was undertaken to develop in advance an economic analysis of various tax proposals so that it gives us more than just the traditional revenue estimates, which measure only the initial impact on increased or decreased tax liabilities.

Senator NELSON. Do you have a copy of that report.

Mr. BIXLER. We do, Mr. Chairman.

Mr. MASSA. I think there are enough copies. Everyone should have one.

Senator NELSON. We will receive this and print the whole report in the appropriate place in the record, near your testimony.

Mr. BIXLER. Mr. Massa is going to discuss that in more detail. But, I cannot over-emphasize the importance of this first effort to quantify the expectation of what may happen over a 5-year period from changes in legislation rather than simply obtaining the estimates of Federal revenues that we have traditionally had before.

The NAM shares the interest of this committee in studying the effects which tax changes have beyond the individual changes in tax payments. And we think that the study that Mr. Massa is going to discuss in detail demonstrates that tax changes do not occur in a

vacuum. That is, the economy does not go on just as it has before, but the economy makes significant adjustments to meet significant tax changes. That certainly has been my own observations through the years in trying to meet the tax bills and do the economic planning for various small businesses.

With your permission, Mr. Chairman, I would like to turn the discussion over to Mr. Massa, who is the director of taxation for the NAM. He has worked very closely with the special industry group which undertook the project and which has published this first report. Hence, he is more familiar with the technique and methodology. So, I have asked him to discuss it, if that meets with your approval.

STATEMENT OF CLIFF MASSA, DIRECTOR OF TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. MASSA. Mr. Chairman, my name is Cliff Massa, and I am the director of taxation for the National Association of Manufacturers. We have submitted in advance copies of my full statement. Unfortunately, I am working with a cold this morning, and we are also running against time.

So, I would just like to summarize briefly what is involved in this report and give you some idea without reading the whole prepared statement.

Senator NELSON. All right. You summarize it however you desire, and your whole statement will be printed in the record as well as the Tax Impact Project Report itself at the conclusion of your testimony.

Mr. MASSA. Thank you, Mr. Chairman.

The NAM undertook this project late in 1974 because the full committee—the full NAM taxation committee—realized that the Internal Revenue Code and our entire tax structure have gotten so large from their original inception in 1913 to over 37 chapters now, and thousands of pages of regulations and they affect so many different areas of the economy, that the use of initial revenue estimates as a means of gauging the impact of tax proposals and proposed tax changes is helpful, but leaves a great deal to be desired because it does not go far enough in attempting to estimate what the larger economic impact is going to be.

As Mr. Bixler indicated, businessmen have to react to changes in tax laws, and those changes are going to affect their ability to invest and their ability to hire new employees. In fact, over the long run, they are going to affect their Federal tax payments because of the change in economic activity. The purpose of the project was to begin to develop a method for estimating in advance what these effects would be, and hence the tax impact project was undertaken with the objective in mind of being able to develop a method of estimating such economic impact.

Now, what the project did essentially was to build on the initial impact of tax changes. We surveyed in late 1974 a number of NAM member companies. In fact, specifically 1,050 of our largest companies in all major manufacturing industry SIC codes (Standard Industrial Classification Codes) and a random sample of 500 of our smaller members. We particularly took these groups because we wanted

to see if there would be any difference in changes in the tax liability as you go between large and small members.

We were trying to get this initial impact data to begin our project with. We got a very good response from our larger members, over 313 out of 1,050. For the small members, unfortunately the response was much less significant—only 16 out of 500. We found in talking with a number of those members that this was just one more piece of paper which came their way that somebody was asking them to do something with and they said, "Fellows, we would like to help you, but it is at the bottom of the stack and we cannot get to it." Also, a number of the businessmen and the smaller independent businessmen do not have the technical staff and capability on hand and on call to be able to answer a questionnaire regarding what would be the impact of a 10-percent investment tax credit or no credit, for example.

So, that attempt on our part met with very little success, the attempt to see whether tax changes affect large and small companies in different ways. I think that it is going to be difficult to attempt to gage the impact of such tax changes on small companies. But, it is something that probably can be developed a little bit further.

We took this initial tax impact and we asked essentially a simple accounting question. In your last taxable year—and for the time that we distributed the survey, that was generally taxable year 1973, sometimes fiscal 1974—what would happen to your tax liability if a particular change were enacted. We sent a long list and there were 17 which were included in the proposals which we have printed in the report. They have to do with the investment tax credit, the Asset Depreciation Range, the minimum tax, DISC, corporate tax rate, and several other areas including changes in foreign source income taxation. We asked a simple accounting question and we got some data on changes in tax liability.

We took that information then and with the technical assistance of a trained economist and econometrician, we introduced the survey input into a well recognized and established econometric model. The one we used was Data Resources, Inc., based in Cambridge, Mass., which is one of, I think, two or three well-known models, including the Wharton School of Finance which has one, I believe, and Chase. But, we took these survey data, introduced them into the model in two areas—to change what the model's economic data says about what Federal tax receipts would be in a given year; and also we made one basic assumption as to how these tax changes would affect investment.

Assume that a dollar change in taxes is going to change a company's cash flow, if you will, by an equal dollar amount. We found that there has been a stable relationship over the years between cash flow (corporate cash flow) and corporate investment—or I should not say corporate investment—all private nonresidential investment in the economy.

So, assuming that a dollar change in tax liability is going to change somebody's cash flow (cash that runs through the company in any given year) and that there is a stable relationship between cash flow and investment in this economy, and historically there has been, and the figures are presented in the report, any percentage change in your tax liability is going to result in an equal percentage change in your ability to invest.

So, using the tax liability changes which we have received from a number of large taxpayers, it was introduced into the econometric ments ourselves. We asked our respondents for no subjective judgments about what they would do in changing their investment patterns. We just took the numbers and made that simple assumption, which seems to be historically accurate, and let the econometric model then work itself out over a period of years to see what the tax change would do to a number of economic factors—to real fixed investment in the economy; to employment in manufacturing; to total employment; to real GNP; and finally, what is the net effect on Federal tax receipts as opposed to the traditional form of revenue estimate which the Congress and the Treasury have worked with. What is the net effect going to be over the years as the feedback effects of tax changes begin to work themselves through the economy?

I think that many people recognize that there are such feedback effects. But no real attempt has been made in the past to quantify them. So, we were attempting to develop a methodology to do just that, and that was what essentially took place in the *Tax Impact Project Report* on 17 particular tax proposals. In a nutshell, that is what the project entails.

Now, the report is some 44 pages long. It goes into detail about the methodology and the econometrics that are involved. I am not really qualified to explain how an econometric model with some 900 simultaneous equations works. But we think we have come up with numbers which will indicate the directions that tax impacts or the economic impacts will take and the order of magnitude that that impact will have over a 5-year period, so that the Congress and the business community will have some additional tools to work with in assessing the impact of tax legislation. Considering how important the Federal income tax structure is in the economy, we think that tax legislation in the future should be the subject of more analysis like this because the tax structure's size is such that it affects virtually everything that goes on. It has grown to that point.

We are hopeful that this will provide a basis for further development and refinement of approaches like this. Your staff has known as we have been developing this approach that it was underway, and that is why they asked us to come this morning, because we understand that the committee is interested in really trying to determine how tax policy affects business, particularly the small business community beyond just initial changes in tax liability. It has to have some effect, and this is a start in trying to come up with such impact.

That briefly is what we have done. As Mr. Bixler indicated, this report was released Monday, June 16. We have provided some additional copies for the committee members and staff. We would be happy to answer now any questions you might have about it, and certainly we would be willing to talk with anyone at any later time after people have had an opportunity to plow through the document itself.

Mr. Chairman, we thank you for the invitation to come up this morning.

[The prepared statement of Mr. Massa and the report referred to follow:]

BEST COPY AVAILABLE

STATEMENT OF CLIFF MASSA III, DIRECTOR OF TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS, BEFORE JOINT HEARINGS OF THE SENATE SELECT COMMITTEE ON SMALL BUSINESS AND THE SENATE FINANCE COMMITTEE'S SUBCOMMITTEE ON FINANCIAL MARKETS, JUNE 19, 1975

Mr. Chairmen, members of the Small Business Committee and Financial Markets Subcommittee, my name is Cliff Massa. I am Director of Taxation for the National Association of Manufacturers. The NAM appreciates your invitation to appear today to discuss with you the methodology of our recently released economic impact study of seventeen specific proposals which would affect the taxation of business income. The business community shares your interest in studying the effects which federal tax policy have on general economic activity, and we welcome this opportunity to discuss one approach to such a study.

The NAM's Taxation Committee undertook the Tax Impact Project in the fall of 1974. There were three general objectives for the project:

To begin the development of a method of estimating the overall economic impact of business-related tax proposals in general;

To develop economic impact estimates for specific proposals which might arise in 1975; and

To lay the groundwork for the possible development of a continuing project which could assess very rapidly the economic impact of any major tax proposal.

Considering the magnitude of the federal income tax structure, its intertwining with the economy and the massive capital needs of the future our Taxation Committee believes it is increasingly important that the economic consequences of proposed tax legislation be studied thoroughly. The project was conceived as a vital step in developing a capability to estimate in advance the effects which tax proposals would have on real capital investment, employment opportunities, real GNP and federal tax revenues over a period of years.

THE INCOME TAX IN OUR ECONOMY

The existing Internal Revenue Code—all 37 chapters plus thousands of pages of Treasury Regulations—has evolved from a very simple and uncomplicated ancestor. Following ratification of the Sixteenth Amendment, the federal income tax was enacted in 1913 as what appears, on the surface, to have been a minor after thought in a major tariff act. Most individuals fell within the 1% rate bracket on taxable incomes of up to $20,000, with relatively few affected by the graduation of rates up to a maximum of 6% at the $500,000 income level. Corporations were subject to a 1% tax rate on their incomes. The income tax provided 5% of federal net revenues in 1913.

However, during the past sixty years, the income tax system has grown considerably in size and in importance. For fiscal year 1974, the income tax on individuals and corporations provided $157.6 billion in federal revenues, approximately 75% of all federal budget receipts, excluding Social Security taxes on employers and employees. The individual rate structure now ranges from a minimum of 14% to a maximum of 70% on unearned income, approximately twelve times the comparable 1913 rates. The maximum rate is now 48% on corporate income.

THE RELATIONSHIP BETWEEN TAX POLICY AND ECONOMIC ACTIVITY

Thus, the federal income tax now plays a very significant role in the functioning of our economy. Business and consumers alike make expenditure plans based on many factors—fixed expenses, prices, availability of goods and services, essentials versus luxury items, hopes and fears about the future. Yet, in the final analysis, it is the availability of money which determines how far down the shopping list they can go. In this day and age, that means after-tax dollars.

This is particularly true of new capital expenditures by business. Investments in new physical plans and productive equipment or in modernization of existing facilities have an impact far beyond merely creating new employment opportunities within the investing companies themselves. Capital expenditures directly create employment for construction workers who build and modernize factories, for production workers who manufacture the construction materials and the equipment for the new and modernized facilities, for service workers who transport and maintain the new equipment, for administrative personnel

who handle transactions and production schedules and for many other related workers. The effects of capital expenditures also are felt as the businesses and individuals who are paid for their goods and services spend their incomes. The spending and re-spending of the invested dollars generate a higher level of economic activity than otherwise would be the case. As business and individual incomes rise, one additional beneficiary is the federal government which realizes increased tax revenues.

Unfortunately, general awareness of the potential economic impact of tax changes is fleeting. While it is easy to comprehend how a tax rebate or a general reduction of individual rates will favorably affect one's personal spending and investment plans, it is more difficult to understand how this effect can be multiplied thousands and millions of times across the country and how the resulting increase in economic activity can benefit the country as a whole, particularly through the business sector. And yet, the family-owned small business and the billion dollar manufacturing corporation are affected in the same general ways by changes in tax liability; only the magnitude of the impact is different.

THE NEED FOR MORE COMPREHENSIVE INFORMATION

One specific function which the project performed was to provide a more comprehensive means of measuring the economic impact of tax proposals. For example, the existing procedure for estimating revenue impacts of tax proposals involves estimating the change in tax liabilities based on expected levels of income in areas affected by a proposal. As a means of comparing the initial impact of various proposals, this can be a useful procedure.

As a means of estimating what will actually happen to federal revenues, such a procedure stops short of a complete assessment of the impact of a specific proposal. In considering only the initial impact of a proposal, it assumes that no compensating actions are taken by the taxpayer.

With respect to changes in taxation of business income, the project considered the secondary or "feedback" effects of tax proposals. As earnings are reduced, business investments will be altered, employment levels will be affected, dividends may be changed and price structures may be subject to review. Multiplying these changes by the thousands of companies and the millions of individuals affected indicates the magnitude of the "feedback" effects which tax proposals can generate. These changes in turn can have a considerable effect on taxable incomes which then determine the federal revenues for a given period. Therefore, the project built on the initial impact revenue figures in estimating the *net* changes in federal tax receipts, one of the factors which was considered.

SELECTION OF THE ECONOMETRIC APPROACH

Studying the impact of tax proposals in terms of changes in investment, jobs, GNP and federal revenues is a complex task. Coupled with the need to consider the "feedback" effects of proposed changes, the project required the use of a well developed econometric computer model to take into account the hundreds of equations which simulate actual relationships within the economy.

An established and well recognized econometric computer model—the Data Resources, Inc., model—was chosen for the purpose of generating the type of information sought by the project. A survey was constructed to collect the data to be used as input into the model. None of the assumptions or structural relationships within the model were altered.

THE ECONOMETRIC MODEL

An econometric model of the economy is a series of functional relationships tying the various sectors of the economy together into a unified system. A model is designed to measure mathematically and statistically these relationships among numerous economic variables. Such models are useful in analyzing specific elements of economic activity, as well as for tracing the complex feedback and interrelationships within the total economy.

Basically, a model consists of a number of simultaneous equations, each of which describes a certain functional relationship within the economic system. The number of equations in a model will vary depending upon the scope of the model. The project used the Data Resources, Inc. (DRI), Long-Term Model of the U.S. Economy, which consists of over 900 equations which identify and measure the interrelationship among all major sectors of the economy.

THE SURVEY

To best utilize the econometric model, it was desirable to gather data regarding the initial impact of the tax proposals on the tax liabilities and capital investments of industrial taxpayers. This was accomplished through a survey of NAM member companies.

The survey was mailed to 1,050 of the largest NAM member companies and 500 of the smallest members in November 1974. The 1,050 largest members were the fifty largest member firms (by sales volume) in each of the manufacturing Standard Industrial Classification (SIC) Codes from 20 through 39, plus utility SIC Code 49. The 500 small members were selected at random from NAM members with 500 or fewer employees. The purpose of surveying such small companies was to determine to what extent, if any, the tax proposals would have different effects on small versus large companies.

The survey form collected data on the initial impact of the proposals by asking for the dollar impact which each proposal would have had on the company's most recent taxable year.

From the 1,050 largest companies, 318 responses were received and used in compiling the percentage changes in tax receipts and investments used as inputs for the model. Over sixty percent of the responses were based on calendar 1973. Approximately twenty percent were for fiscal 1974. At the time of the survey, this was the most recently available information. Only 16 responses were received from the smaller companies.

In order to obtain general macroeconomic results from the initial effect of a tax proposal as determined by the survey, a long-term macroeconomic model was chosen. If a model of the current economy had been used, the results would have been distorted by the existing recession. As a result, the figures would not provide a reasonable statement of the economic impact of the proposals over a long-term period. Further, since the majority of the survey responses were based upon calendar year 1973, it would have been inappropriate to use the results in a model of today's economy. Therefore, the survey results were used as input into the long-term model which assumes that the economy is at or near its long-term growth path. If the tax changes were adopted in a recession, the effects would be somewhat altered.

While 1973 was not a normal year in many respects, industrial utilization, economic growth, and the level of unemployment were close to generally considered long-term full employment growth levels and consistent with the assumptions of the long-term model that was used. Inflation increased dramatically throughout 1973 and was at rates quite above the assumptions of the model. However, since the results of the survey were interpreted in real terms, much of this bias was eliminated.

The survey data on each change in tax liability were compiled by SIC code. It was assumed that such changes in tax liability result in equal dollar changes in corporate cash flow. Also, a constant ratio of total investment to cash flow was assumed for determining the *initial impact* of a change in cash flow on investment. Once the feedback mechanism of the interrelationships within the economy is felt, however, the process becomes much more complex. While the initial impact on investment is determined by the change in cash flow, the subsequent impact is determined by changes in demand, the movement of interest rates, the cost of capital, the change in dividend payments and other factors.

Once the change in investment was determined in each SIC code, these changes were weighted to represent the relative importance of investment in that SIC code to total investment in the economy. Then the initial changes in tax liabilities and investment in each industry flowed into the macroeconomic model where the feedback effects began to work. The changes ripple throughout various sectors of the economy and the macroeconomic impact is determined.

The model solved the various equations and produced the impact data which were included in the report as its findings. For a more detailed discussion of the methodology and assumptions of the project, I refer you to Appendix C of the *Tax Impact Project Report.*

The Tax Impact Project is one approach to the study of the economic impact of tax changes. Its findings are to be interpreted as providing *direction* and the *order of magnitude* which such impact would take. We believe that this project will be useful during current consideration of tax legislation and that it will be stimulative of further developments in this area.

TAX IMPACT PROJECT REPORT

Additional copies of this report
are available upon written request to:

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Washington, D.C. 20006

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DUE TO PRINTER ERROR·

Chart on page 14 is correct; title is incorrect—should read
Chart 1: MACROECONOMIC MODEL

Chart on page 16 is correct; title is incorrect—should read
Chart 2: TAX IMPACT PROJECT MODEL

June 16, 1975

The Committee on Taxation of the National Association of Manufacturers undertook this Tax Impact Project to begin developing a better method of estimating the overall economic consequences of proposed changes in federal taxation of business income. Because of the very close relationship between federal tax policy and economic activity, we believe that it is essential for major tax proposals to be considered in conjunction with objective analyses of their impact on capital investment, employment and the income tax base.

This report is one approach which we believe can be useful at the present time and stimulative of further development and refinement of the analysis of tax proposals in the future.

The project was developed by a special task force of committee members whose very considerable efforts have resulted in the preparation of this report. The task force was provided technical advice and assistance by Dr. Jerry E. Pohlman of Arthur Young and Company, New York, New York.

E. A. Vaughn
Chairman
Committee on Taxation

SUMMARY OF THE REPORT

This report describes a study of the impact on the economy which would be generated by each of seventeen proposals for changes in federal taxation of business income. Survey data were obtained from 313 diverse corporations representing 36% of total U. S. manufacturing sales. These data were used as input to a large macroeconomic computer model of the U. S. economy.

Every change in taxation of business income naturally would affect both corporate earnings and the entire economy in some way. The purpose of the Tax Impact Project is to focus on this relationship and to develop information which will be of use during the consideration of proposed modifications of the U. S. tax structure. The report presents the findings of the project in a manner which allows for comparisons of the economic impact of various proposals. The findings indicate that certain proposals are of major importance to the business community in allocating its resources in the most efficient manner.

Seventeen proposals for changes in federal taxation of business income were studied, and their overall domestic economic impact is described as changes in:

- -- REAL FIXED INVESTMENT,
- -- MANUFACTURING EMPLOYMENT,
- -- TOTAL EMPLOYMENT,
- -- REAL GNP, AND
- -- NET FEDERAL TAX RECEIPTS.

It is recognized that the Tax Impact Project represents only one of a number of possible approaches to the economic analysis of tax proposals. As such, it is one step in the development of a reasonable method for obtaining such analyses. Thus, this report is intended to indicate the direction and the order of magnitude of the impact of the tax changes which were studied. In this regard, the econometric findings presented in this report should only be interpreted as somewhat imprecise estimates -- as are all estimates of what will in fact happen in the future.

The project is not simply a scale-up to the whole economy from the survey response data. Through use of a large macroeconomic model, it also takes into account a complex array of interactions and feedback effects between different parts of the economy, which are intended to simulate the real economic world. Such effects, of course, do not occur simultaneously. The findings are best interpreted as the likely economic consequences a few years after enactment of a tax proposal, i.e., after the effects of the proposed change would have had a chance to work their way throughout the national economy.

THE EFFECT ON TOTAL EMPLOYMENT FOR EACH OF THE SEVENTEEN PROPOSALS IS SHOWN IN THE FOLLOWING TABLE AND IS EXPRESSED AS THE DIFFERENCE FROM WHAT WOULD HAPPEN IN FUTURE YEARS WITHOUT THE TAX CHANGE. Results are presented in the body of the report for real fixed investment, manufacturing employment, real GNP, and net federal tax receipts.

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TOTAL EMPLOYMENT EFFECTS

Proposed Change	First Year	Five Years Cumulative
1. 10% Investment credit	+ 80,000	+1,170,000
2. 40% ADR	+ 70,000	+ 890,000
3. Current CFC taxation with no foreign tax credit	-240,000	-2,720,000
4. Repeal of the investment credit	-120,000	-1,600,000
5. Repeal of the foreign tax credit	-110,000	-1,240,000
6. 50% corporate rate	- 60,000	- 740,000
7. Current CFC taxation	- 60,000	- 680,000
8. Repeal of ADR	- 50,000	- 570,000
9. Multiple changes in the minimum tax	- 40,000	- 520,000
10. Repeal of DISC	- 20,000	- 280,000
11. Repeal of tax deduction in minimum tax	- 10,000	- 170,000
12. 30% rate in minimum tax	- 10,000	- 160,000
13. Repeal of "possessions" treatment	- 10,000	- 160,000
14. Repeal of minimum distributions	- 10,000	- 70,000
15. Repeal of "per country" limitation	- 10,000	- 60,000
16. Repeal of WHTC	- 10,000	- 50,000
17. Repeal of LDCC exceptions	- 10,000	- 50,000

Significantly, the findings indicate that most of these proposed changes would reduce the level of total employment over a period of time.

****

A SHORT-TERM INCREASE IN FEDERAL TAX RECEIPTS IS, OF COURSE, EXPECTED IF BUSINESS TAXES ARE INCREASED. THE FINDINGS OF THIS STUDY, HOWEVER, SUGGEST THAT SUCH INCREASES ARE OBTAINED AT HIGH COST IN THE LONG TERM, THROUGH

1. REDUCED CAPITAL INVESTMENT,
2. REDUCED NUMBER OF JOBS FOR THE LABOR FORCE,
3. REDUCED GNP, AND ALSO, BECAUSE OF THESE ADVERSE CHANGES IN THE ECONOMY,
4. REDUCED FEDERAL TAX RECEIPTS IN THE FUTURE.

ON THE OTHER HAND, SIGNIFICANT DECREASES IN BUSINESS TAXES WILL GENERATE LONG-TERM BENEFICIAL EFFECTS ON INVESTMENT, EMPLOYMENT, THE ECONOMY AND FEDERAL TAX RECEIPTS.

Table of Contents

Page

SUMMARY OF THE REPORT .... ii-iii

INTRODUCTION vii

FINDINGS OF THE PROJECT 1

Major Proposals Affecting Domestic Source Income:

10% Investment Tax Credit 1
40% ADR 2
Repeal of the Investment Tax Credit 2
Repeal of ADR 3
50% Corporate Tax Rate 3

Major Proposals Affecting Foreign Source Income:

Current Taxation of CFC Earnings 4
Repeal of the Foreign Tax Credit 4
Current Taxation of CFC Earnings coupled with Repeal of the Foreign Tax Credit 5
Repeal of DISC Provisions 5

Other Proposals

Changes in the Minimum Tax 6
Repeal of "Possessions Income" Treatment 7
Repeal of "Minimum Distributions" 8
Repeal of "Per Country" Limitation 8
Repeal of Western Hemisphere Trade Corporation (WHTC) Provisions 9
Repeal of Less Developed Country Corporation (LDCC) Provisions 9

WHY A TAX IMPACT PROJECT? 10

The Income Tax in Our Economy 10
The Relationship Between Tax Policy and Economic Activity 11
The Need for More Comprehensive Information 12
Selection of the Econometric Approach 12

METHODOLOGY OF THE PROJECT 13

The Survey 13
The Econometric Model 14

Page

APPENDIX A: DESCRIPTIONS OF THE TAX PROPOSALS........................ 19

Major Proposals Affecting Domestic Source Income................. 19
Major Proposals Affecting Foreign Source Income.................. 20
Other Proposals... 21

APPENDIX B: INDUSTRIES SURVEYED.. 23

APPENDIX C: DETAILED EXPLANATION OF THE METHODOLOGY.................. 24

The Survey of NAM Members... 25
The Microeconomic Effects... 26
The Feedback Effects: Use of the Macroeconomic Model............. 29
Assumptions of the DRI Long-Term Model........................... 32
Data Sources.. 34
References and Selected Bibliography.............................. 36

INTRODUCTION

The federal income tax plays a very significant role in the functioning of our economy, and changes in the tax system can have a very significant impact on the general health of our economy, particularly when those changes affect the industrial sector. Capital investments in new or modernized production facilities, which thereby create new employment opportunities and increase overall economic activity, are funded generally by capital consumption allowances, by retained earnings and by the amount of borrowed capital which such funds can support. To the extent that changes in tax law have a direct impact on the level of such earnings, they have an equally significant indirect impact on future levels of new investments, employment and total federal revenues. Thus, the overall economic impact of any proposed tax legislation will be much greater than can be indicated by an estimate of initial revenue gain or loss.

The project (TIP) used a survey of NAM members to measure the initial impact which specific tax proposals would have on tax liability. Coupled with the specific assumptions that changes in tax liability result in equal but opposite dollar changes in cash flow and that percentage changes in cash flow generate identical percentage changes in investments, these initial changes were applied to the overall economy through the Data Resources, Inc., (DRI) Long-Term Model of the U. S. Economy to determine how they would affect real fixed investment, employment, GNP and federal tax receipts over a period of years.

TIP REPRESENTS ONE METHOD OF ESTIMATING THE OVERALL ECONOMIC IMPACT OF TAX CHANGES. THE TIP FINDINGS ARE TO BE INTERPRETED AS INDICATIONS OF THE DIRECTION AND THE ORDER OF MAGNITUDE OF THE IMPACT OF EACH PROPOSAL, NOT AS PRECISE STATEMENTS REGARDING THE FUTURE EFFECTS OF SUCH PROPOSALS.

THE ECONOMIC EFFECTS OF EACH PROPOSAL, AS DERIVED BY THE ECONOMETRIC MODELING PROCESS, ARE EXPRESSED AS PERCENTAGE DIFFERENCES FROM WHAT WOULD HAPPEN IN THE U.S. IN FUTURE YEARS WITHOUT THE TAX CHANGE. AS SUCH, THEY DO NOT REPRESENT ABSOLUTE CHANGES FROM CURRENT LEVELS OF INVESTMENT, EMPLOYMENT, GNP AND TAX RECEIPTS.

For purposes of illustration, these percentages have been applied to 1977-1981 estimates of economic activity to produce dollar and job figures. Assuming enactment of any of these proposals in mid - 1975, this allows an eighteen-month interim as the period during which the impact of the change would be fully realized throughout the economy. (This does not assume that there will be no effects prior to 1977.)

NOTE: The percentages and the dollar amounts of changes in real fixed investment and real GNP are presented in terms of constant 1958 dollars whereas the percentages and dollar amounts with respect to federal tax receipts are net in terms of current dollars. The tables on pp. 1-9 are structured with the percentage change in each economic factor presented in the top row (%) and the dollar and job change in the bottom row (1958 $ billions, thousands of jobs, current $ billions).

FINDINGS OF THE PROJECT

The Tax Impact Project (TIP) has estimated the overall economic impact which would be generated by each of seventeen specific tax proposals affecting business income. The findings are presented below in three groups of tables -- Major Proposals Affecting Domestic Source Income, Major Proposals Affecting Foreign Source Income and Other Proposals. Explanations of the specific proposals are included in APPENDIX A. For a brief description of what the figures in the tables represent, see the INTRODUCTION on page v.

Major Proposals Affecting Domestic Source Income

Of the seventeen proposals studied by TIP, the findings suggest that five which affect primarily domestic source income would have major impact on the domestic economy. Two of these would have long-term beneficial effects while three others would have adverse consequences.

The two beneficial proposals are enactment of a permanent 10% investment tax credit and of a 40% ADR. The TIP findings indicate that they would stimulate capital investment, thereby generating new employment opportunities throughout the economy. The resulting increase in business and personal taxable incomes would more than offset the initial reductions in tax liabilities.

The proposals with adverse consequences include repeal of the investment tax credit, repeal of ADR and an increase in the corporate tax rate. The TIP findings indicate that the long-term effects of each proposal would be to reduce the level of capital investments, thereby lowering the levels of employment which will otherwise develop. The resulting decrease in economic activity would lower taxable business and individual incomes, thereby more than offsetting estimates of initial revenue gains.

Table 1 -- 10% Investment Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR-CUM TOTAL
Real fixed investment (%)	+3.06	+3.89	+3.85	+3.88	+4.05	+3.73	
(1958 $ billions)	+3.44	+4.77	+5.04	+5.36	+5.87		+24.48
Manuf. employment (%)	+ .90	+1.00	+ .92	+ .98	+1.01	+ .96	
(thousands of jobs)	+ 180	+ 210	+ 190	+ 210	+ 220		+ 1010
Total employment (%)	+ .10	+ .24	+ .28	+ .33	+ .37	+ .27	
(thousands of jobs)	+ 80	+ 200	+ 250	+ 300	+ 340		+ 1170
Real GNP (%)	+ .41	+ .51	+ .55	+ .62	+ .67	+ .56	
(1958 $ billions)	+3.82	+4.99	+5.63	+6.59	+7.38		+28.41
Federal tax receipts (%)	- .46	- .37	- .30	- .14	+ .05	- .24	
(current $ billions)	-1.83	-1.61	-1.42	- .72	+ .28		-5.30

Table 2 -- 40% ADR

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	+2.45	+2.99	+2.88	+2.90	+3.06	+2.86	
(1958 $ billions)	+2.75	+3.67	+3.77	+4.00	+4.44		+18.63
Manuf. employment (%)	+ .69	+ .76	+ .73	+ .76	+ .78	+ .74	
(thousands of jobs)	+ 140	+ 160	+ 150	+ 160	+ 170		+ 780
Total employment (%)	+ .09	+ .19	+ .20	+ .24	+ .28	+ .20	
(thousands of jobs)	+ 70	+ 160	+ 180	+ 220	+ 260		+ 890
Real GNP (%)	+ .41	+ .41	+ .43	+ .49	+ .54	+ .45	
(1958 $ billions)	+3.82	+4.01	+4.40	+5.21	+5.95		+23.39
Federal tax receipts (%)	- .35	- .28	- .23	- .11	+ .03	- .19	
(current $ billions)	-1.39	-1.22	-1.09	- .56	+ .17		- 4.09

Table 3 -- Repeal of the Investment Tax Credit

NOTE: <u>This table assumes the existence of a 7% investment tax credit (4% for utilities)</u>. Similar results could be expected to occur if the credit (now 10% under P.L. 94-12) is repealed during the next several months. However, the magnitude of the impact could be expected to increase substantially if repeal is enacted when the new 10% rate is exercising its full effect.

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-4.17	-5.31	-5.25	-5.30	-5.54	-5.11	
(1958 $ billions)	-4.68	-6.52	-6.88	-7.32	-8.03		-33.43
Manuf. employment (%)	-1.25	-1.32	-1.25	-1.37	-1.45	-1.33	
(thousands of jobs)	- 250	- 270	- 260	- 290	- 310		- 1380
Total employment (%)	- .15	- .34	- .38	- .44	- .51	- .36	
(thousands of jobs)	- 120	- 290	- 330	- 390	- 470		- 1600
Real GNP (%)	- .58	- .70	- .74	- .85	- .95	- .81	
(1958 $ billions)	-5.40	-6.85	-7.58	-9.04	-10.46		-39.33
Federal tax receipts (%)	+ .62	+ .52	+ .43	+ .22	- .03	+ .35	
(current $ billions)	+2.46	+2.27	+2.04	+1.13	- .17		+ 7.73

Table 4 -- Repeal of ADR

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-1.63	-1.95	-1.88	-1.92	-2.03	-1.88	
(1958 $ billions)	-1.83	-2.39	-2.46	-2.65	-2.94		-12.27
Manuf. employment (%)	- .44	- .48	- .45	- .50	- .52	- .48	
(thousands of jobs)	- 90	- 100	- 90	- 100	- 110		- 490
Total employment (%)	- .06	- .12	- .13	- .16	- .19	- .13	
(thousands of jobs)	- 50	- 100	- 110	- 140	- 170		- 570
Real GNP (%)	- .26	- .26	- .28	- .33	- .37	- .30	
(1958 $ billions)	-2.42	-2.55	-2.87	-3.51	-4.07		-15.42
Federal tax receipts (%)	+ .23	+ .18	+ .12	- .01	- .02	+ .10	
(current $ billions)	+ .91	+ .78	+ .57	- .05	- .11		+ 2.10

Table 5 -- 50% Corporate Tax Rate

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-1.88	-2.25	-2.17	-2.21	-2.34	-2.17	
(1958 $ billions)	-2.11	-2.76	-2.84	-3.05	-3.39		-14.15
Manuf. employment (%)	- .53	- .57	- .54	- .58	- .62	- .57	
(thousands of jobs)	- 110	- 120	- 110	- 120	- 130		- 590
Total employment (%)	- .07	- .14	- .15	- .18	- .22	- .15	
(thousands of jobs)	- 60	- 120	- 130	- 190	- 240		- 740
Real GNP (%)	- .30	- .30	- .32	- .38	- .42	- .34	
(1958 $ billions)	-2.79	-2.94	-3.28	-4.04	-4.62		-17.67
Federal tax receipts (%)	+ .26	+ .23	+ .19	+ .10	- .18	+ .12	
(current $ billions)	+1.03	+1.00	+ .90	+ .51	-1.00		+ 2.44

Major Proposals Affecting Foreign Source Income

The TIP findings indicate that four of the proposals affecting foreign source income would have significant impact on the domestic economy.

NOTE: TIP has estimated the economic impact of changes in tax liability, assuming that the relationship between domestic investment and foreign investment will remain constant. While long-term adjustments in the ratio of domestic to foreign investment could be expected to follow major changes in taxation of foreign source income, it is beyond the scope or capacity of TIP to make assumptions in this regard. Therefore, Tables 6, 7 and 8 represent the estimates of the economic impact of these proposals, assuming that changes in levels of investment will be distributed between domestic and foreign uses in the same ratio as presently exists.

Table 6 -- Current Taxation of CFC Earnings

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-1.91	-2.29	-2.20	-2.24	-2.38	-2.21	
(1958 $ billions)	-2.14	-2.81	-2.88	-3.09	-3.45		-14.37
Manuf. employment (%)	- .54	- .58	- .54	- .60	- .63	- .58	
(thousands of jobs)	- 110	- 120	- 110	- 130	- 130		- 600
Total employment (%)	- .07	- .14	- .15	- .19	- .22	- .15	
(thousands of jobs)	- 60	- 120	- 130	- 170	- 200		- 680
Real GNP (%)	- .30	- .30	- .33	- .39	- .43	- .35	
(1958 $ billions)	-2.79	-2.94	-3.38	-4.15	-4.73		-17.99
Federal tax receipts (%)	+ .27	+ .23	+ .19	+ .10	- .01	+ .16	
(current $ billions)	+1.07	+1.00	+ .90	+ .51	- .06		+ 3.42

Table 7 -- Repeal of the Foreign Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-3.44	-4.08	-3.93	-4.00	-4.24	-3.94	
(1958 $ billions)	-3.86	-5.01	-5.15	-5.52	-6.15		-25.69
Manuf. employment (%)	- .96	-1.02	- .96	-1.06	-1.12	-1.02	
(thousands of jobs)	- 190	- 210	- 200	- 220	- 240		- 1060
Total employment (%)	- .13	- .26	- .27	- .33	- .40	- .28	
(thousands of jobs)	- 110	- 220	- 240	- 300	- 370		- 1240
Real GNP (%)	- .55	- .54	- .58	- .69	- .76	- .62	
(1958 $ billions)	-5.12	-5.29	-5.94	-7.34	-8.37		-32.06
Federal tax receipts (%)	+ .48	+ .41	+ .34	+ .17	- .02	+ .28	
(current $ billions)	+1.91	+1.79	+1.61	+ .87	- .11		+ 6.07

Table 8 -- Current Taxation of CFC Earnings coupled with Repeal of the Foreign Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- 7.55	- 8.88	- 8.53	- 8.58	- 9.07	- 8.52	
(1958 $ billions)	- 8.48	-10.90	-11.17	-11.85	-13.15		-55.45
Manuf. employment (%)	- 2.10	- 2.29	- 2.06	- 2.22	- 2.32	- 2.20	
(thousands of jobs)	- 420	- 470	- 430	- 470	- 490		- 2280
Total employment (%)	- .29	- .59	- .62	- .72	- .86	- .62	
(thousands of jobs)	- 240	- 500	- 540	- 650	- 790		- 2720
Real GNP (%)	- 1.20	- 1.24	- 1.24	- 1.47	- 1.61	- 1.35	
(1958 $ billions)	-11.18	-12.14	-12.70	-15.63	-17.73		-69.38
Federal tax receipts (%)	+ 1.03	+ .89	+ .70	+ .35	- .06	+ .58	
(current $ billions)	+ 4.09	+ 3.88	+ 3.32	+ 1.79	- .33		+12.75

Table 9 -- Repeal of DISC Provisions

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .82	- .98	- .94	- .96	- 1.02	- .94	
(1958 $ billions)	- .92	- 1.20	- 1.23	- 1.33	- 1.48		- 6.16
Manuf. employment (%)	- .23	- .25	- .24	- .26	- .27	- .25	
(thousands of jobs)	- 50	- 50	- 50	- 50	- 60		- 260
Total employment (%)	- .03	- .06	- .06	- .08	- .10	- .06	
(thousands of jobs)	- 20	- 50	- 50	- 70	- 90		- 280
Real GNP (%)	- .13	- .13	- .14	- .17	- .18	- .15	
(1958 $ billions)	- 1.21	- 1.27	- 1.43	- 1.81	- 1.98		- 7.7
Federal tax receipts (%)	+ .16	+ .10	+ .08	+ .04	- .01	+ .08	
(current $ billions)	+ .64	+ .44	+ .38	+ .21	- .06		+ 1.61

Other Proposals

The eight remaining proposals studied by TIP were found to have less substantial economic impact than the proposals discussed earlier, although the impact of a series of changes in the so-called minimum tax provisions would be rather significant, if enacted simultaneously.

Table 10 -- Changes in the Minimum Tax
(Increase the Rate to 30%)

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .39	- .48	- .46	- .47	- .50	- .46	
(1958 $ billions)	- .44	- .59	- .60	- .65	- .73		-3.01
Manuf. employment (%)	- .11	- .12	- .11	- .12	- .13	- .12	
(thousands of jobs)	- 20	- 20	- 20	- 30	- 30		- 120
Total employment (%)	- .01	- .03	- .03	- .04	- .05	- .03	
(thousands of jobs)	- 10	- 30	- 30	- 40	- 50		- 160
Real GNP (%)	- .06	- .06	- .07	- .08	- .09	- .07	
(1958 $ billions)	- .56	- .59	- .72	- .85	- .99		-3.71
Federal tax receipts (%)	+ .06	+ .04	+ .04	+ .02	- .01	+ .03	
(current $ billions)	+ .24	+ .17	+ .19	+ .10	- .05		+ .65

Table 11 -- Changes in the Minimum Tax
(Repeal of the Regular Income Tax Liability Deduction)

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .43	- .52	- .50	- .51	- .54	- .50	
(1958 $ billions)	- .48	- .64	- .66	- .70	- .78		-3.26
Manuf. employment (%)	- .12	- .13	- .12	- .13	- .14	- .13	
(thousands of jobs)	- 20	- 30	- 30	- 30	- 30		- 140
Total employment (%)	- .01	- .03	- .04	- .04	- .05	- .04	
(thousands of jobs)	- 10	- 30	- 40	- 40	- 50		- 170
Real GNP (%)	- .07	- .07	- .07	- .09	- .10	- .08	
(1958 $ billions)	- .65	- .69	- .72	- .96	-1.10		-4.12
Federal tax receipts (%)	+ .06	+ .05	+ .04	+ .02	- .01	+ .03	
(current $ billions)	+ .24	+ .22	+ .19	+ .10	- .06		+ .69

Table 12 -- Changes in the Minimum Tax
(30% Rate and Repeal of the Income Tax Deduction
coupled with Repeal of the $30,000 Exemption)

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-1.45	-1.74	-1.68	-1.71	-1.81	-1.68	
(1958 $ billions)	-1.63	-2.13	-2.20	-2.36	-2.62		-10.94
Manuf. employment (%)	- .41	- .44	- .42	- .46	- .48	- .44	
(thousands of jobs)	- 80	- 90	- 90	- 100	- 100		- 460
Total employment (%)	- .05	- .11	- .12	- .14	- .17	- .12	
(thousands of jobs)	- 40	- 90	- 100	- 130	- 160		- 520
Real GNP (%)	- .23	- .23	- .24	- .29	- .32	- .26	
(1958 $ billions)	-2.14	-2.25	-2.46	-3.08	-3.52		-13.45
Federal tax receipts (%)	+ .19	+ .15	+ .12	+ .07	- .02	+ .10	
(current $ billions)	+ .76	+ .65	+ .57	+ .36	- .11		+ 2.23

Table 13 -- Repeal of "Possessions Income" Treatment

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .39	- .47	- .45	- .46	- .49	- .45	
(1958 $ billions)	- .44	- .58	- .59	- .64	- .71		-2.96
Manuf. employment (%)	- .11	- .12	- .11	- .12	- .13	- .12	
(thousands of jobs)	- 20	- 20	- 20	- 30	- 30		- 120
Total employment (%)	- .01	- .03	- .03	- .04	- .05	- .03	
(thousands of jobs)	- 10	- 30	- 30	- 40	- 50		- 160
Real GNP (%)	- .06	- .06	- .07	- .08	- .09	- .07	
(1958 $ billions)	- .56	- .59	- .72	- .85	- .77		-3.49
Federal tax receipts (%)	+ .05	+ .05	+ .03	+ .02	- .01	+ .03	
(current $ billions)	+ .20	+ .22	+ .14	+ .10	- .05		+ .59

Table 14 -- Repeal of "Minimum Distributions"

NOTE: *Table 14 presents figures with respect to repeal of the "minimum distributions" provisions, an action taken by the Tax Reduction Act of 1975 (P. L. 94-12), effective January 1, 1976.*

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-.19	- .22	- .22	- .22	- .24	- .22	
(1958 $ billions)	-.21	- .27	- .29	- .30	- .35		-1.42
Manuf. employment (%)	-.06	- .06	- .06	- .06	- .06	- .06	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		- 50
Total employment (%)	-.01	- .01	- .01	- .02	- .02	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 20	- 20		- 70
Real GNP (%)	-.03	- .03	- .03	- .04	- .04	- .03	
(1958 $ billions)	-.28	- .29	- .31	- .43	- .44		-1.75
Federal tax receipts (%)	+.03	+ .02	+ .02	+ .01	- .01	+ .02	
(current $ billions)	+.12	+ .09	+ .09	+ .05	- .06		+ .29

Table 15 -- Repeal of the "Per Country" Limitation on the Foreign Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-.15	- .18	- .18	- .18	- .19	- .18	
(1958 $ billions)	-.17	- .22	- .24	- .25	- .28		-1.16
Manuf. employment (%)	-.04	- .05	- .04	- .05	- .05	- .05	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		- 50
Total employment (%)	-.01	- .01	- .01	- .01	- .02	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 20		- 60
Real GNP (%)	-.02	- .02	- .03	- .03	- .03	- .03	
(1958 $ billions)	-.19	- .20	- .31	- .32	- .33		-1.35
Federal tax receipts (%)	+.02	+ .02	+ .01	- .01	- .01	+ .01	
(current $ billions)	+.08	+ .09	+ .05	- .05	- .06		+ .11

Table 16 -- Repeal of the Western Hemisphere Trade Corporation (WHTC) Provisions

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .12	- .14	- .14	- .14	- .15	- .14	
(1958 $ billions)	- .13	- .17	- .18	- .19	- .22		- .89
Manuf. employment (%)	- .04	- .04	- .04	- .04	- .04	- .04	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		- 50
Total employment (%)	- .01	- .01	- .01	- .01	- .01	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		- 50
Real GNP (%)	- .02	- .02	- .02	- .02	- .03	- .02	
(1958 $ billions)	- .19	- .20	- .20	- .21	- .33		-1.13
Federal tax receipts (%)	+ .02	+ .01	+ .01	+ .01	- .01	+ .01	
(current $ billions)	+ .08	+ .04	+ .05	+ .05	- .05		+ .17

Table 17 -- Repeal of the Less Developed Country Corporation (LDCC) Provisions

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .08	- .10	- .09	- .10	- .10	- .09	
(1958 $ billions)	- .09	- .12	- .12	- .14	- .15		- .62
Manuf. employment (%)	- .02	- .02	- .02	- .02	- .02	- .02	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		- 50
Total employment (%)	- .01	- .01	- .01	- .01	- .01	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		- .50
Real GNP (%)	- .01	- .01	- .01	- .02	- .02	- .01	
(1958 $ billions)	- .09	- .10	- .10	- .21	- .22		- .72
Federal tax receipts (%)	+ .01	+ .01	+ .01	- .01	- .01	+ .01	
(current $ billions)	+ .04	+ .04	+ .05	- .05	- .05		+ .03

WHY A TAX IMPACT PROJECT?

The Tax Impact Project (TIP) was undertaken with three general objectives in mind. They were:

- -- to begin the development of a method of estimating the overall economic impact of business-related tax proposals in general;
- -- to develop economic impact estimates for specific proposals which might arise in 1975; and
- -- to lay the groundwork for the possible development of a continuing project which could assess very rapidly the economic impact of any major tax proposal.

Considering the magnitude of the federal income tax structure, its intertwining with the economy and the massive capital needs of the future, it is increasingly important that the economic consequences of proposed tax legislation be studied thoroughly. TIP was conceived as a vital step in developing a capability to estimate in advance the effects which tax proposals would have on real capital investment, employment opportunities, real GNP and federal tax revenues over a period of years.

TIP is not represented to be the last word in economic analysis of tax proposals. It is one step in the development of methods of obtaining such analyses. It is intended to aid the illustration of the relationship between tax policy and economic activity and how this relationship is important to business and labor, to producers and consumers, to the private sector and the government, indeed to all facets of the economy. In so doing, it is hoped that TIP will help to raise the debates over federal tax policy from the level of political and emotional harangues to a rational discussion of the economic impact of tax legislation. In addition, it is hoped that TIP will lead to additional development and refinement of economic impact studies of tax proposals.

The Income Tax in Our Economy

The existing Internal Revenue Code -- all 37 chapters plus thousands of pages of Treasury Regulations -- has evolved from a very simple and uncomplicated ancestor. Following ratification of the Sixteenth Amendment, the federal income tax was enacted in 1913 as what appears, on the surface, to have been a minor afterthought in a major tariff act. Most individuals fell within the 1% rate bracket on taxable incomes of up to $20,000, with relatively few affected by the graduation of rates up to a maximum of 6% at the $500,000 income level. Corporations were subject to a 1% tax rate on their incomes. As a source of federal funds, the income tax provided only 5% of federal net revenues in 1913.

During the past sixty years, the income tax system has grown considerably in size and in importance. For fiscal year 1974, the income tax on individuals and corporations provided $157.6 billion in federal revenues, approximately 75% of all federal budget receipts, excluding Social Security taxes on employers and employees. The individual rate structure now ranges from a minimum of 14% to a maximum of 70% on unearned income, approximately twelve times the comparable 1913 rates. The maximum rate is now 48% on corporate income, making the federal government virtually the equivalent of a 50% shareholder in this country's largest business enterprises.

The Relationship Between Tax Policy and Economic Activity

Thus, the federal income tax now plays a very significant role in the functioning of our economy. Business and consumers alike make expenditure plans based on many factors -- fixed expenses, prices, availability of goods and services, essentials versus luxury items, hopes and fears about the future. Yet, in the final analysis, it is the availability of money which determines how far down the shopping list they can go. In this day and age, that means after-tax dollars, because to the extent that the federal income tax consumes taxpayer dollars, it reduces the funds available for private sector activity.

This is particularly true of new capital expenditures by business. Investment in new physical plants and productive equipment or in modernization of existing facilities has an impact far beyond merely creating new employment opportunities within the investing companies themselves. Capital expenditures directly create employment and incomes for construction workers who build and modernize factories, for production workers who manufacture the construction materials and the equipment for the new and modernized facilities, for service workers who transport and maintain the new equipment, for administrative personnel who handle transactions and production schedules and for many other related workers. The effects of capital expenditures also are felt as the businesses and individuals who are paid for their goods and services spend their incomes. The spending and re-spending of the invested dollars generate a higher level of economic activity than would otherwise be the case. As business and individual incomes rise, one additional beneficiary is the federal government which realizes increased tax revenues.

The relationship between tax policy and business investments is particularly close. While many factors affect capital expenditure plans, the availability of funds is of primary importance. Corporate cash flow (capital consumption allowances and retained earnings) plays a primary role in such planning. Not only is cash flow a source of capital itself, it also has a substantial impact on the amount of borrowed capital which a business can obtain. Thus, when changes in tax policy affect the volume of a company's cash flow, the effect on available capital can be larger than the initial change in tax liability itself.

The overall impact of major tax legislation is illustrated readily by the economic history of the investment tax credit. The credit has a direct impact on the capital expenditures of industry by increasing the internal funds available for such expenditures. Following enactment of the credit in 1962, new orders for machinery and equipment increased steadily, along with employment in capital goods industries and with corporate tax revenues. The 1966-1967 suspension period witnessed a leveling off or decline in these areas. From 1967 through the 1969 repeal, new orders for capital goods, employment and corporate tax revenues rose steadily. Following the repeal, the real decline was very significant. Reinstatement of the credit and enactment of ADR in 1971 were followed by renewed growth in these areas.

Unfortunately, general awareness of the potential economic impact of tax changes is fleeting. While it is easy to comprehend how a tax rebate or a general reduction of individual rates will favorably affect one's personal spending and investment plans, it is more difficult to understand how this effect can be multiplied thousands and millions of times across the country and how the resulting increase in economic activity can benefit the country as a whole, particularly through the business sector. And yet, the family-owned small business and the billion dollar

manufacturing corporation are affected in the same general ways by changes in tax liability; only the magnitude of the impact is different.

The Need for More Comprehensive Information

One specific function which the project will perform is to provide a more comprehensive means of measuring the federal revenue impact of tax proposals. The existing procedure for estimating revenue impacts of tax proposals is rather firmly established. It involves estimating the change in tax liabilities based on expected levels of income in areas affected by a proposal. As a means of comparing the initial impact of various proposals, this can be a useful procedure. As a means of estimating what will actually happen to federal revenues, such a procedure stops well short of a complete assessment of the impact of a specific proposal. In considering only the initial impact of a proposal, it assumes that no compensating actions are taken by the taxpayer.

With respect to changes in taxation of business income, TIP considers the secondary or "feedback" effects of tax proposals. As cash flow is reduced, business investments will be altered, employment levels will be affected, dividends may be changed and price structures may be subject to review. Multiplying these changes by the thousands of companies and the millions of individuals affected indicates the magnitude of the "feedback" effects which tax proposals can generate. Thus, TIP builds on the initial impact figures in estimating the long-term net changes in federal tax receipts presented in the tables.

Selection of the Econometric Approach

Studying the feedback effects of tax proposals is a complex task. To determine the overall changes in investment, jobs, GNP and federal revenues, the project required the use of a well developed econometric computer model to take into account the hundreds of equations which simulate actual relationships within the economy.

An established and well recognized econometric model was chosen for the purpose of generating the type of information sought by the project. A survey was constructed to collect the data to be used as input into the model. None of the assumptions or structural relationships within the model were altered.

With the Congress expected to consider a number of major tax proposals in 1975, the study covered by this report was undertaken both to test the methodology and to generate information with respect to a number of perennial tax proposals, including changes in the investment tax credit, ADR, corporate tax rates and foreign source income treatment. Thus, the first TIP results are expected to be of practical usefulness, not just of academic interest.

A possible long-term application of TIP is the development of a capability to analyze any major tax proposal without time consuming surveys. The first study has been structured to allow such development, should that be judged desirable.

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METHODOLOGY OF THE PROJECT

The Survey

In order to utilize the econometric model, it was necessary to gather data regarding the initial impact of the tax proposals on the tax liabilities and capital investments of industrial taxpayers. This was accomplished through a survey of NAM member companies.

The survey form asked that a responding company indicate the dollar amount by which its tax liability for its most recent taxable year would have been increased or decreased if each of seventeen specific tax proposals had been in effect during that year. In addition, the firm was asked to provide information about its retained earnings for the year.

All of these figures were included in calculations to determine the percent by which government tax receipts and total investment in fixed assets would be changed by each particular tax proposal. The percent changes were then used as input for the model in order to calculate the domestic economic effects of the proposals.

The survey was mailed to 1050 of the largest NAM member companies in November 1974. The list of recipients was compiled by selecting the fifty largest member firms (by sales volume) in each of the manufacturing Standard Industrial Classification (SIC) Codes from 20 through 39, plus utility SIC Code 49. (See APPENDIX B for list of industries by SIC Codes.) The cover letter explained the purpose of the survey and asked for cooperation with the understanding that the responses would be collected and compiled in complete confidentiality. The only figures to be released would be the econometric results.

From the 1050 largest companies, 313 responses were received and used in compiling the percentage changes in tax receipts and investments used as inputs for the model. Over sixty percent of the responses were based on calendar 1973. Approximately twenty percent were for fiscal 1974. At the time of the survey, this was the most recently available information.

The responding companies represent all major industries in the U.S., and they represent substantial portions of all sales and investments by U.S. industrial companies. Responses to the survey came from companies in the various manufacturing industries and in the electric and gas utility industries. The responses represent approximately 35% of the companies on the Fortune 500 Largest Industrial Companies list. Total sales of the responding manufacturers represented 36% of total sales of all U.S. manufacturers. Responding Fortune 500 members accounted for approximately 95% of the total sales volume of responding companies. All Fortune 500 sales represent approximately 80% of all manufacturing sales. The responding manufacturers accounted for approximately 35% of all new investment in domestic plant and equipment.

For a detailed discussion of the survey and preparation of the model input, see APPENDIX C.

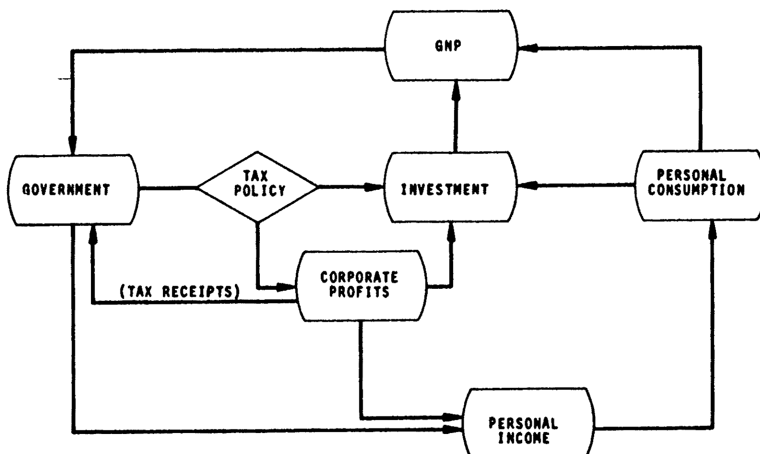
The Econometric Model

Workings of the model. An econometric model of the economy is a series of functional relationships tying the various sectors of the economy together into a unified system. A model is designed to measure mathematically and statistically these relationships among numerous economic variables. Such models are useful in analyzing specific elements of economic activity, as well as for tracing the complex feedback and interrelationships within the total economy.

Basically, a model consists of a number of simultaneous equations, each of which describes a certain functional relationship within the economic system. The number of equations in a model will vary depending upon the scope of the model. TIP used the Data Resources, Inc., (DRI) Long-Term Model of the U. S. Economy, which consists of over 900 equations which identify and measure the interrelationship among all major sectors of the economy.

The following diagram (CHART 1) is a simplified version of how an econometric model ties the economy into a self-contained whole and feeds data from one sector into another. This diagram is highly simplified and is designed to highlight the sectoral relationships important to the project. Thus, the other elements of the economy that are affected by the variables in the diagram are not represented.

CHART 2: TAX IMPACT PROJECT MODEL



Each box represents a major element of the economy. The lines connecting the boxes indicate how elements from one sector are utilized to determine the other elements. The circular nature of the diagram reflects "flow" of economic activity and the simultaneous nature of the system. Thus, the model captures the "circular" nature of economic activity.

Gross national product (GNP) is the measure of total output of goods and services in the economy. Government tax policy, in addition to being a source of revenue, influences economic activity (GNP) by either stimulating or restricting economic growth. Thus, in this simplified diagram, tax policy is seen as influencing investment directly, as well as indirectly through corporate profits. At the same time, the level of GNP affects government in terms of tax receipts, as shown by the connecting boxes. Thus, government tax policy can either stimulate or deter investment spending on new equipment.

Other factors affecting investment spending shown by the diagram are the level of consumer expenditures and the level of corporate profits, which in turn is affected by government tax policy. Consumer expenditures are a factor in determining whether additional investment in equipment is necessary to satisfy demand. In turn, the level of expenditures by consumers is affected by the gain (or loss) in personal income resulting from changes in output and employment. Also, corporate profits and government programs are determinants of the gain or loss in personal income, which will then affect the level of spending that dictates the amount of additional investment necessary to meet demand, and so on. The variables in the diagram illustrate this cause and effect feedback of the economic system.

Many other variables, of course, play a part in determining each of the elements illustrated by the diagram. The purpose of this particular diagram is simply to delineate the crucial connections among tax policy, investment, total output, and government tax receipts.

Once built, a macroeconomic model is able to estimate the impact on hundreds of economic relationships resulting from changes in the parameters of the economic system. The impact of specific changes, such as alterations in tax policy and investment decisions, can be analyzed under varying sets of assumptions. Such models not only allow for the complex feedback of large numbers of economic forces, they also make feasible the analysis of extremely large amounts of data. Therefore, in addition to theoretical considerations, it was useful to adopt an econometric approach for TIP because of the exceptionally large body of data which the project incorporates.

Inputting the survey results. In order to obtain general macroeconomic results from the initial effect of a tax proposal as determined by the survey, a long-term macroeconomic model was chosen. If a model of the current economy had been used, the results would have been distorted by the existing recession. As a result, the figures would not provide a reasonable statement of the economic impact of the proposals over a long-term period. Further, since the majority of the survey responses were based upon calendar year 1973, it would have been inappropriate to use the results in a model of today's economy. Therefore, the survey results were used as input into the long-term model which

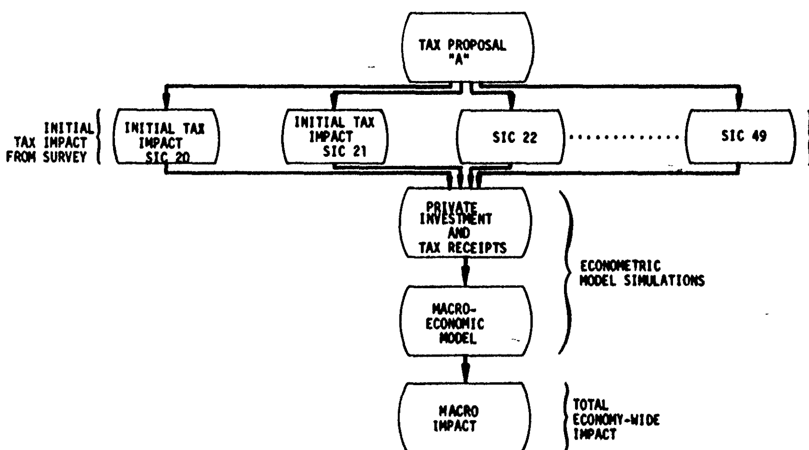
assumes that the economy is at or near its long-term growth path. If the tax changes were adopted in a recession, the effects would be somewhat altered.

While 1973 was not a normal year in many respects, industrial utilization, economic growth, and the level of unemployment were close to generally considered long-term full employment growth levels and consistent with the assumptions of the long-term model that was used. Inflation increased dramatically throughout 1973 and was at rates quite above the assumptions of the model. However, since the results of the survey were interpreted in real terms, much of this bias was eliminated.

The survey data on each change in tax liability were compiled by SIC code. It was assumed that such changes in tax liability result in equal dollar changes in corporate cash flow. Also, a constant ratio of total investment to cash flow was assumed for determining the initial impact of a change in cash flow on investment. Once the feedback mechanism of the interrelationships within the economy is felt, however, the process becomes much more complex. While the initial impact on investment is determined by the change in cash flow, the subsequent impact is determined by changes in demand, the movement of interest rates, the cost of capital, the change in dividend payments and other factors. (See APPENDIX C, pp. 31-32 for a fuller discussion.)

Once the change in investment was determined in each SIC code, these changes were weighted to represent the relative importance of investment in that SIC code to total investment in the economy. Then the initial changes in tax liabilities and investment in each industry flowed into the macroeconomic model (see CHART 2) where the feedback effects began to work. The changes ripple throughout various sectors of the economy (see CHART 1 on p. 14) and the macroeconomic impact is determined.

CHART I: MACROECONOMIC MODEL



NOTE: It was assumed that the existing ratio between domestic and foreign investment will remain the same after any tax change. The findings represent only the changes which would occur in the domestic economy based on the existing relationship. While long-term adjustments to foreign investments could be expected to follow significant changes in tax treatment of foreign source income, it is beyond the scope or capacity of the project to make assumptions in this regard.

The results. The table on page 18 illustrates the format in which all of the TIP findings are presented in this report in pp. 1-9. The results are in terms of fixed investment, manufacturing employment, total employment, GNP and federal tax receipts for the simulation period. These have been selected as the economic factors which best illustrate the overall impact of each tax proposal. It should be noted that changes in GNP and fixed investment are based on constant (1958) dollars while federal government tax receipts are based on current dollars. The reason for this difference is to show GNP and fixed investment without distortion due to inflation while federal government tax receipts are depicted in actual dollars received. Thus, the numbers cannot be analyzed in terms of each other without first "deflating" government tax receipts.

The tables present the economy-wide effects of each tax proposal, both on a percentage change basis (the rows of figures designated (%)) and on a dollar and jobs basis (the rows of figures designated ($) and (jobs)). The percentage change reflects the change in the total economy as a result of the tax proposal as compared to economic conditions in the absence of any tax change. Note that these are differences from what otherwise would occur. The percentages are not intended to represent absolute changes from conditions in 1975.

The percentage effect of each of the tax proposals on the total economy is shown on an annual basis over a five-year period. It is assumed that the tax change remains in effect during the entire five-year period of the study. It is also assumed that the proposal has been in place for a period of approximately 18 months so that its full impact is realized. To translate the percentage changes into real figures, the percentages were applied to the long-term growth model of the U.S. economy. The differences between the basic model (assuming no changes due to tax policy) and the new simulations (based on the impact of the tax proposals) were calculated.

It should be noted that the multiple impact of all of the various feedbacks from the interrelationships within the economic system produce different results depending upon the time framework. For example, manufacturing employment is generally impacted more than total employment during the first year of full impact. This, of course, is what one would expect as employees are initially pulled into manufacturing from other sectors when the effect is positive or find jobs in other sectors when the effect is negative. After the "first round," however, the impact on investment is felt in other sectors of the economy as well, and output and employment react in these areas. Thus, the later effects on total employment are greater than in manufacturing alone.

For purposes of illustration, the five-year period of 1977-1981 was selected to illustrate the effects of the seventeen TIP proposals. This assumes that these proposals were adopted in mid - 1976 and that an eighteen month interim period will allow the full effect of the change to be realized. This assumption was made for illustrative purposes only. It is recognized that the appropriate

periods for any given proposals can vary widely. It should be noted that TIP does not assume that there will be no impact in 1975 or 1976, merely that the full effect is assumed to be reached beginning in 1977.

It should also be noted that the TIP findings were based on tax law prior to P.L. 94-12. Therefore, the findings have been calculated by a model which did not take into account a 10% investment tax credit, except with respect to that specific proposal.

Table 1 -- 10% Investment Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	+3.06	+3.89	+3.85	+3.88	+4.05	+3.73	
(1958 $ billions)	+3.44	+4.77	+5.04	+5.36	+5.87		+24.48
Manuf. employment (%)	+ .90	+1.00	+ .92	+ .98	+1.01	+ .96	
(thousands of jobs)	+ 180	+ 210	+ 190	+ 210	+ 220		+ 1010
Total employment (%)	+ .10	+ .24	+ .28	+ .33	+ .37	+ .27	
(thousands of jobs)	+ 80	+ 200	+ 250	+ 300	+ 340		+ 1170
Real GNP (%)	+ .41	+ .51	+ .55	+ .62	+ .67	+ .56	
(1958 $ billions)	+3.82	+4.99	+5.63	+6.59	+7.38		+28.41
Federal tax receipts (%)	- .46	- .37	- .30	- .14	- .05	- .24	
(current $ billions)	-1.83	-1.61	-1.42	- .72	- .28		- 5.86

Example: Assuming enactment of a 10% investment tax credit, the percentage change in manufacturing employment in the first year, due to the tax impact would mean + 180,000 jobs for that year. The average yearly change in manufacturing employment would be +.96% which, in terms of the model simulations for 1977 to 1981, would result in a cumulative impact of +1.01 million jobs in manufacturing employment.

APPENDIX A: DESCRIPTIONS OF THE TAX PROPOSALS

The Tax Impact Project Report discusses the economic impact of 17 specific tax proposals. These proposals are described below in the order in which they are presented in the report.

Major Proposals Affecting Domestic Source Income

10% Investment Tax Credit (p.1)

The investment tax credit for qualified section 38 property has been raised to 10% across the board during 1975-1976 for all taxpayers, including utilities, by P.L. 94-12, the Tax Reduction Act of 1975. At the time of the TIP survey in 1974, the investment tax credit rate was 7% generally, 4% for utilities. The TIP results represent the effects which the higher rate alone will have, assuming that it is made permanent. This assumes no other changes in credit rules, such as the 50% tax liability limitation, the 3-5-7 rule or any other credit-related provisions. The 10% rate would apply to all qualified property placed in service during the taxable year covered by the survey and to the basis of qualified property attributable to construction, reconstruction or erection during such taxable year.

40% ADR (p. 2)

Under existing law, the Asset Depreciation Range (ADR) allows a 20% variance from the asset guideline period (depreciable life) established for property within each asset guideline class. This allows the taxpayer to select a depreciation period which is up to 20% shorter (or longer) than the guideline period. The proposal would increase the allowable variance to 40%. No changes in the guideline periods or in any other ADR-related provisions would occur. The 40% variance would be applicable beginning with assets on which depreciation began during the taxable year covered by the survey.

Repeal of the Investment Tax Credit (p. 2)

At the time of the TIP survey in 1974, the investment tax credit rate was 7% generally, 4% for utilities. Therefore, the proposal contemplates repeal of a 7% credit as it existed prior to enactment of the 10% rate in P.L. 94-12, the Tax Reduction Act of 1975. Repeal would be effective on the first day of the taxable year covered by the survey. Thus, the TIP results assume that the taxpayer could not have taken any investment tax credit for that year.

Repeal of ADR (p. 3)

The Asset Depreciation Range (ADR), which allows a 20% variance from the asset guideline period (depreciable life) for each class of depreciable property, would be repealed, effective as of the first day of the taxable year covered by the survey. Depreciation deductions would be based on the full guideline lives as established in Treasury Regulations for all property on which depreciation began during that year.

<u>50% Corporate Tax Rate</u> (p. 3)

At the time of the TIP survey in 1974, the corporate tax rate was composed of a 22% normal tax on all corporate income and a 26% surtax on all corporate income in excess of $25,000, creating a 48% tax rate on income above $25,000. The proposal would increase the surtax rate to 28%, thereby creating a 50% rate. This 50% rate would be effective for the taxable year covered by the survey. The TIP results do not take into account certain provisions of P.L. 94-12 which altered the normal tax and the corporate surtax exemption.

Major Proposals Affecting Foreign Source Income

<u>Current Taxation of CFC Earnings</u> (p. 4)

Under existing law, the earnings of foreign subsidiaries of U.S. companies, often called controlled foreign corporations or CFC's, generally are taxable by the United States only when paid as dividends to domestic parents or other domestic shareholders. The only exceptions are found in Subpart F (sections 951-964) which was enacted to reach so-called "tax haven" income.

Under the proposal, 100% of the annual earnings of CFC's (any foreign corporations which are more than 50% controlled by U.S. persons) would be <u>deemed paid</u> as dividends in the year earned without regard to whether they are in fact distributed. The U.S. shareholders would be taxable on their pro rata share of such earnings. The foreign tax credit would remain intact and would be available with respect to such deemed-paid dividends. This proposal would be in effect for CFC earnings during the taxable year covered by the survey, but not for previously accumulated earnings.

<u>Repeal of the Foreign Tax Credit</u> (p. 4)

Under existing law, U.S. persons who have foreign source income must include it in gross income and pay U.S. income tax thereon. If that income has also been subject to income, war profits or excess profits taxes in foreign countries, the taxpayer may credit such taxes against the U.S. tax due on the same income, subject to certain computation rules. (Foreign taxes may not be credited against federal taxes due on U.S. source income.) This credit is available both for taxes paid directly by the U.S. taxpayer and for taxes paid by various levels of foreign subsidiaries and then deemed paid by the U.S. taxpayer.

Under the proposal, the credit would be completely repealed. Foreign taxes would be allowed only as a business deduction in computing taxable income. This would be effective with respect to all foreign taxes which would otherwise be creditable during the taxable year covered by the survey. This proposal would not require current taxation of 100% of CFC earnings.

<u>Current Taxation of CFC Earnings coupled with Repeal of the Foreign Tax Credit</u> (p. 5)

Under this proposal, the current taxation of CFC earnings and repeal of the foreign tax credit, as described above, would occur simultaneously. All subsidiary earnings would be taxable directly to U.S. shareholders and foreign taxes could be taken only as a deduction, not as a credit. This would be effective for CFC earnings and foreign taxes thereon during the taxable year covered by the

survey, but not for previously accumulated CFC earnings.

Repeal of DISC Provisions (p. 5)

At the time of the TIP survey in 1974, Domestic International Sales Corporation (DISC) treatment was available to domestic corporations engaged in exporting all types of domestic products, minerals and foodstuffs. P.L. 94-12, the Tax Reduction Act of 1975, restricted somewhat the list of qualified export items. A DISC is a separate, non-taxable corporation which receives 95% of its receipts from export business. Tax on 50% of its income is deferred until distributed while 50% is taxable to its shareholders, usually a parent company, in the year earned. Income attributable to export receipts is treated as foreign source income by the parent and receives separate treatment for foreign tax credit purposes. The DISC may loan its deferred income to the parent for export-related uses. This proposal would repeal DISC treatment effective for all income during the taxable year covered by the survey, but not for previously tax-deferred DISC income.

Other Proposals

Changes in the Minimum Tax (pp. 6-7)

Under current law, a corporation is subject to an additional tax (also known as the minimum tax) on the total of "tax preference" items which it uses. These items include capital gains, accelerated depreciation on real property, special amortizations and percentage depletion. The total of "tax preferences" is reduced by a $30,000 exemption and by the amount of regular income tax liability (minus tax credits). The remaining amount of "tax preference" income is subject to a 10% tax.

The various proposals considered by TIP would (1) increase the tax rate to 30%, (2) repeal the regular income tax liability deduction, and (3) enact these simultaneously with a repeal of the $30,000 exemption. These proposals would be effective for the taxable year covered by the survey.

Repeal of "Possessions Income" Treatment (p. 7)

Under current law, a U.S. corporation which derives 80% of its gross income from U.S. possessions (including Puerto Rico and Guam but excluding the Virgin Islands) and 50% of its gross income from active conduct of a trade or business in such possessions, may exclude from gross income all income from such possessions and from foreign sources. The proposal would repeal this treatment effective for all possessions income and foreign source income earned or received during the taxable year covered by the survey, but not for previously excluded income.

Repeal of "Minimum Distributions (p. 8)

At the time of the TIP survey in 1974, section 963 of the Code provided a "minimum distributions" mechanism through which U.S. taxpayers, who otherwise would be subject to the special Subpart F treatment of so-called "tax haven" income, could be relieved of the administrative and accounting burdens of . Subpart F. Under this concept, taxpayers could exclude from gross income all

Subpart F income if their worldwide income was taxable at 90% of the maximum U.S. rate, or 43%. The schedule in section 963 provided the minimum percentage of foreign income which had to be distributed to U.S. shareholders to raise the effective worldwide rate to 43%.

P.L. 94-12, the Tax Reduction Act of 1975, repealed "minimum distributions" effective January 1, 1976. The TIP results are based on such a complete repeal in the taxable year covered by the survey.

Repeal of the "Per Country" Limitation on the Foreign Tax Credit (p. 8)

Prior to P.L. 94-12, the Tax Reduction Act of 1974, there were two methods of computing the maximum foreign tax credit--the "per country" limitation and the "overall" limitation. Under the "per country" limitation, the foreign tax credit is computed with respect to the taxes paid on income from each foreign country. The maximum credit which can be taken against U.S. taxes on Country X source income is computed by multiplying tentative U.S. tax liability times the ratio of Country X source taxable income to worldwide taxable income. This is repeated for income from each foreign country. Under the overall limitation, the maximum credit is computed by multiplying tentative U.S. tax liability times the ratio of all foreign source taxable income to worldwide taxable income.

P.L. 94-12 repealed the "per country" limitation with respect to foreign oil-related income. The TIP proposal would repeal the "per country" limitation altogether for all foreign source income during the taxable year covered by the survey.

Repeal of Western Hemisphere Trade Corporation (WHTC) Provisions (p. 9)

Under current law, a U.S. corporation, which (1) does all of its business in the Western Hemisphere, (2) receives 95% or more of its gross income from non-U.S. sources, and (3) receives 90% or more of its gross income from the active conduct of a trade or business, receives a special deduction from taxable income as otherwise computed. The effect is to reduce the maximum 48% corporate rate by 14 percentage points, down to 34%. This proposal would repeal WHTC treatment effective for all income during the taxable year covered by the survey, but not for WHTC income which was previously taxed at a lower rate.

Repeal of Less Developed Country Corporation (LDCC) Provisions (p. 9)

At the time of the TIP survey in 1974, income of less developed country corporations (LDCC's) was subject to less U.S. taxation than other foreign source income. There were LDCC exceptions to Subpart F treatment, to foreign dividend gross-ups and to taxation of gain on the sale or exchange of stock in a foreign corporation.

P.L. 94-12, the Tax Reduction Act of 1975, repealed the exception to Subpart F treatment for LDCC dividends which are reinvested in LDCC's, beginning in 1976. The TIP proposal would repeal all of the LDCC exceptions listed above. This would apply to all LDCC income, dividends and gain during the taxable year covered by the survey.

APPENDIX B: INDUSTRIES SURVEYED

The TIP survey recipients included NAM member companies in the manufacturing industries. The following industry groups were used:

SIC		Industry
20	--	food and kindred products
21	--	tobacco products
22	--	textile products
23	--	apparel and other fabric products
24	--	lumber and wood products (except furniture)
25	--	furniture and fixtures
26	--	paper and allied products
27	--	printing, publishing and allied industries
28	--	chemicals and allied products
29	--	petroleum refining and related industries
30	--	rubber and miscellaneous plastic products
31	--	leather and leather products
32	--	stone, clay, glass and concrete products
33	--	primary metals
34	--	fabricated metal products (except ordnance, machinery and transportation equipment)
35	--	non-electrical machinery
36	--	electrical machinery
37	--	transportation equipment
38	--	instruments, photographic goods, watches, and clocks
39	--	miscellaneous manufacturing
49	--	electric, gas and sanitary services

APPENDIX C: DETAILED DESCRIPTION OF THE METHODOLOGY

The economic effects of changes in federal corporate taxes have been studied and debated at length by legislators and the public at large, as well as by professional economists. At issue is the response of investment to changes in corporate taxes. The professional economic literature is robust with many studies of the investment function, going back to classical studies by Jan Timbergen in the 1930's and to Keynes' criticism of monetary policy as having little effect on the level of investment in the General Theory of Employment, Interest, and Money. The broad outline of the investment function is now generally agreed upon; the details and importance of various factors are not.

The problem of estimating the economy-wide effects of corporate tax changes must be viewed from two major perspectives: (1) How do changes in corporate taxes affect corporate cash flow and the user cost of capital? (2) Given the marginal changes determined in (1), that is, the partial equilibrium effects, how will changes in investment and federal tax revenues affect the working of the economy and in turn feed back into subsequent effects on investment? The initial effect can be termed the direct impact on corporate investment spending, while the second element can be termed the feedback effect of tax changes.

The discussion which follows covers the complete methodology of the Tax Impact Project (TIP). Included is a description of the TIP survey form and the responses to it which were received. Also discussed is the microeconomic effect which proposed changes would have on corporations' propensity to invest and to pay taxes along with the assumptions inherent in the analysis. The final section describes the macroeconomic process which estimated the magnitude of the secondary or "feedback" effects based on the changed propensity to invest and to pay taxes.

The Survey of NAM Members

Survey Questions. A survey of industrial companies was necessary to obtain data on the dollar impact of various tax proposals and how they would affect domestic capital investments. The survey form was constructed after the econometric approach was selected and was tailored to provide the type of information necessary to prepare the input for the model. All answers were to be based on the most recently completed taxable year.

The form requested certain company profile information regarding gross sales, number of employees and book value of gross fixed assets. However, this information was not used in the econometric model input. Other company profile questions requested information about the dollar amount of capital invested during the year in fixed assets in the U.S. and about the company's retained earnings for the year.

Each company was asked to state the two digit Standard Industrial Classification (SIC) code number which identifies its general industrial business. The SIC code numbers were used to group survey responses by industry for use in preparing the final survey results as model input.

The form also asked for the initial dollar impact which each of a number of proposals would have had on the federal income taxes of the responding company for its most recently completed taxable year. The company was asked to indicate the year for which it was responding.

A separate cover sheet for the survey provided space for identifying the responding company and the person under whose direction the survey response was prepared. This sheet was used for two purposes: (1) to identify companies so that additional solicitations would not result in duplicate responses, and (2) to provide ready access to a person within each company who could answer any questions about the response.

Survey Distribution and Response. To obtain the responses which would provide the most worthwhile and reliable data for use in preparing model input, the survey was mailed to a selection of NAM member companies in a wide diversity of industries and which are responsible for a significant portion of domestic capital investment in fixed assets.

The fifty largest NAM member companies (by sales volume) in each of twenty manufacturing SIC codes 20 through 39, plus utility company SIC code 49, were included in the list. SIC code 21 contained only 20 companies. An additional 30 manufacturing companies, which were overlooked in the original selection, were sent survey forms at a later date. This list of 1050 large companies was supplemented by 500 small NAM members. The selection was made at random by computer from all NAM companies which employ fewer than 500 persons.

The survey form was mailed to the list of 1550 companies in November 1974. It was sent under cover of a letter which described the purpose of the survey and requested a prompt response of a completed form with the understanding that the information provided would be confidential and that no individual company data would be released.

A total of 360 responses to the survey were received prior to March 1, 1975. Of this number, 344 were from the 1050 largest members and 16 were from the 500 smaller members.

The survey responses were reviewed individually for omitted answers and any other answers which seemed to be incorrect. Responses which were questioned during this process were discussed with the person responsible for the survey. The answers were confirmed or altered as appropriate.

Compilation of the Results. The answers on each response were recorded on the appropriate SIC code list and on a master list. The cover letter with identifying company and individual names were detached and retained. The completed survey forms were destroyed.

A total of 313 responses were used in compiling the results. Because the overall response by the small companies was very limited, none of their individual responses were used. Also excluded were responses from larger firms which needed verification but which did not provide the name of the person responsible for completing the form. Results were compiled for each SIC code and for the total response.

The Microeconomic Effects

The determination of the initial effects of tax changes on cash flow and the user cost of capital can be approached both theoretically and by use of a survey. This first stage of analysis is not amenable to econometric analysis as historic time series data on investment contain the very feedback or macroeconomic effects which are at issue. Also, there have not been sufficient observations to determine the effects of new tax changes empirically.

Many theoretical articles on the effect of taxes on investment have been published of late. While these all permit some degree of qualitative and quantitative conclusions, they exhibit certain deficiencies for the purposes of the TIP analysis.[1] First, theoretical derivations generally give only qualitative conclusions. For example, a model might be constructed which demonstrates that a lowering of taxes will cause an increase in investment. The crucial question for policy purposes, however, is by how much federal tax revenues will change and by what magnitude invesment, employment, and output will change. Purely theoretical constructs do indicate the direction and impact of these changes, but they are less effective in measuring the magnitude of the changes.

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[1]Theoretical models of investment by the firm include references 20, 25, 30, 8, 16 cited in the selected bibliography, pp. 36-37.

The impact of a policy change on tax payments is by no means obvious. It is a complex question that depends upon the current structure of each corporation affected and can only be accurately estimated by someone familiar with the details of both the firm and the tax change. Thus, to obtain answers as to the effect of tax policy changes on corporate tax payments, the TIP survey asks a purely accounting question: Given the conditions of the latest fiscal year, what would be the dollar effect of different tax changes on corporate tax payments?[2] These survey results were then classified by two-digit SIC code.

With the change in tax liabilities determined by the survey, the next question is whether these funds will be retained in whole by the corporation or retained only in part with dividend payments increased. The approach adopted by TIP is that dividend payments are assumed to be unchanged, initially, ie., they are a part of the "other things held constant." Several studies indicate that while dividends have risen over time, there is no immediate correlation between changes in after-tax corporate profits and changes in dividends.[3] This can be shown empirically by the following regression equation:

$$DDIV = .279 + .028*DZA$$
$$(6.25) \quad (2.04)$$

$\bar{R}^2$ = 0.04
DW = 1.65
SE = .389
FIT: 1955:1 TO 1974:4

WHERE:

DDIV = QUARTERLY CHANGE IN CORPORATE DIVIDENDS

DZA = QUARTERLY CHANGE IN AFTER-TAX CORPORATE PROFITS

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[2]Many other surveys have attempted to determine the effect of tax policy change on investment. Among the more notable are the McGraw-Hill surveys that are analyzed in reference 12. A major shortcoming of these surveys (in addition to their small sample size) is that they require an opinion as to how tax changes will affect corporate investment. However, many times decisions concerning investment by large corporations are independent of knowledge concerning the effect of tax policy changes on after-tax profits. Thus, there is a very poor observed relation between these type surveys and other empirical evidence concerning changes in investment.

[3]The classic article on this subject is the paper by Modigliani and Miller, reference 30, which proves that in a perfect capital market optimal investment decisions are independent of how the investment is financed. Dhrymes and Kurz, reference 8, present a model where capital market imperfections make internal funds a cheaper source of financing for the firm. A recent study by Fama, reference 14, finds that the hypothesis of a complete independence between dividend policy and investment decisions of the individual firms cannot be rejected. Also, see references 4 and 29.

Given these results and on the basis of other studies (see Footnote 3), it is assumed that changes in tax liabilities will not immediately affect dividends. Once the initial impact is fed into the model, however, dividends are increased (or decreased) as firms respond to the altered levels of profits and cash flow.

The effect of changes in cash flow on investment can be viewed as a partial equilibrium or microeconomic effect. While many other factors affect the level of investment such as interest rates and the aggregate level of economic activity, the initial effect of such changes can be considered a changed propensity to invest.

TIP assumes that if a particular tax policy were to alter tax liabilities by X dollars, then cash flow would also change by X dollars. Comparing this change in cash flow to total cash flow gives the percentage change in cash flow, which is assumed to result in an equal change in capital investments. This percentage change was computed from the survey data for each SIC code and represents the initial impact of the proposal on that industry, i.e., the changed propensity to invest, if all other factors remain unchanged. This initial impact was used to trigger the model, which then simulated other changes in the economy which would follow the changes in taxes and investment.

The assumption that there is a constant relation between total investment and cash flow is based upon the hypothesis that a firm has an approximately constant leveraging ability in that an increase (decrease) in internally generated funds will allow for an expansion (contraction) in externally borrowed funds, whether this is to be used as replacement investment or expansion investment. Empirically this has been the case. The ratio of total investment to cash flow for the U.S. economy exhibits a remarkably stable pattern over the past 20 years. This is shown in Table 1.

Table 1

AVERAGE RATIO OF FIXED PRIVATE NONRESIDENTIAL INVESTMENT TO CASH FLOW *

Year	Ratio	Year	Ratio
1955	1.1	1965	1.1
56	1.3	66	1.2
57	1.3	67	1.2
58	1.3	68	1.2
59	1.1	69	1.4
60	1.3	70	1.4
61	1.2	71	1.3
62	1.1	72	1.2
63	1.1	73	1.2
64	1.1	74	1.2

*Cash Flow = corporate retained earnings plus corporate capital consumption allowances.

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The Feedback Effects: Use of the Macroeconomic Model

NOTE: Most of the data used in constructing the relationships discussed here were prepared by the U. S. Department of Commerce. For specific sources, see pp. 34-35.

Aggregate investment functions have been widely discussed in the literature. (See, for example, reference 26 for a recent survey article; also see selected references, on pp. 36-37.) Since the Data Resources, Inc., (DRI) long-term macroeconomic model deals with an aggregate investment function for the private economy, it was necessary to transform the two-digit industry results into economy-wide effects on investment.

To do this, it was assumed that the TIP sample of manufacturing firms and utilities were representative of the economy in terms of the effect of tax policy changes on changes in fixed nonresidential investment (i.e., producer's durable equipment plus nonresidential structures). In assessing the reasonableness of this assumption, it is informative to examine the historical relation between investment in manufacturing and utilities--the sectors covered by the survey--and investment in other areas.

That is, IFIXER = IM&U + IOT

WHERE:

IFIXER = Fixed private nonresidential investment

IM&U = IPE&M + IP&E49

IPE&M = Investment in manufacturing

IP&E49 = Investment in utilities

IOT = Investment in "other" sectors

Table 2 below presents the historical relationship among these variables annually from 1953 to 1974. IR represents the ratio of IOT to IM&U. The relationship remains quite constant over time, thereby implying that factors impacting investment in manufacturing and utilities have a similar impact on other sectors. (Of course, the timing of the impact can be expected to be different; in particular, manufacturing investment can be seen to be more cyclically sensitive than "other" investment.)

Table 2

HISTORICAL RELATIONSHIP OF MANUFACTURING AND UTILITY INVESTMENT TO OTHER INVESTMENT

DATE	IFIXER	IM&U	IOT	IR
53	34.1500	16.1925	17.9575	1.10900
54	33.6500	15.2550	18.3950	1.20583
55	38.1250	15.8025	22.3225	1.41259
56	43.7000	19.7950	23.9050	1.20763
57	46.3500	22.1775	24.1725	1.08996
58	41.6000	17.9825	23.6175	1.31336
59	45.1000	17.8750	27.2250	1.52308
60	48.4000	20.3050	28.0950	1.38365
61	47.0250	19.3175	27.7075	1.43432
62	51.6500	19.9225	31.7275	1.59255
63	54.3250	21.1300	33.1950	1.57099
64	61.0500	24.7400	36.3100	1.46766
65	71.3000	29.4375	41.8625	1.42208
66	81.5750	35.5275	46.0475	1.29611
67	83.3000	37.2775	46.0225	1.23459
68	88.8250	38.5475	50.2775	1.30430
69	98.5000	43.2675	55.2325	1.27654
70	100.5750	45.0950	55.4800	1.23029
71	104.5750	45.3200	59.2550	1.30748
72	116.8500	48.2850	68.5650	1.42001
73	136.7500	56.5875	80.1625	1.41661
74	149.1750	66.3950	82.7800	1.24678

Quarterly, from 1955 to 1974, the mean of IR is equal to 1.35866 with a standard deviation of 0.134375, further illustrating the relative stability of this variable.

Another method of examining the relationship between "other" investment and manufacturing and utility investment is to regress the former on the latter, i.e., IOT = f(IM&U). This resulted in the following equation: 4

$$IOT = \underset{(1.9043)}{2.6638} + \underset{(.053945)}{1.25729} * IM\&U$$

$\bar{R}^2 = .9661$ DW = 1.1171 SE = 3.4691

[4]Quarterly, similar regression results are obtained, although the different timing of the changes in investment is apparent.

$$IOT = \underset{(0.903755)}{1.56787} + \underset{(.0265735)}{1.28036} * IM\&U$$

$\bar{R}^2 = .9639$ DW = 0.1938 SE = 3.62815

Thus, abstracting from cyclical effects of timing, the relationship between investment in manufacturing and utilities and investment in the rest of the economy is quite stable. Furthermore, the above regressions imply that a change in IM&U will result in an approximately equal percentage change in IOT.

The effects on investment in percentage terms were weighted by the relative level of investment in 1973 for each of the two-digit SIC manufacturing industries and utilities (SIC 49, also included in the survey). This resulted in a weighted-average effect on the propensity to invest which was then introduced into the econometric model.

A number of equations were used by the model to analyze the impact of the various tax proposals on the total economy. The fixed private nonresidential investment (IFIXER) equation is the sum of investment in producer's durable equipment (IPDE) plus construction excluding residential (ICER), and represents the basic investment level altered by the survey results.

IFIXER = IPDE + ICER

In order to illustrate the number of variables in the model which impact the final level of investment, the major elements impacting investment are summarized below. It should be stressed that it is these variables--along with several others which impact the ones listed--which determine the final "feedback" effects of increased or decreased taxes.

ICER = f(DODPCAUS, IPDE, ICR, PICER)

Where:

ICER = Investment in private nonresidential structures
PICER = Implicit price deflator - private nonresidential structures
IPDE = Investment in producer's durable equipment
ICR = Investment in residential structures
DODPCAUS = DOD military prime contract awards - total

IPDE = IPDE58 (PIPDE)

Where:

IPDE58 = Investment in producer's durable equipment - 1958 dollars
PIPDE = Implicit price deflator - producer's durable equipment

IPDE58 = f(KGDPE58, DODPCAUS, GNP58, PGNP, IPDECOST, CASH58, SF58)

Where:

IPDE58 = Investment in producer's durable equipment - 1958 dollars
KGPDE58 = Capital stock of producer's durable equipment - 1958 dollars
DODPCAUS = DOD military prime contract awards - total
GNP58 = Gross national product - 1958 dollars
PGNP = Implicit price deflator - gross national product
IPDECOST = Cost of capital variable
CASH58 = ZA + CCACORP - DIV
ZA = Corporate profit after tax excluding IVA
CCACORP = Corporate capital consumption allowances
DIV = Dividends
SF58 = Final sales, total - 1958 dollars

IPDECOST = f(PIPDE, RMMDCNEWNS, RTCGFS, DPNDIS, RITC)

Where:

PIPDE = Implicit price deflator - producer's durable equipment
RMMDCNEWNS = Average yield on new issues of high-grade corporate bonds
RTCGFS = Statutory corporate tax rate
DPNDIS = Discounted value of depreciation allowances
RITC = Effective rate of the investment tax credit

The weighted average effect on the propensity to invest was incorporated into the fixed nonresidential investment (IFIXER) equation as a multiplier. In other words, the investment equation, which is based upon the user cost of capital and aggregate demand, was multiplied by one plus the fraction that investment would change based on the survey data as subsequently weighted. The percentage change in corporate tax payments was averaged and also included in the long-term macroeconometric model as a multiplier on corporate tax payments. The model was then solved over a five-year period for each tax proposal.

Assumptions of the DRI Long-Term Model

The assumptions of the DRI Long-Term Model of the U. S. Economy basically are such that the economy operates at near full employment after recovering from the initial business cycle.[5] Since the model used by TIP was developed in 1974, the "control" solution returns to near full employment by the year 1975. Thus, the results of the survey give the macroeconomic effects that would occur if the economy were operating at a much more normal level than the current economy. If the survey results were incorporated into the model of today's economy, the effects would, in many cases, be greater because of the correspondingly greater degree of idle capacity at present. However, again, the purpose of the analysis is to develop long-term trend estimates.

The general long-term propositions are:

1. The investment/GNP ratio will be high.

   The model assumes that over the next several years, the economy will be characterized by a major catch-up element for investment because of:

   A. Inadequate outlays in the latter 1960s when the dollar was overvalued and the manufacturing sector was suffering from a depressed rate of return;

   B. The anti-pollution requirements of the future; and

   C. The need to develop new energy sources;

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[5] A complete discussion is presented in "Problems and Prospects for the U. S. Economy: Data Resources Long-Term Projections, 1974-1985," Data Resources, Inc., May, 1974.

2. The financing needs for this large volume of investment will be met by large amounts of personal and business saving.

   This requires that the saving ratio be higher than its historical average, which seems reasonable given the maturing nature of the population;

3. Budget deficits will be kept small in accordance with near full employment once the current recession ends;

4. The inflation of 1973-74 represents an historical episode rather than a permanent change in the economic structure; and

5. The growth in potential GNP is 3.9 percent per annum for the first five years of the model simulation, below the 4.7 percent rate of growth during the five years prior to 1974 and consistent with the projected slower population growth.

Major assumptions of the control solution are summarized in Table 3.

Table 3

RATES OF GROWTH OF MAJOR ECONOMIC INDICATORS
FOR THE CONTROL SOLUTION

	Historical 70-74	Control 75-79
Real GNP	4.1	4.3
Gross private domestic investment	6.2	5.2
Fixed investment	6.0	5.3
GNP deflator	5.1	4.4
Unemployment rate (level)	5.4	5.4
Interest rate on high grade corporate bonds	7.5	7.6

DATA SOURCES

DESCRIPTION OF SERIES DIV

Dividends
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income & Product Accounts of the United States, Table 2.2

DESCRIPTION OF SERIES GNP58

Gross National Product--1958 Dollars
Billions of 1958 Dollars
Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES ICER

Investment in Private Nonresidential Structures
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES ICR

Investment in Residential Structures
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES IFIXER

Fixed Private Nonresidential Investment
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES IPDE

Investment in Producers' Durable Equipment
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES IPDE58

Investment in Producers' Durable Equipment--1958 Dollars
Billions of 1958 Dollars
Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES IP&E49

Plant and Equipment Expenditures--Public Utilities
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
Survey of Current Business, Jan. 1970; Subsequent Quarterly Issues

DESCRIPTION OF SERIES IP&EM

Plant and Equipment Expenditures--All Manufacturing
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
Survey of Current Business, Jan. 1970; Subsequent Quarterly Issues

DESCRIPTION OF SERIES PGNP

Implicit Price Deflator--Gross National Product
Index Base: 1958 = 1.0
Seasonally Adjusted
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES PICER

Implicit Price Deflator--Investment, Private Nonresidential Structures
Index Base: 1958 = 1.0
Seasonally Adjusted
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES PIPDE

Implicit Price Deflator--Investment in Producers' Durable Equipment
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DESCRIPTION OF SERIES RMMBCNEWNS

Average Yield on New Issues of High-Grade Corporate Bonds
Adjusted to AAA Basis, Per Cent Per Annum, Not Seasonally Adjusted
Courtesy of the Economics Department
The First National City Bank of New York
Estimates Beginning April 1972 Computed by DRI

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Senator NELSON. Thank you very much for taking time to come.

Of course, I have not had the chance, nor have any of the other members, to look at your tax impact project report. But, it looks to be——

Mr. BIXLER. Excuse me, Mr. Chairman, could I just highlight a couple of things which stood out when I saw the report yesterday for the first time? (I had known about the project being underway, but had not seen the results.) If, for example, you look on page iii——

Senator NELSON. What page?

Mr. BIXLER. Roman numeral iii. It is in the beginning before the Arabic numbers start. There it talks, for instance, about the employment effects, if the 10-percent investment credit were made permanent. In the first year it would equate out to about 80,000 jobs, and in over 5 years, it would result in approximately 1,170,000 more jobs.

This is not to say that we asked the tax managers of these businesses how many jobs a permanent 10-percent investment credit would create. Instead, we asked them what would be the tax impact on their own firms, then ran their replies through this whole econometric model to obtain this kind of answer. For more detail on other results may I refer you to page 1. (That page does not have a number, but is called Findings of the Project). Right below is table No. 1 which shows that while Federal tax receipts would go down sharply in the first 3 years, by the fourth year the reduction would be small and by the fifth year Federal revenue would actually start to gain. Accordingly, while the net impact over a 5-year period would be a revenue loss of $5.3 billion, there would be a gain in real investment on the order of $24.5 billion, and increased employment of approximately 1,170,000 persons, which seems like a pretty good result for that amount of revenue change.

All the way through, each of these tables evaluates the impact of a particular change in tax policy, asking if the asset depreciation range were repealed, what would the effect be all the way through in the 5-year cumulative totals? At least to me it seems to produce quite different answers than those which arise when you simply read the Treasury estimates as to what will be the revenue change in the first year of the 17 possible alternatives covered by the *Tax Impact Project Report.*

No one would want to claim as a first effort that every detail will be correct, but I think the study gives an important new indicator of trends and interrelated effects.

Senator NELSON. Of course, you know there are many who argue that the investment tax credit is quite unnecessarily wasteful in the sense that you get your 7 or 9 or 10 percent of tax credit on investment you intended to make anyway. That is to say, how much are you losing in taxes in order to induce that marginal expansion of investment that would not have occurred that year?

I remember when we first dealt in the 1960's with the investment tax credit. An attorney for one of our very large corporations in the country, who is a friend of a friend of mine, simply said: "We will be very happy to have it, but we have our investment plans laid out for the next whatever it is, 5, 6, or 7 years, and we are going to get a lot of money out of it. But, this is not going to expand, detract, or affect our investment in capital goods at all."

So, in this case you give a very large tax break to a company in which the management side of the company was saying privately it was not going to affect their investment. Now, there would be others where the credit might expend investment. There is a certain amount of investment that is going to be done, maybe 90 percent of it is going to be done with or without investment tax credit, or 95 percent. But, if you had your choice between an investment tax credit or an adoption of a different depreciation schedule, which would you chose? Now, I do not have a specific one in mind; I do not know the impact of all the alternatives. We did talk with some Canadian experts respecting what was adopted there. Canada allows, as I recall, something like 50-percent writeoff the first year, and then the next 50 percent written off at the discretion of management, over I do not know how many more years. The whole thing was totally in the control of the company, and they were allowed 50 percent the first year and 50 the second year if they wanted to take it. Or they could stretch it out in any way if that was in their advantage.

Now, if you had your choice, which one in your judgment would do the most good for small business?

Mr. BIXLER. Now, this is a personal opinion because we do not have a policy of the National Association of Manufacturers on this.

Senator NELSON. I understand. I do not expect you to be speaking for anybody but yourself.

Mr. BIXLER. In our own case, since we are in a technology-based business, we essentially need to be making more capital investments along the line. I think now that a permanent 10-percent investment credit would be most desirable for us, but I certainly recognize that the present depreciation or capital recovery system is not adequate. New equipment costs so much more than it used to and we need so much more of it to maintain our market position that we recognize we are not getting nearly enough cash flow from depreciation to meet our needs for new investment. So, you are giving me a Hobson's choice that is indeed difficult.

However, if we had a simple and adequate cost recovery system, there would not be as much need for the investment tax credit——

Senator NELSON. Because you would be recapturing your investment much more quickly, and therefore——

Mr. BIXLER. Yes, and we would have the option to do it at the time the recovery worked best for our particular enterprise. But again, if we did not have such high corporate rates, and if we did not have the depreciation system that now is in the law and the regulations, we might well not need the investment credit to the same extent. But all that is a hypothetical situation.

Mr. MASSA. Mr. Chairman, I would like to comment, too, on the point that you made about subjective judgments as to whether the investment tax credit, for example, created any new investment or stimulated any new investment that would otherwise not have taken place. I should point out, so that there is no misunderstanding, that his survey and these results are basically mathematical calculations on the change in capital, the change in available capital.

In other words, we have not attempted to analyze or to determine whether one particular system versus another has any technical or

administrative ease or might encourage or discourage investment in one way or another. What the impact project does is to say, given a change in capital of x dollars, whether it is because of a change in credit or depreciation in the tax rate, or whatever, what would that mean if investment in the economy or capital investment in the economy were changed by that amount. So, the study does not attempt to say that it is because there is a 10-percent investment tax credit necessarily that these particular numbers would be developed. It is because a 10-percent investment tax credit would generate this much additional capital or that repeal would reduce the amount of available capital and that that being worked through the model is what generates the numbers.

We have not attempted in the survey and we do not attempt to reach any subjective conclusions about which particular approach is better or which particular approach is easier to handle or would or would not stimulate more activity. It is basically a mathematical calculation on changes in available capital.

Senator NELSON. The argument for it has been to induce capital investment, not to provide more capital for the company. Both of them provide capital. If you have an accelerated depreciation, it gives you the money more quickly; you have it now, rather than 10 years from now. The investment tax credit also gives you capital. In some places it may and certainly does induce additional capital investment this year that would not have been made until the next or the year after—at least that is what the economists argue. But both devices provide capital for the business, do they not?

Mr. MASSA. That is right.

Mr. BIXLER. Also, a small business can get the capital investment credit by leasing the equipment from someone else and still arranging with the company doing the leasing to allow the user to have the investment credit. That improves the user's capital in the very year that the new equipment is obtained. In other words, if you make a lease-purchaser arrangement for example, for a machine tool——

Senator NELSON. You are not just talking about leasing; you are talking about lease purchase.

Mr. BIXLER. Yes, lease purchase, and the option can be with the leasee to take the investment credit. Frankly, in our company, that is the only basis on which we will enter a lease-purchase agreement.

Senator NELSON. Is it for the reason that you get the investment tax credit?

Mr. BIXLER. Right.

Senator NELSON. Well, thank you very much, gentlemen, for your testimony. We may wish to have you back again to discuss the *Tax Impact Project Report* after we have had a chance to look at it.

Mr. MASSA. We will be happy to come back.

Senator NELSON. Thank you, sir.

[Whereupon, at 12:22 p.m., the committees recessed, to reconvene upon the call of the Chair.]

APPENDIXES

Appendix I

[From the Congressional Record, June 12, 1975, pp. S10459–S10460]

Hearings on Small Business Tax Reform

Mr. Nelson. Mr. President, on April 24, 1975, the Select Committee on Small Business gave notice of its in-depth study of the business tax structure. We now announce that the study will move to the state of public hearings on June 17, 18, and 19.

BACKGROUND

Earlier this year, in February, the Select Committee conducted 3 days of hearings on small business tax needs in connection with congressional consideration of the emergency Tax Reduction Act of 1975. As a result of this activity, several small business provisions were incorporated into that legislation, as I have previously reported to this body in a series of statements—Congressional Record, February 12, 1975, page S1861; March 10, 1975, page S3488; March 22, 1975, page S4848.

PURPOSE OF THIS STUDY

The objective of the study launched in April ultimately is to develop small business recommendations for inclusion in the omnibus tax reform bill on which the House Ways and Means Committee will begin hearings at the end of this month.

The method we have chosen is a thorough study of the facts and figures which—

Demonstrate the special financial and capital problems of small- and medium-sized business;

Show how these difficulties are related to the tax system; and

Indicate how proposed solutions will benefit the economy as a whole, as well as the small business community.

JOINT PARTICIPATION OF FINANCE COMMITTEE

We are pleased that the study will be conducted jointly with the Subcommittee on Financial Markets under the chairmanship of the Senator from Texas (Mr. Bentsen). Because of this, eight members of the Senate Committee on Finance will be involved. The perspective of that subcommittee, its excellent past work on access to equity capital, and its resources will be valuable in achieving the aims of this study.

FORMAT OF THE HEARINGS

The hearings on June 17–19 are directed toward basic economic issues, such as recession, unemployment, inflation; capital formation and productivity; and specifically how the tax system either hinders or helps the small and independent businesses to cope with these problems. I ask unanimous consent that a list of these topics and witnesses addressing these subjects be included in the Record at the conclusion of my remarks for the interest of all concerned.

We are all aware of the major problems in the U.S. economy:

The worst recession since the 1930's;

A jump in the wholesales price index—reflecting the cost of goods for business—of 21 percent last year, compared to a consumer price index rise of 12 percent;

Loan delinquencies of consumers at the level of 2.8 percent, the highest rate since 1949; and

A steep fall in profits over the last 12 months which appears to have been most severe for smaller and independent firms.

NEED FOR ADDITIONAL RESEARCH

There are many things we do not know and which statistics do not tell us. The data on record does reflect that small business is being squeezed from every direction. We have asked our witnesses to document the particular features of the tax system which affect the smaller firms in a disproportionate or discriminatory way.

Our hearings in February demonstrated that all but the smallest of businesses are required to pay more in taxes in relation to their income than the biggest corporations in the country. It follows that a growing business generally must pay higher tax rates than its established competitors. The additional financial burden on smaller and independent companies stifles their ability to bring better products and services to consumers at lower prices. This kind of imbalance threatens to undermine the whole free enterprise system.

In the past, the tax writing committees have been able to devote too little time to these underlying economic issues. Small and independent business traditionally accounts for between 52 and 53 percent of the Nation's total private employment, 48 percent of the business product and about one-third of the gross national product. It has also been the predominant source of innovation, and a major source of capital accumulation, increased productivity, and competition at home and abroad. The American economy needs all these all the time, but especially now, as we attempt to work our way out of a recession where unemployment is running above 9 percent.

We hope to receive testimony on how new, small, and independent companies can help solve these problems if fledgling firms are treated equitably and the unfair burdens of the tax system and excessive paperwork are taken off their backs.

Therefore, we hope to fulfill an important role in exploring these matters and in making sound and responsible recommendations for improvement of the tax code in behalf of small business and the entire economy.

We are reaching out to include in our study the most modern and up-to-date computer techniques, and to avail our committees of the foremost academic tax law and economic talent in the country.

We expect to report periodically to the Senate as this study advances. Any persons interested in participating or learning more about this project may contact the Select Committee on Small Business, 424 Russell Senate Office Building, Washington, D.C., 224-5175.

I ask unanimous consent that a schedule of hearings be printed in the Record at this point.

There being no objection, the schedule was ordered to be printed in the Record, as follows:

[Hearings before Senate Select Committee on Small Business and Subcommittee on Financial Markets, Senate Finance Committee, June 17, 18 and 19, 1975, 9:30 a.m. daily, room 2221, DSOB]

WITNESS LIST

TUESDAY, JUNE 17

Employment, Taxes and Small Business: Professor Robert Eisner, Chairman, Department of Economics, Northwestern University; Charles Holt, Director, Unemployment and Inflation Research, Urban Institute.

Impact of Recession on Small and Large Business Profits and Prospects: John Lewis, Executive Vice President, National Small Business Association, accompanied by: Herbert Liebenson, Staff Vice President for Government Affairs, NSBA: and John Mendenhall, C.P.A. and Attorney.

WEDNESDAY, JUNE 18

Small Business Problems and Areas for Additional Research: Bruce Fielding, C.P.A., Secretary, Board of Directors, Dr. W. C. Dunkelberg, Consultant, National Federation of Independent Business; Dr. Edward Shils, Director, and William Zucker, Assistant Director, Entrepreneurial Center, Wharton School of Finance, University of Pennsylvania.

Specific Tax Reform Proposals and Further Research Projects:

Panel of Presidents of the Four Major Regional Small Business Organizations: Oliver O. Ward, Smaller Business Association of New England, John W. Hannon, Smaller Manufacturers Council of Pittsburgh, Edward H. Richard, Council of Smaller Enterprises, Bruno Mauer, Independent Business Association of Wisconsin.

THURSDAY, JUNE 19

Venture Capital and Its Significance to Innovation and Growth: Walter Stults, Executive Vice-President, National Association of Small Business Investment Companies; Paul Bancroft, III, President, Bessemer Securities Corporation; Richard Hanschen, President, New Business Resources.

Tax and Capital-Problems of Agriculture as Small Business: Gilbert C. Rohde, President, Wisconsin Farmers Union.

New Techniques of Revenues Estimating: Roland Bixler, President, J.B.T. Instruments, Inc., Chairman, Task Force on Small Business Tax Policy, National Association of Manufacturers; Cliff Massa, Director of Taxation, National Association of Manufacturers.

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APPENDIX II

national milk producers federation

30 F Street, N. W., Washington, D. C. 20001
(202)393-8151

Patrick B. Healy
Secretary

The National Milk Producers Federation is a national farm commodity organization representing virtually all of the dairy farmer cooperatives and their dairy farmer members who serve this nation by producing and marketing milk in every state in the Union.

Since its inception in 1916, the Federation has actively participated in the development of dairy programs which are a part of a total system of agricultural law and policy which can appropriately be termed a national food policy.

The policies of the Federation are determined by its membership on a basis that assures participation from across the nation. The policy positions expressed by NMPF are thus the only nationwide expression of dairy farmers and their cooperatives on national public policy.

To The

SENATE SELECT COMMITTEE ON SMALL BUSINESS

and

SUBCOMMITTEE ON FINANCIAL MARKETS

SENATE COMMITTEE ON FINANCE

With Respect To

Tax and Financial Problems of Small Business

June 19, 1975

The National Milk Producers Federation is a nationwide farm commodity organization representing dairy farmers and the dairy marketing cooperative associations they own and operate throughout the nation. The dairy cooperatives represented by the Federation represent the only nationwide expression of public policy issues directly affecting dairy farmers and their cooperatives.

Your committees are to be commended for calling these hearings on the problems related to capital needs of small businesses, including agriculture. Representing the nation's dairy farmers as we do our comments will be confined entirely to the agricultural problem.

In rural areas we often heard it said that "Farming is big business today." Implied in this remark is that the operation of a farm requires broad managerial skills commensurate with those found in businesses, including the handling of capital. In truth, however, farming is more comparable to small businesses, but this in itself is an evolution from farming as we knew it throughout much of the United States only a generation ago. Farming with "forty acres and a mule" is a thing of the past.

To understand the scope of the financial problem facing a farmer one has only to look at USDA statistics showing the dramatic growth in farm sizes and land values during the past fifteen years. They show:

Year	Farmland value per acre (Including improvements)	Average farm Size (acres)	Investment
1959	$103	288	$ 29,664
1964	138	332	45,816
1969	188	369	69,372
1974	346	385	133,210

Note that the average farmer has twice as much invested in his land and buildings today as he had five years ago. And this does not take into account his corresponding increases in investment in livestock and equipment.

For potential young dairy farmers the problem is even more difficult than for the producers of most other commodities. This is particularly true of that vast majority of dairy farmers who, as a part of their operation, raise a considerable part of their own feed. In raising this feed they have the same escalating costs as farmers who produce field crops, for such input items as fertilizer and seed, along with the greatly increased cost of farm machinery.

But in addition to this, they have the costs of producing pure and wholesome milk. Seventy-eight percent of the milk now produced in the United States is designated as Grade A. To produce this requires meeting certain basic standards in the barns and yards which house the cattle, in the milk house in which the product is assembled and cooled, and in the stainless steel equipment which is needed for this purpose.

Because of this, dairy farming is not something which a young farmer can grow into. With these standards he cannot start out with a cow or two and gradually expand until he has an adequate-sized herd. Even at the start his operation must be big enough to carry his investment in the required capital items.

Dairying is a labor-intensive type of farming. As such it has been highly receptive to replacing labor with equipment, which costs more money, but which in turn allows a family-farm operator to handle a larger sized herd, which also costs more money to establish.

As a result, dairy herd sizes have increased dramatically the past few years. U.S. Department of Agriculture in a recent publication titled, "Questions and Answers on Federal Milk Marketing Orders" shows daily production per producer as follows:

1954 -	399 lbs. per day
1964 -	888 lbs. per day
1974 -	1,461 lbs. per day

Basically this means that this average producer had 15 cows in 1954, 30 cows in 1964, and 50 cows in 1974. This figure has increased every year; there is every reason to believe that it will continue to increase.

We are, therefore, talking about an investment of over $200,000 for an average dairy farmer in his land, buildings, equipment, cattle and feed. If he is a farm tenant, his investment (which excludes land and buildings) would be in the $100,000 range.

Much of the problem in farm financing stems from the fact that agriculture has not moved away from its traditional financing methods in spite of the ever-increasing needs for capital. As a result it becomes extremely difficult for a young farmer to acquire the needed capital unless he has some type of sponsorship, usually by a father in transferring to a son. These traditional methods will have to change.

As a result any changes which your committee considers for meeting the financial needs of non-agricultural small business as well as tax application to it should, where practicable, be extended to agriculture.

In the tax realm there are two areas which the committees should review which directly affect agriculture.

The first of these involves capital gains. To obtain the benefit of this section of income tax law a dairy farmer must hold his cattle for a much longer period than the basic six months which makes other types of assets eligible for this treatment. A speculator on Wall Street need hold a stock certificate for only six months to qualify, but a dairy farmer, on his dairy cattle, must own the item for at least two years. This is not required of his other personal property nor of the personal property of non-agricultural small businesses. This disparity is hard to rationalize.

Estate taxes are creating an even greater problem for farmers in the orderly transfer of property. This is particularly true of transfers within a family, such as from father to son.

Currently the tax-exempt base, unchanged since 1942, is $60,000. Note in our earlier table that the average investment in a farm in 1959 was (in round figures) $30,000. If this average farmer had an equal investment in equipment, cattle and feed (i.e. another $30,000) his total farm investment of $60,000 placed him in a position where, if this was his entire estate, he had no tax liability.

By contrast the average farmer in 1974 has $133,000 invested in his farm. If his personal property equals this figure (another $133,000) his total farm investment is $266,000 and he would have an estate tax liability in the $40,000-$50,000 range. Most farm operations do not have the liquidity to meet this type of obligation.

Realistically the 1942-based figure of $60,000 should be increased to at least $200,000, as proposed in a number of bills which have been introduced in this session of Congress.

Farmers are also penalized under the estate tax laws where, in appraising the estate, it is determined that the farm has a higher value if the land is used for other purposes. This is particularly true in suburban areas, where land on its agricultural use is worth several hundred dollars an acre but which is worth several thousand dollars an acre if converted to other uses. Changes in law are necessary to permit such land to be valued as agricultural.

We ask, too, that your committees continue to keep in mind the role of the farmer cooperatives as marketing agencies and representatives of their farmer members. Your committees are concerned, and rightly so, with the disparity which tends to develop between small businesses and their larger counterparts. Farmers individually are completely at the mercy of large companies with their economic concentration. The only means they have to combat this is to join

together into cooperative associations to represent them in the marketing of their products. Obviously, therefore, as corporations become larger these cooperatives must of necessity become larger if they are going to be able to properly function in behalf of their members.

Cooperatives must, therefore, be assured of adequate sources of financing if they are to continue to play their vital role in the handling of agricultural goods and services.

As legislation on these and other areas involving the financing and taxing of small businesses is considered in detail by your respective committees, we look forward to presenting our views on the effects such legislation will have on the dairy farmers of our nation, and their cooperatives. You are to be commended for focusing at this time on the basic need for legislation in these areas.

APPENDIX III

GAYLORD NELSON, WIS., CHAIRMAN
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United States Senate
SELECT COMMITTEE ON SMALL BUSINESS
(CREATED PURSUANT TO S. RES. 58, 81ST CONGRESS)
WASHINGTON, D.C. 20510

June 20, 1975

Mr. William E. Woods
Washington Representative and
Associate General Counsel
National Association of Retail Druggists
440 National Press Building
529 14th Street, N. W.
Washington, D. C. 20045

Dear Mr. Woods:

This will acknowledge your letter of June 16 transmitting comments pertaining to tax reform for small business.

We will be pleased to include this material as part of the record of our hearings on June 17, 18, and 19.

We will be glad to keep you informed of the future course of this study.

Sincerely,

GAYLORD NELSON
Chairman

GN:hsmvc

COMMENTS
of
THE NATIONAL ASSOCIATION OF RETAIL DRUGGISTS

HEARINGS ON SMALL BUSINESS TAX REFORM
JUNE 17,18,19, 1975
THE SELECT COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

1. Our members are plagued by a rather complicated and difficult rule which requires the deposit within three banking days after a payroll payment where the accumulated taxes will reach $2,000 or more for a quarterly monthly period. This rule is complicated and difficult for the small businessman to understand. He does not have the staff and he, himself, cannot cope with determining when he may reach this point of deposit. Even though he may have an accountant handling his work, the accountant will not get the records until many days or weeks after the end of a month and cannot assist him in meeting this rule. The penalties are very stiff and we urgently request adjustment of this rule with respect to small businessmen. In fact, we understand that Senator Bible of Nevada a few years ago attempted to change the application of the rule by requiring that small taxpayers would no longer be required to make the payments other than monthly if the total amount required to be paid does not exceed $7,000.

2. We urgently request that consideration be given to the handling and reporting of payroll information to relieve the small businessman of all of the difficulties attendant with quarterly reports. This procedure would actually assist the government in reducing the paperwork received and the attendant handling costs.

3. We submit that the Federal government, because of the information that it has available and the ability to use its computers for this purpose, should prepare and compute the Federal unemployment information and merely bill each employer for the amount due. This procedure would reduce the amount of paperwork required by small businessmen because this form does require special handling and work.

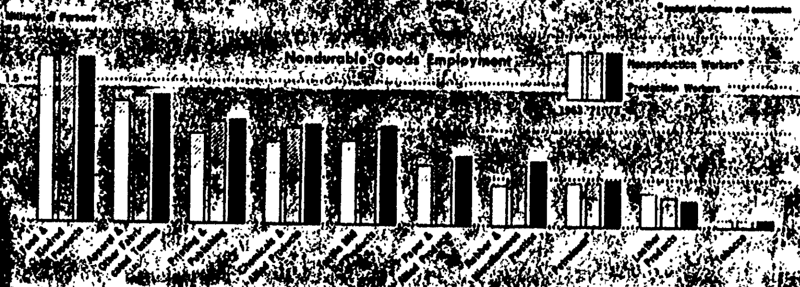
APPENDIX IV

THE CONFERENCE BOARD

Capital Invested Per Employee

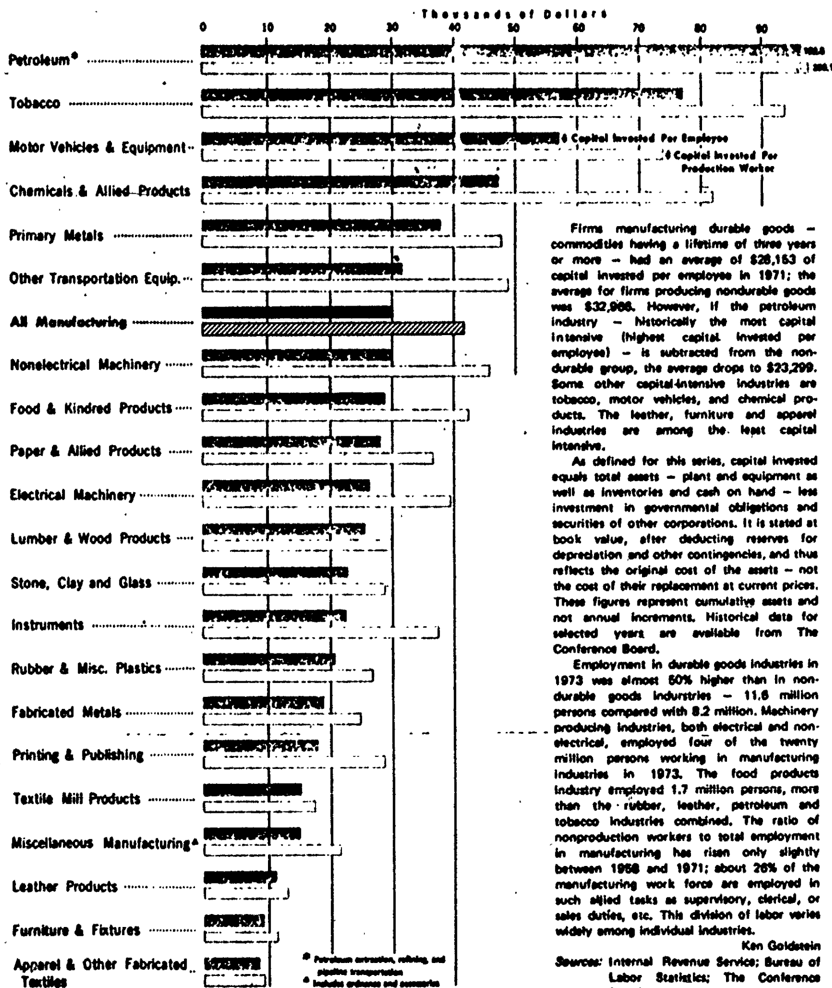
Road Maps of Industry
No. 1749 November 1, 1974

Capital expenditures, which include the procurement of additional and more efficient plant facilities and equipment, are instrumental in augmenting the output produced for each hour of labor input. Manufacturing firms had an average of $30,061 per employee invested in factory buildings, machinery, and other assets by the end of 1971. Just ten years earlier, at the end of 1961, the book value of capital invested per employee was only half that amount.



The number of persons employed in the manufacturing sector of the economy increased from 15.9 million in 1958 to 19.8 million in 1973. During this time labor productivity — the amount of goods produced per hour of labor spent — in manufacturing increased by an average of 3.7% a year. Capital investment is one of the major factors contributing to increased productivity and economic growth. In 1958 the book value of capital invested per employee in manufacturing averaged $13,210. This does not necessarily mean, however, that a capital expenditure of equal amount was needed to hire [illegible] additional worker, since such hiring need not have entailed building new plant or purchasing new equipment. Between 1958 and [illegible] per employee rose on an average of 3.8% a year. In the succeeding four years, it increased at an average 6.6% annual rate; and, from 1967 to 1971, it advanced 10.1% a year. Labor productivity improved at a more rapid rate between 1964 and 1971 than in the 1958-63 period.

Capital Invested per Employee in Manufacturing, 1971



Firms manufacturing durable goods – commodities having a lifetime of three years or more – had an average of $28,153 of capital invested per employee in 1971; the average for firms producing nondurable goods was $32,966. However, if the petroleum industry – historically the most capital intensive (highest capital invested per employee) – is subtracted from the nondurable group, the average drops to $23,299. Some other capital-intensive industries are tobacco, motor vehicles, and chemical products. The leather, furniture and apparel industries are among the least capital intensive.

As defined for this series, capital invested equals total assets – plant and equipment as well as inventories and cash on hand – less investment in governmental obligations and securities of other corporations. It is stated at book value, after deducting reserves for depreciation and other contingencies, and thus reflects the original cost of the assets – not the cost of their replacement at current prices. These figures represent cumulative assets and not annual increments. Historical data for selected years are available from The Conference Board.

Employment in durable goods industries in 1973 was almost 50% higher than in nondurable goods indurstries – 11.6 million persons compared with 8.2 million. Machinery producing industries, both electrical and nonelectrical, employed four of the twenty million persons working in manufacturing industries in 1973. The food products industry employed 1.7 million persons, more than the rubber, leather, petroleum and tobacco industries combined. The ratio of nonproduction workers to total employment in manufacturing has risen only slightly between 1958 and 1971; about 26% of the manufacturing work force are employed in such allied tasks as supervisory, clerical, or sales duties, etc. This division of labor varies widely among individual industries.

Ken Goldstein

Sources: Internal Revenue Service; Bureau of Labor Statistics; The Conference Board

ROAD MAPS OF INDUSTRY
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APPENDIX V

BOB DOLE
KANSAS

United States Senate
WASHINGTON, D.C. 20510

STANDING COMMITTEES:
AGRICULTURE AND FORESTRY
BUDGET
FINANCE
POST OFFICE AND CIVIL SERVICE
SELECT AND SPECIAL COMMITTEE:
NUTRITION AND HUMAN NEEDS

June 25, 1975

Honorable Gaylord Nelson
Chairman, Senate Select Committee
on Small Business
424 Russell Office Building
Washington, D. C.

Dear Mr. Chairman:

The joint hearings of the Financial Markets Subcommittee and the Select Committee on Small Business have again demonstrated the need for reform of Federal tax statutes. For it is evident that the present complex provisions of the Internal Revenue Code have placed the small businessman, farmer, and rancher in an unfavorable position in relation to larger enterprises. I am hopeful that we will move swiftly to include small business tax relief in the first tax reform bill considered by the Finance Committee.

In addition, I request that this letter be inserted in the hearing record in order that the following statistics with respect to small businesses in Kansas will be brought to the attention of Committee members.

> Of the 46,384 businesses in Kansas, 45,690 employ less than 100 persons, according to County Business Patterns, a publication of the U. S. Department of Commerce.
>
> Of the 4,306 manufacturing firms in Kansas, 4,020 employ less than 100 persons, according to the Kansas Department of Economic Development Manufacturing Directory.

It is apparent from these statistics that the needs of small business are of vital importance to the people of Kansas.

Sincerely yours,

BOB DOLE
U. S. Senate

BD:kww

APPENDIX VI

Social and Economic Consequences of the Merger Movement in Wisconsin

by

Jon G. Udell
Graduate School of Business
The University of Wisconsin

Wisconsin Economy
Studies Number 3

SOCIAL AND ECONOMIC CONSEQUENCES OF THE MERGER MOVEMENT IN WISCONSIN

by

Jon G. Udell

Sponsored Jointly by:

Division of Economic Development
Department of Local Affairs and
Development
The State of Wisconsin

Bureau of Business Research & Service
Graduate School of Business
The University of Wisconsin
Madison, Wisconsin

May, 1969

SOCIAL AND ECONOMIC CONSEQUENCES
OF
THE MERGER MOVEMENT IN WISCONSIN

Prepared for

The Honorable Warren P. Knowles, Governor

The State of Wisconsin

and the

Merger Study Commission:

Palmer B. McConnell, Chairman
Kenneth W. Haagensen
James R. Morgan
Thomas Nelson
Philip A. Sundal
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BEST COPY AVAILABLE

ACKNOWLEDGMENTS

The financial support for the research was provided by the Division of Economic Development of the Department of Local Affairs and Development and the Graduate School of Business of The University of Wisconsin. Equally important were the personal contributions of time and effort so generously given by Palmer McConnell, Kenneth Haagensen, and other members of the Merger Study Commission, Courtland Conlee of the Milwaukee Journal Company, Raymond McClelland and Robert Anthony of the United Fund of Milwaukee, and Orin Reich and Sidney Knope of Wisconsin's Department of Industry, Labor, and Human Relations.

The author is also grateful to the presidents of the Wisconsin firms who participated in the management survey of acquired companies, the Chamber of Commerce and newspaper executives, and members of the general public who participated in the surveys of Wisconsin communities.

The study would not have been possible without the able assistance of Robert Smith, Leigh Lawton, and Keith Davis--all graduate students in the School of Business of The University of Wisconsin, and Mrs. Jean Robertson and Mrs. Linda Kohl of the staff of the Bureau of Business Research and Service. A vote of thanks also goes to the members of The University of Wisconsin chapter of Alpha Kappa Psi, the professional business fraternity, for giving part of their Christmas recess to conduct personal interviews.

FOREWORD

This is a study of the social and economic consequences of the acquisition of Wisconsin firms by Wisconsin and out-of-state corporations. Because many of the larger mergers occurring in recent years were of the conglomerate type, the study is, to a major extent, one of conglomerate acquisitions.

While the Federal Trade Commission and others are attempting to evaluate the relationship of conglomerate mergers to competition and prices, this research emphasizes other possible social and economic implications of the merger movement. Among the topics covered are changes in the growth of employment and payrolls, the movement of corporate headquarters and company executives, and changes in corporate contributions and support of community causes.

Each of the subjects explored by the study could easily have consumed the entire research effort, which spanned less than six months. While additional research may be desirable to further confirm or deny the findings of this study, several analyses are quite conclusive. Among them is the effect of acquisitions on the growth of employment and payrolls in Wisconsin.

Further research is needed to investigate those social and economic consequences of corporate acquisitions that have not been explored by this study, such as the impact of acquisitions on Wisconsin's income tax receipts. The author invites others to join him in future research on the merger movement in Wisconsin and other states.

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TABLE OF CONTENTS

Chapter	Subject	Page
I	Possible Social and Economic Implications of Corporate Acquisitions	1
II	Effect of Corporate Mergers as Seen by Newspaper Executives in Wisconsin	9
III	Effect of Corporate Mergers as Seen by Local Chambers of Commerce in Wisconsin	15
IV	Effect of Mergers as Seen by Management of Acquired Companies	19
V	Public Reaction to Corporate Mergers	30
VI	Impact of Corporate Mergers on Employment and Payrolls in Wisconsin	34
VII	Mergers and Corporate Giving in Milwaukee	57
VIII	Summary, Conclusions, and Recommendations	66

Chapter I

POSSIBLE SOCIAL AND ECONOMIC IMPLICATIONS OF CORPORATE ACQUISITIONS

The purpose of this chapter is to present an overall picture of the possible social and economic consequences of the merger movement.

The Merger Movement

There have been at least three waves of merger activity in the United States. One began in the 1890's and another followed World War I. The current merger movement is lasting longer and is of greater magnitude than those that preceded it. According to figures compiled by the Federal Trade Commission (FTC), which include only mergers of manufacturing and mining companies, there were 2,268 corporate mergers in 1968, ten times as many as in 1950. According to estimates by W. T. Grimm & Company of Chicago, mergers of all kinds totaled 4,462 in 1968, up from 2,975 in 1967. In addition, there is a trend toward larger acquisitions. As recent as 1961 there were no acquisitions of companies with assets of $250 million and over; in 1968 acquisitions of this magnitude were a considerable proportion of all mergers.

Another aspect of the current wave of merger activity is the rising number of conglomerate mergers--those involving firms which have neither a competitive (horizontal) nor supplier-user (vertical) relationship. Approximately 80 percent of all large mergers in the first half of 1968 were of the conglomerate type, and these represented 90 percent of the assets involved in all mergers with assets of over $10 million.

What Is a Merger?

A merger, among other things, involves a transfer of business ownership; but determining which transfers of business ownership are mergers is not easy. For example, is the consolidation of a wholly-owned subsidiary into a parent corporation really a merger? Because there is no real change in ownership, this study does not consider it to be a merger. The same is true of the consolidation of two corporations previously affiliated by ownership ties.

A more difficult case is presented by the firm which leases its business or assets to another firm. For all practical purposes, this is at least a temporary merger. However, the ownership remains with the original firm and therefore it is excluded from the analysis. Somewhat similar to leasing is the sale of assets by one firm to another. If the sale does not represent the major proportion of the seller's total assets, we do not consider it to be a merger. In addition, the transfer of one corporation to a new corporation for the purpose of changing the corporate name or state of incorporation is not a merger.

The terms "merger," "consolidation," "amalgamation," and "acquisition" are frequently used interchangeably, even though the FTC and various state statutes have distinguished among them. However, these definitions are not uniform from one state to another. Therefore, only two terms will be used--"merger" and "acquisition." In this study, a "merger" is defined as the combination of two or more formerly independent business units into one organization with a common ownership. An "acquisition" is defined as a merger in which one firm acquires another. In this case, the merger has a dominant partner--the acquirer--rather than being the union of two equal partners. In recent years, most mergers have been acquisitions.

The types of corporate changes which are included under our definition of a merger are: (1) an acquisition where the transferor ceases to exist as a separate corporation and becomes a division or part of the transferee; (2) the acquisition where transferor continues operation, but as a subsidiary corporation of the transferee; (3) transfers in which a major portion of the assets of a company are sold to another corporation; and (4) the consolidation of two separately owned corporations into a new corporation with one ownership and management.

In-state and Out-of-state Mergers

From a state's point of view, there are three major merger situations to be recognized. First, there is the acquisition of a local firm by an out-of-state firm, usually a larger company. Secondly, there is the merger of an in-state firm with another Wisconsin company. Thirdly, there is the acquisition of an out-of-state firm by a Wisconsin company. In this study, research is concentrated on the first two types of mergers. By comparing the results of in-state mergers with out-of-state mergers, one is able to obtain an estimate of the impact of the geography of the acquiring firm on Wisconsin communities and the state.

Potential Social and Economic Consequences

The possible social and economic effects of mergers on Wisconsin are varied and numerous. They include:

1. Alteration of competitive conditions and price levels.
2. Changes in the growth (or decline) of employment.
3. Changes in the growth (or decline) of payrolls.
4. Growth or decline of physical assets and construction activity.
5. Increased or decreased profitability and changes in accounting methods which influence the corporate income tax revenues of the state.

6. Post-merger movement of corporate executives in and out of the state.
7. Changes in purchasing procedures and sources of supply for both goods and services.
8. Alteration of union agreements, labor relations, and working conditions.
9. Changes in the value of shareholders' equity.
10. Alteration of the corporation's attitude toward and support of community causes.

While other possible effects could be named, these are among the most prominent and are worthy of brief comment.

Competition and Prices--Any change in the intensity of competition and level of prices brought about by the merger of a Wisconsin firm could have a significant impact on the firm's customers and the economic environment of the state. There are, of course, several studies and numerous case histories of the impact of horizontal and vertical mergers on competition. There is reason to believe that conglomerate mergers also alter competitive conditions by increasing the financial strength, marketing and distribution capabilities, technological capabilities, and management of a merging company. If the company is a weak competitor made stronger, the merger is likely to benefit society. However, if an already powerful competitor is made still stronger, the result may be decreased competition and higher prices.

While important, the study of the effect of mergers on competition and prices is best done at the national level because competition usually transcends state boundaries. For this reason, and because the federal government is currently investigating the anti-trust implications of conglomerate mergers, this dimension of the merger movement is not included in the study.

Employment and Payrolls--If the acquisition of a firm results in greater capital resources, a better marketing organization, increased productivity, and an improved competitive position, the firm will expand and employment is likely to rise. On the other hand, the acquired firm may be less well managed following the merger, or the acquirer may "milk" the firm, using its resources and income to build other divisions of the parent company. The parent company may go so far as to shut down the acquired firm or transfer the operations to another state. The consequence, of course, is a reduced level of employment for Wisconsin's labor force.

A merger may also affect the quality of employment opportunities. Some acquisitions by out-of-state firms result in the removal of corporate headquarters and management personnel from Wisconsin. As a result, the community involved may lose several talented citizens active in civic affairs. Also lost are the incomes, purchases, and taxes paid by the transferred executives. On the other hand, some acquisitions result in an increased executive staff and therefore enlarged payrolls, expenditures, tax revenues, and talent for the community and the state.

The employment and payroll changes resulting from the acquisition of Wisconsin firms by in-state and out-of-state companies are discussed in Chapter VI. In addition, information and opinions on employment changes induced by mergers constitute part of Chapters II-V. The movement of executives and corporate offices is explored in Chapters II-IV.

Sources of Supply--The acquisition of a firm may change its sources of goods and services. This is particularly true when the parent firm has other divisions which produce some of the materials which are purchased by the acquired firm. Even when this situation does not exist, the acquiring firm may have a central purchasing arrangement, reciprocal purchase agreements with suppliers, or it may use different criteria in selecting sources of supply. Also, the acquiring firm is less likely to feel any allegiance

or rapport with suppliers in the area of the acquired firm. In addition, the acquired firm may be required to use the accounting, legal, and financial services of the parent corporation. When the parent is an out-of-state firm, this may cause a significant loss to business service organizations in Wisconsin.

Changes in purchasing policies and sources of supply are not fully investigated by this study. However, interviews with the presidents of acquired Wisconsin companies (Chapter IV) produced some interesting findings which are not likely to be rejected by further research.

Stockholder's Equity--When a company is acquired through a cash transaction, there is little doubt about how the previous owners of the acquired firm have fared. However, in recent years most mergers have been accomplished by an exchange of securities or a combination of securities and cash. Those who receive securities of the acquiring corporation as a compensation for their company are likely to market them gradually to postpone and reduce capital gains taxes. Therefore, the ultimate amount received for a company will depend upon the value of the acquiring company's securities over a considerable period of time.

The data collection, adjustments for stock splits and other changes, and the analysis of changes in the light of overall market conditions is a time-consuming endeavor which is currently in process. The results of this research will be reported separately.

Corporate Commitment to the Community--The dedication of corporate management to community causes may be adversely affected when a locally owned and managed company is acquired by a firm in another state. On the other hand, some large corporations are socially conscious and have a policy of active involvement in community affairs at all company locations.

Changes in community commitment and contributions following the acquisition of a local firm are explored in sections of Chapters II-IV. Chapter VII is devoted to an analysis of the United Fund contributions of acquired and non-acquired companies in Milwaukee.

Employee Relations and Union Agreements--The merger of two or more corporations may have a significant impact on unionization and the labor relations of the firms. A merger may bring together a unionized and a non-unionized company, or firms with competing unions. In addition, the labor contracts of the two companies often differ markedly. The meshing of fringe benefits has been one of the most difficult problems arising from acquisitions. It may take years to integrate differing pension, profit-sharing, and other employee benefit plans. While the impact of a merger on unionization, labor relations, and working conditions is one of the major unknowns today, it is a subject best explored at an interstate level. Therefore, it is not included in this research endeavor.

State Revenues--A merger is likely to either raise or lower the efficiency, sales, and profitability of the firms involved. In addition, accounting procedures, when changed, can alter the stated profitability of a business. For example, a division's prorated share of profits in a consolidated income report will differ from those that would be shown by separate reports for each geographical unit or division of the company. If the acquiring firm is less profitable than the acquired Wisconsin company, the parent company is in a position to legally avoid a considerable proportion of the Wisconsin income taxes which the acquired company would otherwise have had to pay. While important, the constraints of time did not allow for an investigation of the impact of acquisitions on Wisconsin's corporate tax revenues. Such a study will be conducted by the author in the future. However, the effect of acquisitions on

Wisconsin's personal income tax revenues may be derived from the study of pre- and post-merger payroll growth (Chapter VI).

Other Research Topics

In addition to the investigation of several social and economic consequences of mergers, this study also explores the reasons which prompted Wisconsin companies to be acquired, the advantages and disadvantages experienced by acquired corporations, and the public's attitude toward mergers.

Sources of Information

Some of the research data were acquired through two mail questionnaire surveys of persons who should have some knowledge of the impact of mergers in their communities—Chamber of Commerce officials and newspaper executives. Personal interview surveys were conducted among two other groups—the general public and presidents of acquired Wisconsin companies. Data on corporate contributions were gathered through the cooperation of the United Fund of Milwaukee. Information on employment and payrolls was collected from the records of the Unemployment Compensation Division of the Wisconsin Department of Industry, Labor, and Human Relations.

The six components of the total study are reported on separately in Chapters II-VII. Those wishing to minimize their reading time will find a summary of the findings and conclusions in Chapter VIII.

Chapter II

EFFECT OF CORPORATE MERGERS AS SEEN BY NEWSPAPER EXECUTIVES IN WISCONSIN

To obtain information and opinions concerning the impact of mergers on Wisconsin's communities, newspaper executives throughout the state were asked to cooperate in a mail questionnaire survey. Responses from over one-half of the state's newspapers were received, with almost all of the larger Wisconsin cities being represented.[1]

Attitudes Usually Favorable

Fifteen of the 18 respondents reported that there had been a merger in their locality in the past ten years. Of those reporting mergers, 20 percent estimated that the general public's attitude toward the acquisition of a local firm by an out-of-state corporation was highly favorable, 33 percent felt that the attitude was favorable, 33 percent believed it was neutral, and only 13 percent believed the public's attitude was unfavorable.

Nature of the Mergers

The newspaper executives reported on 39 specific mergers in their communities. Almost three-fourths of these (29) involved the acquisition of a local corporation by an out-of-state firm. Six firms had been acquired by another Wisconsin company; and in four cases a local firm had acquired the other company in the merger transaction.

---

[1] Appleton, Baraboo, Beaver Dam, Columbus, Eau Claire, Green Bay, Janesville, La Crosse, Madison, Manitowoc, Marshfield, Milwaukee, Oshkosh, Racine, Two Rivers, Waukesha, Wausau, Wisconsin Rapids.

The executives were asked to select those mergers in recent years (usually the last five years) which involved the larger firms in the community. Therefore, the above data suggest that of the larger Wisconsin companies involved in recent merger activity, the majority are acquired by out-of-state corporations. In contrast, only a few of Wisconsin's larger corporations are acquiring other companies.

Impact on Employment

The majority of the respondents (54 percent) reported that the mergers had no effect on the employment of the local corporation. Only three mergers, all involving Wisconsin companies acquired by out-of-state corporations, reportedly had an unfavorable effect. In two of these, the acquiring company eliminated the Wisconsin corporation from the local community. Thirty-eight percent of the mergers were judged to have favorably influenced local employment, as opposed to 8 percent with an unfavorable impact.

Movement of Management Personnel

Mergers sometimes result in the shifting of top management personnel. The newspaper executives were asked if the mergers increased or decreased the number of top management personnel in the community. In some instances, respondents did not feel qualified to answer the question; however, 57 percent of those who did make a judgment reported "no change." Twenty-five percent claimed the merger had increased the number of management personnel, and the remaining 18 percent reported a decreased number of management personnel in the local community.

Among those firms acquired by out-of-state corporations, the number of increases and decreases were equal. However, in two instances the number of management personnel dropped to zero because the local firm was removed from the community following its acquisition.

In summary, it appears that the acquisition of a Wisconsin corporation by an out-of-state firm usually leaves the number of management personnel in the local community unchanged. However, in some acquisitions all executives are removed from the community, so the net result of acquisitions is probably a reduced number of executives in Wisconsin. These general conclusions are limited to the larger acquired corporations. It would be logical to assume the smaller companies are more likely to have their managements dissolved upon acquisition by larger corporations.

Location of Home Offices

The acquisition of a firm sometimes results in its home office being moved to the location of the home office of the parent company. (Occasionally, however, the opposite occurs.) In 85 percent of the mergers covered by the newspaper executives, the home offices of the merging firms were not relocated. In the remaining 15 percent of the mergers, the home offices were removed from the Wisconsin communities. Obviously, these removals reduced the economic base of the communities involved. In one instance, the Wisconsin corporation was the acquiring firm, but the company moved its home office out of state following the acquisition of another firm.

The full impact of the acquisition of Wisconsin firms on employment, number of management personnel, and home office locations may not be revealed by the above findings. Most of the mergers covered by the questionnaire survey occurred quite recently, and it sometimes takes several years for the full effect of the acquisition to be realized. For example, one acquired Wisconsin firm experienced very few changes until seven years after its acquisition. At that time, several Wisconsin executives were retired because of a move to centralize the entire organization of

the parent company. The managerial autonomy previously enjoyed by the Wisconsin division was eliminated, and the economic base of the community was reduced. The community's payroll, retail sales, tax revenues, and real estate market were adversely affected.

Rate of Growth

When asked how the acquisition affected the rate of growth of the firm in their community, 51 percent of the newspaper executives reported "no effect." In only two instances (5 percent), was the rate of growth adversely influenced. In both of these cases, the firm was removed from the community. In 44 percent of the mergers, the rate of growth of the local firm was accelerated. The most frequently mentioned reasons given for the growth were the input of more capital, more management talent, and more aggressive marketing.

Community Commitment

In several instances, the respondent did not have sufficient information to judge the community commitment of the local firm following its merger. Among those mergers where a judgment was made, 48 percent reportedly had no impact on "the firm's commitment to the community and its financial support of civic projects." For 38 percent of the mergers, a favorable change was reported. Frequently, those who reported favorable changes also noted a poor community commitment by the previous owners of the corporation. As one respondent put it, "Previous ownership, although local, was not enlightened and participation in civic affairs was limited. Present management participates widely in local affairs and gives fair-to-excellent support for civic operating and capital fund drives."

In 14 percent of the mergers, the community commitment of the local firm was unfavorably affected. One respondent reported, "There is now

little or no availability of executive talent to help staff civic and local projects. Apparently, fiscal problems in the parent firm developed after the acquisition. Local budget cutbacks seemed to be the order of the day."

The newspaper executives were asked specifically about the personal involvement of company executives and other personnel in civic projects. Forty percent reported a favorable change, 20 percent an unfavorable change, and 40 percent no change since the merger.

It is quite evident that changes in the social commitment of an acquired firm are dependent on its historic commitment relative to that of the acquiring firm. A second important factor is the financial well-being of the parent firm following the acquisition. Among the firms included in this survey (which are the larger acquired firms in Wisconsin's communities), there were two favorable results for every unfavorable result. However, the data are qualitative rather than quantitative in nature; and, given the growing awareness of social responsibility by American industry, one would anticipate a favorable change without any alteration in ownership and management due to a merger.

Summary

Most mergers involving Wisconsin's larger corporations in the past few years have been the acquisition of a Wisconsin firm by an out-of-state corporation. Because these acquisitions sometimes brought new capital and new management talent to the community of the acquired firm, favorable results were more prevalent than unfavorable results. However, in most instances no changes were reported in the employment, number of management personnel, home office location, corporate rate of growth, and community commitment of the acquired firm. Given the vitality of Wisconsin's economy

in recent years, and the purported advantages of mergers, one would have expected a higher proportion of favorable results. However, it appears from the minority of unfavorable results reported by the newspaper executives that Wisconsin companies usually are not "milked" by their out-of-state acquirers; and in some instances, Wisconsin communities have benefited substantially.

Chapter III

EFFECT OF CORPORATE MERGERS AS SEEN BY LOCAL CHAMBERS OF COMMERCE IN WISCONSIN

To obtain further information and opinions on the impact of mergers on Wisconsin communities, Chamber of Commerce executives throughout the state were asked to participate in a survey similar to that of the newspaper executives. While a high proportion of the newspaper executive responses were from larger Wisconsin communities, the Chamber responses were predominantly from smaller towns and cities.[2]

When a given community was represented by a response from both a Chamber and a newspaper executive, the responses were compared. In most instances, these responses were found to be highly similar.

Attitudes Toward Mergers

When asked, "What is your best estimate of the general public attitude in your area toward the acquisition of a firm in your community by an out-of-state firm?" the following response was received:

Highly favorable	18.5%
Favorable	29.6
Neutral	18.5
Unfavorable	14.8
Highly unfavorable	----
Don't know	18.5
Total	100.0%

[2] Ashland, Beaver Dam, Berlin, Brillion, Clintonville, Cudahy, Delafield, Eau Claire, Fort Atkinson, Hartland, Hayward, Hilbert, Janesville, La Crosse, Marshfield, Medford, Menomonie, Milwaukee, New Glarus, Peshtigo, Pewaukee, Richland Center, River Falls, Sheboygan, Sparta, Sturgeon Bay, Wahene, Waukesha, Waupun, Wisconsin Dells, and West Allis.

When asked, "What is the general attitude of your Chamber of Commerce toward such mergers?" a slightly more favorable response was received:

Highly favorable	14.8%
Favorable	37.0
Neutral	37.0
Unfavorable	3.7
Highly unfavorable	----
Don't know	7.4
Total	100.0%

The generally favorable opinion shown above was even more pronounced than the favorable opinion expressed by the newspaper executives. Apparently, mergers have been somewhat better received among Wisconsin's smaller communities than among its larger ones.

Nature of the Mergers

The Chambers were asked to supply information on the local impact of specific mergers in their community. Of the 43 mergers covered by this inquiry, 79 percent involved a local firm which had been acquired by another firm; 21 percent involved a local firm which had acquired another firm.

Impact oh Employment

When asked, "Did the merger favorably or unfavorably affect the employment of the firm?" 40 percent felt that the effect was favorable. Only 8 percent believed there was an unfavorable effect, and 52 percent indicated that the merger had no impact on employment.

The favorable effect was most common among those local firms which had acquired other firms. In the case of local firms which had been acquired, employment reportedly was favorably influenced in 41 percent of the mergers, unfavorably in 9 percent. In one-half of these acquisitions, the merger reportedly had no effect on employment.

Movement of Management Personnel

The Chamber executives were asked whether the mergers increased or decreased the number of high-caliber personnel in the local firm. In 26 percent of the mergers, the number rose, in 14 percent there was a decrease, and in 60 percent of the mergers there was no change in the number of executives.

As to be expected, the number of high-caliber personnel rose in most instances (64 percent) when the local firm was the acquiring firm. When the local firm was acquired by a firm outside the community, the number of executive personnel rose in only 21 percent of the firms. There was a decrease in 15 percent of these acquisitions, and no change in the remaining 64 percent.

Location of Home Office

In 74 percent of the acquisitions covered by the survey, local home offices were not affected. In 21 percent of the mergers, the community lost the home office of the acquired firm. In 5 percent of the mergers, the local firm gained the home offices of the other firm in the merger.

Home offices of acquired firms were moved to the Wisconsin community in three of the eleven acquisitions by Wisconsin firms. In one instance, the home office was moved from the local community.

The Wisconsin communities lost eight home offices among those local firms which were acquired by other firms.

Community Commitment

Contributions to the local Chamber of Commerce constitute one measure of a firm's commitment to its local community. In the great majority of cases, there was no change in these contributions. In a few instances, the amount contributed did rise or fall by a small amount.

The Chamber executives were asked, "How did the merger affect the firm's commitment to the community and its financial support of civic projects?" For 59 percent of the mergers, no change was reported. Thirty-one percent of the mergers reportedly had a favorable effect, and 10 percent an unfavorable effect.

Favorable effects were reported for those local firms which were the acquiring firm. No change was the most common result reported for those firms which had been acquired. However, 31 percent of these mergers reportedly had a favorable effect, and 13 percent had an unfavorable effect.

The Chamber executives were also asked if the merger affected the personal involvement of company personnel in civic projects. Sixty percent reportedly had no effect; 26 percent increased personal involvement, and 14 percent decreased the involvement of corporate personnel. A favorable effect was most common among those local firms which were the acquiring firms. No change was reported for most of the local firms which had been acquired. However, 24 percent reportedly had a favorable effect, and 19 percent had an unfavorable effect. Among those with a favorable effect, some respondents indicated that the parent corporation actively encouraged executives to participate in local affairs and community benefit programs.

Conclusion

The Chamber of Commerce and newspaper executives held similar opinions and reported fairly similar effects resulting from the merger of Wisconsin corporations. Favorable effects were most common in those communities where the local firm was the acquirer. When the local corporation was acquired, generally "no change" was reported for employment, number of executive personnel, location of home office, and community commitment of the acquired firm.

Chapter IV

EFFECT OF MERGERS AS SEEN BY MANAGEMENT OF ACQUIRED COMPANIES

With the cooperation of the University of Wisconsin-Madison chapter of Alpha Kappa Psi, a professional business fraternity, management personnel of several acquired Wisconsin companies were interviewed. Those interviews provide the basis for this chapter.

Nature of the Sample

Twenty acquired firms, from all parts of the state, cooperated in the study. All the respondents were major executives of the acquired companies. Most of them held the title of president, some were vice-presidents and general managers, one was a public relations officer.

The companies involved had been merged sometime during the period of 1957-1968. Eight of the mergers had occurred in 1967; five had occurred prior to 1965.

Five, or 25 percent, of the firms had been acquired by other Wisconsin firms; 75 percent (15 firms) had been acquired by out-of-state corporations. Twelve, or 60 percent, of the acquisitions had been accomplished by an exchange of stock or other corporate securities; five, or 25 percent, had been cash purchases; and three, or 15 percent, had been acquired by a combination of cash and corporate securities.

Ninety percent of the respondents had been officers of the company prior to its acquisition. In other words, the acquiring corporation usually had not placed one of its own men in control of the acquired corporation. This, of course, does not mean that there weren't changes in management personnel

as a result of the merger. In several instances, such changes were reported. In the two instances where the chief officer had not been with the company prior to its acquisition, the acquirers were Wisconsin companies.

Possible Sources of Bias

It is possible that a chief executive of a corporation would hesitate to state anything adverse about his company's merger. (Some executives refused to participate in the study, perhaps because of adverse conditions which they did not care to discuss.) In other words, those with a happy corporate merger might be more willing to participate than those with a less favorable merger history.

Despite possible biases, many of the interviews were unquestionably unbiased. Several respondents stated adverse reactions to the merger and in some cases it was possible to check the accuracy of the responses. While the data received from the executives may be a mixture of biased and unbiased information, we believe that most of the answers are highly factual. To the extent that any bias exists, it should be favorable to mergers.

Reasons for Being Acquired

The executives were asked for the reasons that prompted their companies to be acquired or merged. The two most frequent reasons were "to reduce estate tax problems for the previous owners" and "to acquire greater financial sources for the companies." Twenty-five percent of the respondents mentioned the estate taxes, and an additional 15 percent said the acquisition was desirable because it allowed the owners of the corporation to sell the company without incurring capital gains taxes. As shown in Table 1, 20 percent of the respondents indicated that the acquisition was a way for the company to "go public" or to get on the New York Stock Exchange.

FOR SAME REASON ?

1. CAPITAL
2. ESTATE TAXES

One respondent mentioned the desirability of diversifying personal holdings through acquisition. Only two respondents mentioned the financial gain resulting from the acquisition.

Twenty-five percent of the respondents mentioned the desirability of acquiring larger capital resources. Twenty percent stated that the diversification and expansion of product lines were major reasons for being acquired.

Two executives felt that marketing considerations had prompted the merger. In both cases, they stated that the anticipated marketing advantages had never been realized. The research and development advantage anticipated by one respondent also was not realized.

More personal reasons, such as aging management, retirement of owner, and death of owner were each mentioned by one respondent.

Impact on Management Personnel

The executives were asked if there was any increase or reduction in the number of upper management personnel located in their community as a result of the merger. Only three respondents, or 15 percent, stated that the number of management personnel had increased. Similarly, three respondents said there had been a decrease. Two of these three mergers involved the acquisition of a Wisconsin company by another Wisconsin company. Obviously, it is easier to consolidate the home offices of merging corporations in close geographical proximity. Sixty-five percent of the respondents stated that there had been no change in the number of upper management personnel even though there had been some movement of executives. Several respondents reported that some of the company's executives had been promoted to the home office of the acquiring company. Others mentioned that some executives had

Table I

REASONS FOR MERGER OF
TWENTY ACQUIRED WISCONSIN COMPANIES

Reasons Given by Corporate Executives	Percent Mentioning Each Reason
Eliminate estate tax problems of owners	25
Acquire greater financial resources for company	25
Obtain listing on a stock exchange or larger exchange	20
Diversification and expansion of the company's line of products	20
Reduce taxes upon sale of the business	15
Attractiveness of the acquirer's offer	10
Potential marketing advantages of the merger	10
Diversify personal holdings	5
Greater potential for growth	5
Aging management	5
Owner of business retiring	5
Death of owner	5
Problems of a small company	5
Potential R & D advantages	5

been retired early or had left in disgust for one reason or another. One respondent was unable to determine whether the number of management personnel had changed since the merger.

Location of Home Offices

Twenty percent of the acquired corporations had their home office dissolved as a result of the merger. However, in three of these instances, Wisconsin firms had been the acquiring corporations. In fact, the acquiring corporations had been located in the same community as the acquired firm. In 80 percent of the mergers, there was no change in the locations of the executive offices of the acquired firms.

Growth of the Acquired Firms

The respondents were asked if there had been any change in the rate of growth of their firms since acquisition. Thirty-five percent of the respondents stated that growth had accelerated since acquisition. Three of the seven firms enjoying faster growth were firms that had been acquired by other Wisconsin firms.

Only one executive stated that his firm's growth had declined since acquisition. This was a firm that had been acquired by another Wisconsin corporation. Declines in growth may well be understated because many executives were in the position of being asked to state whether the growth of their company had increased or decreased since they had become president or general manager of their division of the company. Despite this possible bias, 60 percent of the respondents claimed that there had been no change in their firm's rate of growth since the merger. Given the financial advantages, mainly greater working capital for expansion, one would have expected an acceleration in the growth of the firms. In most instances, this had not occurred.

Advantages of Becoming Acquired

The executives were asked, "What advantages to the company, if any, resulted from the merger?" To aid their response, financial, marketing, production, personnel, and research and development advantages were suggested. The majority of the responses received were financially oriented. Seventy percent of the respondents indicated that greater financial resources were available to the company as a result of the acquisition. Related advantages reported were sounder financing, combined resources, increased financial strength, and more financial leverage. One respondent mentioned better financial management, two respondents said that profits had increased as a result of the merger, one indicated that the company now enjoyed greater stability. Two executives mentioned the spreading of financial risks through the pooling of the resources of the merging companies. Four respondents reported that the company had enjoyed greater growth because of the acquisition.

Few marketing advantages were reported. The most frequently mentioned benefit was better distribution, indicated by 15 percent of the respondents. Two respondents mentioned a better advertising program, and two an expanded product line.

Reports of production advantages were not prevalent. However, two respondents did mention improved technology made possible by the acquisition. Obviously, some of the firms had greater production because of the growth that occurred since the acquisition.

Some personnel and organizational advantages were mentioned. One respondent said that the company had a stronger management since the acquisition, another mentioned the value of management guidance from the parent corporation. Two respondents indicated that the company now has new and better management. One respondent reported improved employee benefits and another consolidated office procedures.

Research and development improvements of some type were mentioned by 35 percent of the respondents. However, several executives indicated that these advantages were not as great as had been anticipated at the time of merger.

A few other advantages were indicated by the executives. Twenty percent of the respondents said that the parent corporation's brain bank was a definite asset to the management of the acquired corporation. Two of the companies now have access to computers which they did not have prior to merger. Two other companies mentioned the increased possibility of overseas expansion because of their acquisition.

Disadvantages in Being Acquired

According to the respondents, there are not very many disadvantages as far as finance, marketing, production, personnel, and research and development are concerned. However, several respondents did mention managerial or organizational disadvantages. One complained of the control exercised by the parent corporation. Another respondent disliked the procedures which the company now had to use. A third resented having to use the parent company's financial institutions rather than local banks. Two respondents indicated that there was a definite friction between management of the acquired and the parent company. One respondent resented the drain of local talent to the acquiring corporation.

One manager was dissatisfied because he felt his company was not being fully developed. He wanted the parent corporation to give him more money and more managerial assistance so that the potential could be realized. Still another indicated that the parent corporation did not understand the company and its problems and he resented the large amount of paper work required by

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the parent corporation. Two respondents disliked the loss of flexibility and freedom in making financial and purchase decisions. One executive felt that he had lost status as a result of becoming part of another corporation.

Changes in Sources of Supply

One of the greatest potential disadvantages of Wisconsin corporations being acquired by out-of-state corporations is the loss to Wisconsin suppliers of goods and services. Frequently, the parent corporation will require the acquired company to utilize its legal, financial, and accounting services and to purchase supplies through the purchasing operations of the parent corporation.

According to the executives, only 25 percent of the acquired corporations use the same legal services they used prior to the mergers. In an additional 15 percent of the mergers, the company was still able to use local legal services for some purposes such as labor negotiations. However, in 75 percent of the mergers the legal services of the acquiring company were used in whole or in part.

Thirty percent of the companies still use the same financial institutions they used prior to the mergers. Seventy percent of the companies had shifted to the financial institutions of the parent corporation. Similarly, 30 percent of the companies used the same accounting firms as were used prior to the merger. In an additional two companies, the original accounting firm and the accounting firm of the parent corporation are now being used.

Only two firms have been required to use the centralized purchasing of the parent corporation. In both instances, the acquiring corporation was a Wisconsin company. However, several respondents mentioned that some items must now be purchased through the parent corporation.

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Financial Contributions to the Community

Executives were asked if there had been any increase or decrease in their company's financial contributions to the local community as a result of the merger. Forty-five percent of the executives claimed that their company's financial contribution to the community had increased (three of these nine companies were acquired by other Wisconsin firms). However, specific comments indicated that in six of the nine companies with increased contributions, the contribution was in the form of greater employment and larger payrolls, not increased financial contributions to community causes. Only three respondents indicated that the company now gives more to local charities and causes such as the Community Chest or United Fund. These three executives said that as a result of acquisition, their company's contributions had increased because of their greater ability to give and a greater awareness of social responsibility.

Twenty percent of the respondents said that their financial contributions to the community had decreased. These respondents complained that their corporate giving had been taken over by central management or that the management of the parent corporation was not community-minded.

The remaining 45 percent of the executives claimed that there had been no change in their company's contributions.

Conclusions

Three out of every four companies covered by this survey were firms acquired by out-of-state corporations. Most of the acquisitions were accomplished through the transfer of stock or other corporate securities.

The major reasons which prompted the company to be acquired were predominantly financially oriented. The reduction of estate tax problems and the provision of greater capital were mentioned most frequently. In addition,

the ability to sell the original company without immediate capital gains taxation and other financial advantages were mentioned often. Most of those who had merged for nonfinancial considerations indicated that the anticipated advantages had not been realized.

Most of the companies had not experienced great changes in management personnel as a result of the merger. It is significant that 90 percent of the executives interviewed were with the corporation prior to its acquisition. Eighty percent of the companies continue to operate the home offices which existed prior to the acquisition.

Most of the companies experienced no change in growth since the acquisition. Given this finding, one can question the validity of corporate financial advantages associated with a merger. If the existence of additional sources of financing does not accelerate the growth of the acquired corporation, there is little advantage to having additional capital available.

Despite the fact that most acquired companies experienced little or no additional growth, the financial advantages of merging were mentioned more often than any others. A few of the executives were also able to name marketing benefits and some improvement in the company's research and development program. Production and personnel advantages were infrequently mentioned.

The disadvantages resulting from the mergers were primarily organizational in nature. They included friction between the acquired and the acquiring companys' management.

Changes in sources of supply may represent the greatest loss to Wisconsin's economy resulting from the acquisition of local companies by out-of-state firms. Most of the acquired firms now use the financial institutions, legal services,

and accounting services of their parent companies. Apparently, suppliers of services are more likely to lose clients than suppliers of goods when their customers are acquired by larger firms.

Chapter V

PUBLIC REACTION TO CORPORATE MERGERS

With the cooperation of Alpha Kappa Psi, the professional business fraternity, interviews were conducted throughout the state during the University's Christmas recess. Unfortunately, a high proportion of the people contacted were unaware of corporate mergers in their community in spite of the fact that all interviews were conducted in towns and cities having local firms acquired within the past five years. As a consequence, only 31 interviews were obtained from persons aware of local mergers.

Sixteen of the respondents had been employed, or had immediate members of their family employed, by one or more of the companies which had been acquired. The remaining 15 respondents had no employment relationship with the merged firms. Separate questionnaires were used for the two groups of respondents. However, some of the questions were similar and can be reported on jointly.

Impact of Mergers on Employees

Respondents were asked, "Do you feel that employees are better or worse off as a result of mergers involving firms in your community?"[3] The opinions of both groups of respondents were fairly similar, with one exception--there were four "don't know" responses among those not having an employment relationship with an acquired firm. Among the 27 interviewees with a definite opinion, 42 percent said that employees are better off as a

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[3]Persons employed by acquired firms were asked, "Do you feel that the company's employees are better or worse off because of the merger?"

result of the acquisition; 19 percent said employees were worse off. The remaining 39 percent felt that there had been no change in employee welfare since the acquisition.

The most frequent reason given for improved employee conditions was "better pay" or "better pay and improved fringe benefits." The benefits were mentioned by 27 percent of the respondents holding some opinion on employee welfare. "Increased opportunity for promotion" was mentioned by 15 percent of the respondents. More employment and greater job security were other benefits indicated by the interviewees.

The reasons for those reporting a negative impact were: "the distant management of the parent company is less responsive to the needs of local employees," "the new management doesn't understand the company's problems," "bigness is bad," and "the company now has lower quality merchandise and this is hurting sales and employment." The latter comment was the only one mentioned twice, and it pertained to the acquisition of a Milwaukee retail establishment by a national retailer.

Those respondents employed (or having an immediate member of their family employed) by an acquired company were asked if the merger had any direct impact on their employment. Sixty-seven percent said there had been no effect on their employment. Only one respondent reported a negative impact--decreased opportunity for advancement. Among those with a favorable report, increased pay and longer hours were mentioned by three out of four. One person said that he was promoted more rapidly because of the merger.

Those respondents not having an employment relationship with an acquired firm were asked if mergers had increased or decreased the growth of employment

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in their community. Thirty-seven percent believed that mergers had increased employment, and 13 percent said employment had decreased. Six percent felt that local employment had not changed as a result of acquisitions, and 44 percent were unable to answer the question.

Impact of Acquisitions on Strength of Companies

Respondents were asked if they felt that mergers had strengthened or weakened the acquired companies in their community. Two-thirds of the persons without an employment relationship with an acquired firm believed that the companies had been strengthened as a result of the mergers. The majority of the remaining respondents were unable to answer the question. Only one person believed that local companies had been weakened by merger. The most frequent reason given for improvement was the financial strength and backing of the parent corporation. Better management, greater productivity, local expansion, and improved ability to compete were also mentioned.

Persons with an employment relationship to acquired companies were asked, "Do you feel that the company is any stronger or better managed as a result of the merger?" One-third said "yes," about two-thirds said "no." (One person had no opinion.) Among those saying "no," some felt that the new management was not as good as the previous one; others felt there had been no change in the quality of management or the strength of the company.

Growth of Acquired Corporations

Those with an employment relationship were asked if the company's rate of growth had increased or decreased as a result of the merger. About one-half believed that the growth rate had increased; only 13 percent felt it had decreased. Thirteen percent believed that there had been no change, and 27 percent held no opinion on possible changes in the company's rate of growth.

Impact of Acquisitions on the Community

Interviewees were asked if the community was better or worse off because of the mergers. The distribution of opinions for the two groups of respondents were almost identical. Forty-five percent believed that their community had benefited; 26 percent felt that their community was worse off because of the acquisitions. Sixteen percent believed that the welfare of the community had not changed because of mergers. The remaining 13 percent held no opinion on the impact of mergers on community welfare.

Conclusion

A substantial proportion of the general public is unaware of corporate mergers in their community. Among those with an awareness, opinions are more often favorable than unfavorable. In fact, the employees and general public interviewed in this survey gave a higher proportion of favorable responses than did the post-merger presidents of acquired corporations. The presidents were more prone to report no change than the employees and the general public.

Because of the small sample size, further research is necessary to confirm the results of this survey; however, the fact that both sub-samples in the survey held similar opinions strengthens the likelihood that the data already obtained are statistically reliable.

Chapter VI

IMPACT OF CORPORATE MERGERS ON EMPLOYMENT AND PAYROLLS IN WISCONSIN

One of the potentially most significant social and economic consequences of the merger movement is its impact on employment and payrolls. Because of the importance and the difficulty of obtaining appropriate data, more effort was devoted to this phase of the research than all other phases combined.

When a Wisconsin firm is acquired by another Wisconsin corporation, the management of the firm and its operations are likely to remain in the state. However, an acquisition by an out-of-state corporation removes the ownership and ultimate control from Wisconsin. In turn, this may lead to the transfer of executives, corporate offices, and even plants from the state. For this reason, two sub-samples were developed -- one consisting of Wisconsin businesses that have been acquired by out-of-state corporations, the other consisting of Wisconsin companies acquired by other Wisconsin firms. The former type of acquisition will be referred to as an out-of-state merger, the latter as an in-state merger.

Methodology

The first step in the research was to identify Wisconsin firms involved in mergers during the five years 1963-1967. Unfortunately, no agency of the state records all mergers and acquisitions. However, several agencies record mergers involving a change of ownership that is relevant to some statute which directs the agency's activities. For example, the Unemployment Compensation Division of the Department of Industry, Labor, and Human Relations records all "formal changes" in business ownership. Most of these changes,

such as the outright sale of a restaurant from one person to another or the addition of a fourth member to a partnership, are not mergers. Some mergers, such as those accomplished by the gradual purchase of corporate securities in the open market, are not recorded by this agency.

Most of the mergers identified in the study were found through a tedious search of the records and reference files of the Unemployment Compensation Division. This search was greatly aided by the cooperation of Orin Reich and Sidney Knope of that Division. Mergers were also identified through the records of the Commissioner of Securities, the questionnaire surveys of Chamber of Commerce officials and newspaper executives, National Industrial Conference Board reports, and newspaper and magazine articles. The efforts undoubtedly yielded an identification of most of the mergers occurring in the 1963-1967 period.

The second step in the research process was to gather employment and payroll data for Wisconsin companies that have been acquired in recent years. These data were obtained from the records of the Unemployment Compensation Division. However, several difficulties were encountered:

1. Some records, because of inadequate storage space, had been discarded. As a consequence, employer reference numbers for firms which have discontinued operations in Wisconsin were not always available. Without these reference numbers, there often was no way to identify the firm's payroll and employment data. The inability to identify these data is probably the major weakness of this section of the study. A discontinuation completely eliminates the acquired firms' employment and payroll from Wisconsin's economy, and these firms probably are not adequately represented in the analysis.

2. Employers differed in their reporting procedures. Some employers already having employees in Wisconsin consolidated their employment and payroll reports following the acquisition of another firm. Other acquirers continued to file separate reports for each member of the merger. A case can be made for using either procedure. When a firm already having operations in Wisconsin acquires another firm in the state, it is relatively easy to move many employees, especially executives and office staff, from one Wisconsin location to another. Such moves usually do not benefit or harm the state as a whole because the employees and payroll remain in Wisconsin. Using the employment and payroll data of the acquired firm only, however, may misrepresent (usually understate) changes following the merger. On the other hand, the combined report of the acquirer-acquiree makes it impossible to determine how much of the growth or decline of payrolls and employment should be attributed to the acquired firm as opposed to the acquiring firm. Adopting the "art of the possible" provided the answer to this dilemma. When separate reports for the acquiree were available, both prior and subsequent to the merger, they were used. This procedure was used for 61 percent of the 227 acquisitions studied. When only consolidated acquirer-acquiree reports were available following the merger, they were used if the employment of the acquired

2. (continued)

   firm represented a significant proportion of the combined employment of the two firms at the time of merger. When this was done, the separate employments and payrolls of the firms involved were consolidated for the period preceding the merger. All the data used, of course, are for Wisconsin operations only. An employer must, by law, provide separate employment and payroll reports for operations in each state.

3. Because of the time-consuming process of gathering the data and the seasonal fluctuations during any given year, fourth-quarter payrolls and December employments were used. While these payrolls and employments may not perfectly represent their annual counterparts, this should not bias the results because the same time periods were used for each year. Furthermore, end-of-year data have the advantage of usually being post-merger data in the year of the merger.

4. The movement of the business cycle could bias the data. The more recent years have been highly prosperous and increases in employment and payrolls during those years may be due to general prosperity, rather than expansion as a result of mergers. To the extent that this possible bias is prevalent, it should overstate growth following mergers because the most recent years are post-merger years.

Nature of the Sample

The 227 Wisconsin companies included in the analysis were acquired during the five years 1963-1967. Thirty-seven percent of the sample firms were acquired by out-of-state corporations, 63 percent by companies in Wisconsin. As these statistics indicate, most Wisconsin firms that are acquired are merged with other Wisconsin corporations. However, the proportion of in-state mergers declines with the size of the acquired Wisconsin corporation. Apparently most of Wisconsin's larger corporations entering mergers are being acquired by out-of-state conglomerates such as W. R. Grace and Company and Litton Industries, Incorporated.

A breakdown of the sample by type of industry is as follows:

a. 67 percent of the firms were manufacturers.

b. 15 percent of the firms were retail and wholesale establishments.

c. 7 percent of the firms were in the transportation, communication, and utility industries.

d. 11 percent of the firms were in other types of businesses, such as finance, construction, insurance, and real estate.

The size of the firms in the sample, at the time of their merger, is as follows:

a. 43 percent of firms had fewer than 50 employees.

b. 39 percent of firms had between 50 and 200 employees.

c. 12 percent of firms had between 200 and 500 employees.

d. 6 percent of firms had employments of greater than 500.

In the above distribution, those firms having consolidated employment and payroll reports are represented by the Wisconsin employment of the acquiree and the acquirer at the time of merger.

With the exception of the under-representation of discontinued firms, the sample should be fairly representative of all Wisconsin firms with more than ten employees that were acquired during the years 1963-1967. The sample does not represent Wisconsin firms that have acquired out-of-state corporations because sufficient information on these mergers is not available, and because this study is primarily concerned with the social and economic impact of the acquisition of Wisconsin businesses by other corporations.

The third major step in the research process was to calculate employment and payroll growth rates for each of the acquired companies. As will be shown, these rates have been analyzed according to size of firm, year of merger, and type of merger--in-state or out-of-state.

Effect of Acquisitions on Employment in Wisconsin

The average rate of employment growth of each company before and after the merger was calculated, starting with the year 1960. If the post-merger average growth rate of a given firm exceeded the pre-merger rate of growth, the result was recorded as an "advance." If, however, the after-merger rate was less than that prevailing before the merger, a "decline" was recorded for the firm.

One hundred three, or 45 percent, of the acquired companies, grew more rapidly, i.e. had advances, after their mergers. Conversely, 55 percent of the merged corporations saw their employment growth rates decline after their acquisition. This finding tends to discredit the hypothesis (and frequently cited reason for being acquired) that a merger will accelerate the growth of the acquired firm because of the advantages of large scale and the financial strength, management skills, and research and development programs

of the acquiring company. The evidence against this hypothesis is even stronger than the 55/45 decline-advance ratio suggests, because employment changes in the state as a whole were substantially smaller in the first half of the 1960-1968 period than in the latter half. In other words, the movement of Wisconsin's economy in recent years would have produced more advances than declines had the mergers had no effect on employment growth.

It should be recognized, however, that the acquired Wisconsin companies may have grown more rapidly than the post-merger employment data suggest. Conceivably, some employees were transferred to nonWisconsin locations following the merger. However, the fact remains that among 55 percent of the acquired firms, the growth of employment in Wisconsin declined following the acquisition.

The number of advances and declines in employment growth, classified according to year of merger, is shown in Table II. The number of post-merger advances and declines for acquisitions occurring during the years 1963 and 1964 were approximately equal. During these two years, 45 firms enjoyed an increased rate of employment growth following the merger; 47 experienced a lower rate of growth following the merger. For mergers occurring during the years 1965, 1966 and 1967, the number of firms with declines in rate of growth exceeded advances by a considerable margin (77 to 58).

Among firms acquired by other Wisconsin firms, there were about four declines in employment growth rate for every three advances. Among those firms acquired by nonWisconsin companies, the number of advances and declines was about equal.

Table II

ADVANCES AND DECLINES OF POST-MERGER EMPLOYMENT GROWTH
OVER PRE-MERGER GROWTH OF 227 ACQUIRED WISCONSIN CORPORATIONS

Year of	All Mergers:		In-State Mergers:		Out-of-State Mergers:	
Merger	No. of Advances	No. of Declines	No. of Advances	No. of Declines	No. of Advances	No. of Declines
1963	23	24	17	16	6	8
1964	22	23	14	17	8	6
1965	20	25	12	18	8	7
1966	22	25	12	16	10	9
1967	16	27	7	14	9	13
Total	103	124	62	81	41	43

For comparison purposes, it is convenient to analyze the changes in rate of employment growth by using the proportion of advances and declines. These proportions for in-state and out-of-state mergers and for large and small employers are shown in Table III. As shown, small firms (less than 100 employees) acquired by out-of-state corporations were the only group with more advances than declines in employment growth.

Table III

PROPORTION OF ADVANCES AND DECLINES IN
THE EMPLOYMENT GROWTH OF ACQUIRED WISCONSIN COMPANIES

	Total Sample	Large Employers[1]	Small Employers[2]
In-State Mergers	Advances--43.4% Declines--56.6	Advances--38.8% Declines--61.2	Advances--45.7% Declines--54.3
Out-of-State Mergers	Advances--48.8% Declines--51.2	Advances--45.9% Declines--54.1	Advances--51.1% Declines--48.9

[1] Employers having an employment of over 100 at the time of merger.

[2] Employers having an employment of less than 100 at the time of merger.

Aggregate Impact of Mergers on Employment

The preceding makes no allowance for differences in the number of employees of the various acquired firms. This allowance must be made to determine the overall impact of corporate acquisitions on employment in Wisconsin.

Table IV shows the total December Wisconsin employment of the 227 acquired firms for the years 1960-1968. The data are classified according to whether the acquirer was an in-state or out-of-state firm. Also shown is an index of aggregate employment, with the employment during the year of merger as the index base (base = 1000).

With the exception of out-of-state mergers occurring in 1966 and 1967 and in-state mergers occurring in 1964 and 1966, the acquired companies had a greater employment in 1968 than they had during the year of merger. If employment in 1968 is compared to the employment in the year preceding the merger, one finds that aggregate employment has risen in all instances except the out-of-state mergers of 1967 and the in-state mergers of 1966.

Table V presents the average annual pre- and post-merger employment growth rates of the various merger groups. Looking first at the in-state mergers, one finds that the average pre-merger growth rate exceeded the average post-merger growth for mergers occurring in all years except 1967. The declines in employment growth among firms merging in other years may have been due to efficiencies resulting from the mergers, the transfer of employees to a non-Wisconsin location, and the slower overall growth of some firms following their mergers. For all the in-state mergers consummated during the 1963-1967 period, the average pre-merger employment growth rate was 4.23 percent. The post-merger employment growth rate was 1.04 percent.

Table IV

AGGREGATE WISCONSIN EMPLOYMENT OF 143 FIRMS
ACQUIRED BY WISCONSIN COMPANIES

	Year of Merger				
	1963	1964	1965	1966	1967
1960	2096	1558	2516	3127	3947
1961	2298	1581	2562	3160	3864
1962	2397	1611	2688	3287	3924
1963	2369	1717	2918	3477	4043
1964	2500	1870	2962	3747	4500
1965	2679	1764	3044	3953	4836
1966	2851	1752	3155	4199	5065
1967	2687	1732	3298	4026	5063
1968	2769	1841	3261	3896	5252

INDICES OF AGGREGATE EMPLOYMENT--IN-STATE MERGERS

	1963	1964	1965	1966	1967
1960	885	833	827	745	780
1961	970	845	842	753	763
1962	1012	861	883	783	775
1963	1000	918	959	828	799
1964	1055	1000	973	892	889
1965	1131	943	1000	941	955
1966	1203	937	1036	1000	1000
1967	1134	926	1083	959	1000
1968	1169	984	1071	928	1037

AGGREGATE WISCONSIN EMPLOYMENT OF 84 FIRMS
ACQUIRED BY OUT-OF-STATE COMPANIES

	Year of Merger				
	1963	1964	1965	1966	1967
1960	3751	3643	1584	3136	4255
1961	2829	3450	1591	3452	4346
1962	2701	4479	1760	3620	4689
1963	3187	4849	1823	3710	4972
1964	3705	5799	1831	3753	5589
1965	4568	6516	2278	3509	6034
1966	5563	6793	2446	4309	6418
1967	5631	6059	2165	3714	6347
1968	5439	6387	2281	4020	5883

INDICES OF AGGREGATE EMPLOYMENT--OUT-OF-STATE MERGERS

	1963	1964	1965	1966	1967
1960	1177	628	695	728	670
1961	888	595	698	801	685
1962	848	772	773	840	739
1963	1000	836	800	861	783
1964	1163	1000	804	871	881
1965	1433	1124	1000	814	951
1966	1746	1171	1074	1000	1011
1967	1767	1045	950	862	1000
1968	1707	1101	1001	933	927

Table V

AVERAGE ANNUAL GROWTH OF AGGREGATE WISCONSIN EMPLOYMENT

	(In-State Mergers)					
	1963	1964	1965	1966	1967	1963-1967
Pre-merger Growth Rate	4.16%	4.66%	3.89%	5.03%	3.63%	4.23%
Post-merger Growth Rate	3.18	-0.39	2.31	-3.68	3.73	1.04

	(Out-of-State Mergers)					
	1963	1964	1965	1966	1967	1963-1967
Pre-merger Growth Rate	-5.48%	12.33%	7.54%	5.44%	5.88%	6.02%
Post-merger Growth Rate	11.29	2.43	0.03	-3.41	-7.31	-0.48

With the exception of 1963 and 1966, out-of-state mergers experienced a substantially larger decline in employment growth rates than the in-state mergers. Interestingly, the 1963 mergers included the smallest number of conglomerate mergers and the firms involved enjoyed a substantial rise in employment growth; the 1967 mergers had the largest number of conglomerate mergers and the greatest decline in employment growth. It should be recognized, however, that the post-merger employment growth rate of the 1967 mergers is based on only one year's experience.

The average pre-merger Wisconsin employment growth rate of out-of-state acquired firms was 6.02 percent. Following the mergers, their employment growth rate declined to -.48 percent. In other words, the growth of aggregate Wisconsin employment among the out-of-state acquired companies has declined 108 percent since their mergers. The post-merger growth rate of the Wisconsin acquired companies was more than three times

as great as that of the out-of-state acquired companies, in spite of the fact that the latter group had a substantially larger pre-merger growth rate. In other words, the out-of-state acquirers merged with faster growing Wisconsin firms than the in-state acquirers. However, following the mergers, the in-state acquired firms continued to expand their Wisconsin employment while the out-of-state acquired firms, on the average, did not.

While changes in employment are an imperfect measure of corporate growth, the aggregate employment data--like the number of advances and declines--also tend to discredit the hypothesis that corporate growth is usually enhanced by a merger. On the other hand, it should be recalled that 103 of 227 acquired companies have enjoyed an accelerated employment growth since the year of merger. Unfortunately, the major proportion of those with increased growth were small firms.

Impact of Acquisitions on Wisconsin's Payrolls

A comparison of pre-merger to post-merger payrolls shows that 107, or 47 percent, of the acquired companies had an increased rate of payroll growth following the merger. Conversely, 53 percent of the companies had a slower post-merger payroll growth. The number of advances and declines for each merger year, classified by type of merger, are shown in Table VI.

Table VI

ADVANCES AND DECLINES IN THE GROWTH OF PAYROLLS OF 227 ACQUIRED WISCONSIN COMPANIES

Year of Merger	All Mergers: No. of Advances	All Mergers: No. of Declines	In-State Mergers: No. of Advances	In-State Mergers: No. of Declines	Out-of-State Mergers: No. of Advances	Out-of-State Mergers: No. of Declines
1963	27	20	17	16	10	4
1964	21	24	14	17	7	7
1965	23	22	15	15	8	7
1966	21	26	10	18	11	8
1967	15	28	8	13	7	15
Total	107	120	64	79	43	41

The proportion of advances and declines is presented in Table VII. As shown, companies acquired by out-of-state corporations had a higher proportion of advances than those acquired by Wisconsin companies. In other words, post-merger payroll growth was higher than the pre-merger growth in more companies acquired by out-of-state corporations than in those acquired by in-state corporations. However, among the larger acquired corporations, in-state mergers had a higher percentage of advances than the out-of-state mergers.

As the ratios indicate, acquired corporations fared slightly better in the growth of payrolls than in the growth of employment (Table III). This is not unexpected, given the more rapid growth of inflation and larger wage settlements of recent years.

Table VII

PROPORTION OF ADVANCES AND DECLINES IN
THE WISCONSIN PAYROLL GROWTH OF 227 ACQUIRED COMPANIES

	Total Sample	Large Employers[1]	Small Employers[2]
In-State Mergers	Advances 44.8% Declines 55.2	Advances 49.0% Declines 51.0	Advances 42.6% Declines 57.4
Out-of-State Mergers	Advances 51.2% Declines 48.8	Advances 45.9% Declines 54.1	Advances 55.3% Declines 44.7

Aggregate Payroll Growth of Acquired Companies

The numbers of declines and advances do not recognize differences in the sizes of the payrolls of the various companies and differences in the amount of decline or advance. Aggregate data, as presented in Table VIII, do recognize these differences.

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[1]Employers with more than 100 employees at time of merger.

[2]Employers with less than 100 employees at time of merger.

Table VIII

AGGREGATE WISCONSIN PAYROLLS OF 143 FIRMS
ACQUIRED BY WISCONSIN COMPANIES
(In Millions of Dollars)

	Year of Merger				
	1963	1964	1965	1966	1967
1960	$2.86	$2.18	$3.16	$4.16	$4.74
1961	3.15	2.33	3.37	4.31	4.83
1962	3.45	2.37	3.60	4.65	5.21
1963	3.40	2.47	4.08	4.98	5.60
1964	3.75	2.77	4.38	6.06	6.71
1965	4.05	2.79	4.86	6.71	7.63
1966	4.59	2.86	5.41	7.93	8.48
1967	4.63	2.96	6.08	7.97	8.58
1968	5.60	3.43	6.00	7.83	9.50

INDICES OF AGGREGATE PAYROLLS--IN-STATE MERGERS

	1963	1964	1965	1966	1967
1960	842	787	650	524	553
1961	927	842	692	543	563
1962	1015	856	740	587	607
1963	1000	892	840	629	653
1964	1105	1000	900	765	783
1965	1193	1009	1000	846	890
1966	1353	1035	1113	1000	989
1967	1364	1072	1252	1005	1000
1968	1649	1240	1235	988	1108

AGGREGATE WISCONSIN PAYROLLS OF 84 FIRMS
ACQUIRED BY OUT-OF-STATE COMPANIES
(In Millions of Dollars)

	Year of Merger				
	1963	1964	1965	1966	1967
1960	$3.14	$ 5.59	$1.83	$4.07	$ 6.21
1961	3.40	5.33	2.02	4.34	6.62
1962	3.25	7.02	2.08	4.74	7.20
1963	3.29	8.07	2.34	4.79	8.19
1964	4.45	10.12	2.29	5.33	9.74
1965	4.87	11.40	3.31	5.58	11.04
1966	5.42	12.55	3.67	6.09	11.48
1967	5.92	11.64	3.44	5.65	11.72
1968	6.44	12.89	3.68	6.45	11.59

INDICES OF AGGREGATE PAYROLLS--OUT-OF-STATE MERGERS

	1963	1964	1965	1966	1967
1960	954	552	553	669	530
1961	1034	527	610	712	564
1962	989	694	629	779	614
1963	1000	797	706	787	698
1964	1354	1000	693	875	831
1965	1482	1127	1000	917	942
1966	1649	1240	1109	1000	979
1967	1800	1151	1040	927	1000
1968	1958	1274	1112	1058	989

54-397 O - 75 - 39

For all merger groups except in-state 1966 and out-of-state 1967, payrolls in the fourth quarter of 1968 were higher than in the corresponding quarter of the year of merger. For mergers consummated during the years 1965 and 1967, in-state mergers had a higher rate of post-merger aggregate payroll growth than the out-of-state mergers. As shown in Table IX, the out-of-state mergers occurring in 1963, 1964, and 1966 had the largest post-merger payroll growth rates. However, if payrolls from the year preceding the merger are used, rather than payrolls during the year of merger, the above comparisons are altered somewhat. Using either approach, no clear picture emerges as to whether aggregate payroll growth is greatest among in-state or out-of-state mergers. To obtain an answer, the average annual aggregate pre-merger and post-merger payroll growth rates were calculated for the 227 firms.

The average aggregate pre-merger growth rate of in-state mergers was 8.96 percent; the post-merger payroll growth rate was 6.31 percent. This decline in payroll growth rate was not nearly as large as the decline in the employment growth rate, indicating that employees have fared fairly well since the acquisitions.

The aggregate average pre-merger payroll growth of firms acquired by out-of-state companies was 10.49 percent. After merger, the average growth slowed to 3.68 percent. The post-merger growth rate was only about one-third as great as the pre-merger growth rate. However, the post-merger payroll growth rate was considerably higher than the -.48 percent employment growth.

Interestingly, out-of-state corporations, as a group, acquired faster growing companies than the Wisconsin acquirers. The pre-merger annual payroll growth rate of companies acquired by the out-of-state firms was two and one-half percentage points greater than the growth rate of those acquired by Wisconsin firms. After the mergers, the average payroll growth

rate of the Wisconsin acquired firms was almost three percentage points higher than that of the out-of-state acquired firms. This change may have been due to the removal of executives from Wisconsin by some of the out-of-state acquirers.

Table IX

AVERAGE ANNUAL GROWTH OF
AGGREGATE WISCONSIN PAYROLLS

In-State Mergers

	1963	1964	1965	1966	1967	1963-1967
Pre-merger Growth Rates	5.94%	6.18%	8.99%	11.35%	8.85%	8.96%
Post-merger Growth Rates	10.49	5.48	7.29	-0.63	10.72	6.31

Out-of-State Mergers

	1963	1964	1965	1966	1967	1963-1967
Pre-merger Growth Rates	1.57%	16.00%	12.59%	6.94%	9.50%	10.49%
Post-merger Growth Rates	14.38	6.24	3.60	2.91	-1.11	3.68

Conclusion

The growth of employment in Wisconsin apparently has been slowed by the acquisition of Wisconsin companies. The decline in employment growth rates was greater among firms acquired by out-of-state companies than among those acquired by in-state companies.

There was a dramatic difference between the pre- and post-merger growth of payrolls of in-state and out-of-state mergers. The growth of payrolls declined 30 percent among firms acquired by Wisconsin companies and 65 percent among those acquired by out-of-state corporations.

Given the size of the sample and the magnitude of the differences in the growth rates of the two merger types, the findings of this section of the study are fairly well established. However, it should be emphasized that the conclusions apply to merger groups and not to individual firms in the group. Several out-of-state mergers, for example, have resulted in a substantially increased rate of employment and payroll growth in Wisconsin.

Impact of Acquisitions by Conglomerates

Because of the rapid rise of conglomerates, a separate analysis of the Wisconsin employment and payroll growth of firms acquired by conglomerates is presented in Tables X-XII. These analyses do not include all conglomerate mergers, but they do include most of the recent Wisconsin-based acquisitions of well-known conglomerates such as W. R. Grace and Company, Litton Industries, Incorporated, "Automatic" Sprinkler Corporation of America, Tenneco Corporation, and Gulf and Western Industries, Incorporated. Also included are acquisitions by established corporations which, in recent years, have been actively involved in conglomerate mergers. Among this group of quasi-conglomerate companies are Beatrice Foods Company, FMC Corporation, Consolidated Foods Corporation, and Ametek, Incorporated.[5]

As shown in Table X, the Wisconsin employment of firms acquired by conglomerates and quasi-conglomerates was not very large in the early part of the 1963-1968 period. As to be expected, given the national merger movement, acquisitions by conglomerates have been considerable in more recent years. Perhaps significant is the fact that employment in the year of merger was often less than that of the year preceding the merger (this usually was not true of other mergers). In fact, the total 1968 employment of firms acquired by conglomerates in 1963-1966-1967, and 1968 was

[5]Unlike the earlier analyses, not all the acquired firms were previously owned by corporations headquartered in Wisconsin.

Table X

AGGREGATE WISCONSIN EMPLOYMENT OF 30 FIRMS
ACQUIRED BY CONGLOMERATES

	Year of Merger					
	1963	1964	1965	1966	1967	1968
1960	21	1	271	2340	7524	3200
1961	33	2	251	2244	8065	3295
1962	40	105	245	2301	9378	3913
1963	45	106	475	2280	10195	4505
1964	43	112	520	2175	11850	4511
1965	10	116	495	2193	12909	4857
1966	--	130	585	2131	13065	5584
1967	--	135	591	2030	12629	5769
1968	--	106	522	2096	12742	5628

INDICES OF AGGREGATE EMPLOYMENT

	Year of Merger					
	1963	1964	1965	1966	1967	1968
1960	467	9	547	1098	596	569
1961	733	18	507	1053	639	585
1962	889	938	495	1080	743	695
1963	1000	946	960	1070	807	800
1964	956	1000	1051	1021	938	802
1965	222	1036	1000	1029	1022	863
1966	----	1161	1182	1000	1035	992
1967	----	1205	1194	953	1000	1025
1968	----	946	1055	984	1009	1000

less than in the years preceding the mergers. The total 1968 employment of firms acquired in 1964 and 1965 was about the same as that in the years preceding the mergers.

Using the year of merger as the basis for calculation, the pre-merger employment growth of the 24 firms acquired during the 1963-1967 period was 6.6 percent. Following the merger, the growth rate declined to .5 percent. These rates are fairly similar to those of all firms acquired by out-of-state companies, except that the post-merger rate is slightly higher. However, if employment in the year prior to the merger is used as the division point between the pre- and post-merger periods, the pre-merger annual growth rate rises to 8.4 percent and the post-merger growth rate declines to -1.3 percent. When six acquisitions occurring in the first part of 1968 are included in the latter calculation, the pre-merger growth rate is 8.5 percent and the post-merger rate is -1.6 percent. Using the year prior to the merger and only the firms acquired by conglomerates (quasi-conglomerates excluded), the pre-merger employment growth rate is 11.6 percent and the post-merger rate is -1.8 percent. Therefore, conglomerate acquisitions have had a substantially adverse impact on the growth of employment in Wisconsin. To the extent that these acquirers have shifted their sources of goods and services to suppliers outside the state, the impact may be even greater than the employment statistics indicate. However, it should be remembered that Wisconsin's total employment has risen considerably in recent years and the state's economy has prospered in spite of any such losses.

It would be highly inappropriate to conclude that all acquisitions by conglomerate and quasi-conglomerate corporations have adversely influenced employment in Wisconsin. As shown in Table XI, nine of the 24 firms acquired by conglomerates enjoyed an increased rate of employment growth following

Table XI

PRE- AND POST-MERGER EMPLOYMENT AND PAYROLL GROWTH RATES
OF FIRMS ACQUIRED BY CONGLOMERATES
1953 - 1957

Firm No.	Pre-merger Employment	Post-merger Employment	Pre-merger Payroll	Post-merger Payroll
1	-1.98%	-1.05%	3.72%	0.70%
2A	3.65	4.88	5.92	3.34
2B	4.90	-13.06	2.97	19.00
3A	4.10	-21.07	8.06	-7.20
3B	-0.95	-5.88	10.39	-0.72
3C	3.28	-1.37	5.01	9.59
4A	3.91	10.41	4.85	14.49
4B	13.23	5.85	19.09	2.24
4C	4.88	39.37	8.94	22.25
4D	63.04	-12.09	76.97	-79.46
4E	0.20	6.24	-5.60	12.52
5	1.44	10.32	4.19	9.84
6	15.51	38.60	22.49	49.51
7	10.86	37.85	14.04	36.02
8	21.72	-12.63	27.23	-0.51
9A	5.55	5.14	9.49	10.64
9B	50.00	29.63	54.78	25.22
9C	68.18	19.64	91.90	20.28
10	1.23	-6.15	2.98	-0.49
11	7.23	0.00	7.29	6.76
12	16.54	41.99	11.67	30.26
13	-24.64	Out of Business	-10.04	Out of Business
14	-1.24	-3.04	4.01	1.74
15	28.92	Out of Business	28.44	Out of Business

Alphabetic sequencing denotes acquisitions by the same acquiring company. Acquiring firms 1-5 are conglomerates; firms 6-15 are quasi-conglomerates.

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their acquisitions. The apparent impact of a merger on employment varies greatly from one acquired company to another, and in some cases, it varies among the firms acquired by a given conglomerate. For example, conglomerate Number 4 in Table XI acquired five Wisconsin companies. Since the year of acquisition, three of its acquired companies have enjoyed an increased rate of employment growth; one has experienced a slower rate of employment growth and one has had a significant decline in employment.

Payroll data for firms acquired by conglomerates and quasi-conglomerates during the 1963 to mid-1968 period are shown in Table XII. The 24 companies acquired by conglomerates and quasi-conglomerates during the 1963-1967 period had an average annual pre-merger payroll growth rate of 10.2 percent; following the merger their growth rate declined to 2.5 percent. If the year prior to merger is used as the dividing point between the pre- and post-merger periods, the pre-merger rate is 11.5 percent, the post-merger rate is 2.8 percent. If 1968 conglomerate acquisitions are included in the latter analysis, the pre- and post-merger rates are 11.6 and 1.7 percent, respectively. When only the acquisitions by conglomerates are included (quasi-conglomerates excluded), the pre-merger growth rate is 15.6 percent and the post-merger growth rate is 2.1 percent. The above calculations compare unfavorably to the pre- and post-merger history of all in-state and out-of-state acquired companies. Furthermore, the average decline of payroll growth among companies acquired by conglomerates was greater than their average decline in employment. In the other mergers, just the opposite occurred. Conglomerates are not immune to union demands and higher wage rates; therefore, it appears that some conglomerates may have removed a considerable number of higher salaried executives from Wisconsin.

As shown in Table XI, 14 of the 24 firms acquired by conglomerates and quasi-conglomerates had a slower post-merger than pre-merger rate of payroll growth. Five of these firms went from a position of payroll growth to one of payroll decline, and two additional firms were out of business by 1968. As with employment, the changes in payroll growth varied considerably from one acquired company to another, even when two or more companies were acquired by the same firm.

Table XII

AGGREGATE WISCONSIN PAYROLLS OF 30 FIRMS
ACQUIRED BY CONGLOMERATES
(Thousands of Dollars)

	Year of Merger					
	1963	1964	1965	1966	1967	1968
1960	$101	$ 9	$1409	$15025	$44792	$17622
1961	175	14	1405	16272	48273	18194
1962	201	740	1471	17299	54365	22218
1963	214	821	3114	16666	61376	25027
1964	222	816	3082	18093	74692	25709
1965	77	877	3133	18579	85668	29105
1966	----	1072	3720	18974	90994	35770
1967	----	1128	3961	18658	94151	38803
1968	----	1177	3862	19168	96824	38115

INDICES FOR AGGREGATE PAYROLLS

	Year of Merger					
	1963	1964	1965	1966	1967	1968
1960	$472	$ 11	$ 450	$ 792	$ 476	$ 462
1961	818	17	448	858	513	477
1962	939	907	470	912	577	583
1963	1000	1006	994	878	652	657
1964	1037	1000	984	954	793	675
1965	360	1075	1000	979	910	764
1966	----	1314	1187	1000	967	938
1967	----	1382	1264	983	1000	1018
1968	----	1442	1233	1010	1028	1000

Summary

Inasmuch as acquisitions by conglomerates apparently have an impact on employment during the year of merger, the year preceding the merger is a meaningful division point between the pre- and post-merger periods. Using employment preceding the year of merger, one finds that the annual pre-merger employment growth of Wisconsin companies acquired by other Wisconsin firms during the 1963-1967 period was 4.7 percent; the post-merger growth was 1.4 percent. In contrast, the pre-merger employment growth of companies acquired by out-of-state conglomerates and quasi-conglomerates was 8.4 percent; the post-merger rate was -1.3 percent. When the acquisitions by conglomerates are eliminated from all acquisitions by out-of-state firms, one finds that the pre-merger employment growth was 3.2 percent. The post-merger employment growth of Wisconsin companies acquired by these out-of-state non-conglomerate firms was also 3.2 percent per year.

Using the year preceding the merger as the division point, the annual payroll growth rates of in-state and out-of-state non-conglomerate acquired companies are about the same. In-state acquired companies had an average pre-merger payroll growth of 9.2 percent and an average post-merger rate of 6.5 percent. Firms acquired by out-of-state non-conglomerate companies have an average pre-merger payroll growth of 9.2 percent and a post-merger rate of 6.3 percent. Interestingly, the post-merger rate was slightly less than that of the in-state group, even though their post-merger employment growth rate was 1.8 percent greater than that of the in-state acquired firms. The pre-merger annual payroll growth of firms acquired by out-of-state conglomerate and quasi-conglomerate companies was 11.5 percent; the post-merger rate was only 2.8 percent.

Chapter VII

MERGERS AND CORPORATE GIVING IN MILWAUKEE

When a local firm is acquired by a larger out-of-state corporation, the new owners may not have much interest in the charitable causes of the local community. A low level of interest is likely to be reflected in the acquired firm's corporate giving.

On the other hand, large corporations are aware of the importance of their public image, and apparently are becoming increasingly social-conscious for both altruistic and selfish reasons. As was shown in the surveys of newspaper executives, Chamber of Commerce officials, and executives of acquired corporations, some Wisconsin companies have a keener sense of social responsibility since their mergers. Whenever this occurs, corporate giving to local causes is likely to be enhanced by the acquisition.

Another factor of substantial import is the prosperity and growth of a firm following the merger. In those instances where acquisition leads to the eventual demise of the firm, corporate giving ceases. In those mergers where the acquisition greatly increases the growth and profitability of the acquired firm, corporate giving is likely to rise substantially.

Changes in corporate giving resulting from mergers are also a function of the generosity of the previous owners and management. When public spirited owners sell their corporations, corporate giving is likely to decrease or cease to grow. If the previous owners lacked public spirit, an increase in social contributions is probable.

In short, anything can happen, depending upon a variety of factors. An examination of corporate giving to the United Fund in Milwaukee shows that

almost anything does happen. Some firms, which historically gave little, have become generous contributors since their acquisitions. Others, which historically made substantial contributions, now give little or nothing.

Nature of the Sample

Because corporate giving data are highly confidential, no specific information on individual firms can be presented. However, statistics for aggregates of firms can be given so long as the firms composing the aggregate remain anonymous.

Two samples of Milwaukee firms were selected. The first is composed of Milwaukee firms which have been acquired by out-of-state corporations since 1958. While it was not possible to find a perfect match for every acquired corporation, the second sample is composed of non-acquired Milwaukee corporations of similar industries and sizes as the acquired companies. This sample is for control purposes and provides a basis for estimating what would have happened to the giving of the acquired companies had they not merged.

Both samples are composed of medium and large corporations, most having an employment of over 100. These firms were selected because of the availability of data for each year and the size of their gifts.

The consolidation of corporate contributions following several mergers limited the size of the samples. For example, when Schusters (a Milwaukee firm) was acquired by Gimbels (a national company), the United Fund contributions of the Milwaukee stores were consolidated, making it impossible to determine the post-merger contribution of Schusters. Also limiting the size of the sample was the availability of non-acquired firms which were reasonably similar to acquired firms. Despite these difficulties, two samples of 30 firms each were selected.

Contributions of Acquired Companies

Thirty Milwaukee companies, which have since been acquired, contributed $176,279 in 1958. By 1963, their contribution had grown to $200,050--an increase of about 14 percent. However, during this period the Red Cross of Milwaukee and the United Fund of Milwaukee had merged, so contributions in 1963 should have been significantly greater than in 1958.[6]

During the 1959-1963 period, six of the 30 firms were acquired by out-of-state corporations. These six firms increased their corporate giving to the United Fund by 20 percent--more than those who had not been acquired. Most of the six mergers were of the horizontal type, rather than vertical or conglomerate.

In the years 1964-1968, the remaining 24 firms were acquired by out-of-state corporations. As to be expected, given the recent history of the merger movement, around one-half of these mergers were of the conglomerate type.

The total giving of the 30 corporations rose from $200,050 in 1963 to $203,779 in 1968, a gain of only 2 percent. The six companies acquired during the years 1959-1963 increased their United Fund gifts by 16 percent, but the 24 companies acquired since 1963 decreased their contributions 2 percent.

Taking the 30 corporations as a group, one finds that total corporate giving to the United Fund in Milwaukee rose from $176,279 in 1958 to $203,779 in 1968--a gain of 16 percent during the ten years.

As indicated earlier, corporate giving is a function of ability to give, and generosity or public spirit. While employment is an inadequate measure

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[6] During 1960, the year of the merger, total contributions to the United Fund of Milwaukee rose 33.4 percent.

of ability, it does reflect the growth or decline of a company. Therefore, change in employment provides an imperfect measure of change in ability to give, and corporate contributions per employee can be used as an indicator of corporate generosity.

As shown in Table XIII, the six firms acquired during the years 1959-1963 enjoyed a substantial increase of employment between 1963 and 1968—a gain of 33 percent. Therefore, the increase in their corporate giving during those years may be attributed primarily to corporate growth.

Two average corporate gifts per employee are shown in Table XIII. The first is a simple average, i.e., the average corporate gift per employee of each firm weighted equally. For the six firms, this average rose from $13.56 in 1958 to $18.34 in 1963; however, it declined to $11.53 in 1968. The latter amount was lower than the average ten years earlier despite the addition of the Red Cross to the United Fund in 1960.

The second average weights the contribution of each corporation according to the number of employees. It is the more meaningful of the two means and is the average corporate gift per employee of all the companies involved. Among the six firms, this average rose from $8.51 in 1958 to $10.69 in 1963. During the next five years it declined to $9.26.

Turning to the 24 companies acquired since 1963, one finds that their employment declined from the pre-merger level of 11,707 to 11,045 in 1968—a decrease of 6 percent. This decline is especially significant in light of the fact that 1968 was a far more prosperous year than 1963 for industry in Milwaukee and the nation.

The average corporate gift per employee, unweighted, of the 24 companies declined substantially, but the weighted average (actual mean for all the

Table XIII

CORPORATE GIVING TO MILWAUKEE UNITED FUND BY
COMPANIES ACQUIRED BY OUT-OF-STATE CORPORATIONS, 1958-1968

	1958	1963	1968
Six Firms, Acquired 1959-1963			
Total Gift	$32,772	$ 39,300	$ 45,451
Average Gift	5,462	6,550	7,575
Total Employment	3,849	3,676	4,910
Average Employment	642	613	818
Average Gift per Employee, Unweighted	$ 13.56	$ 18.34	$ 11.53
Average Gift per Employee, Weighted	8.51	10.69	9.26
Twenty-four Firms, Acquired 1964-1968			
Total Gift	$143,507	$160,750	$158,328
Average Gift	5,979	6,697	6,597
Total Employment	11,683	11,707	11,045
Average Employment	487	488	460
Average Gift per Employee, Unweighted	$ 8.43	$ 10.69	$ 8.55
Average Gift per Employee, Weighted	12.28	13.73	14.34
Thirty Firms, Acquired 1959-1968			
Total Gift	$176,279	$200,050	$203,779
Average Gift	5,875	6,668	6,792
Total Employment	15,532	15,383	15,955
Average Employment	518	513	532
Average Gift per Employee, Unweighted	$ 9.46	$ 12.25	$ 9.15
Average Gift per Employee, Weighted	11.35	13.00	12.77

employees) rose from $13.73 in the pre-merger year of 1963 to $14.34 in the post-merger year of 1968. Despite this rise, the total gift of the 24 companies fell slightly because of a decline in their employment.

For the 30 companies, total employment rose 3 percent during the 1958-1968 period, and the average gift increased from $11.35 in 1958 to $12.77 in 1968. This increase may be attributed to the incorporation of Red Cross into United Fund, rather than an increase in total contributions.

To fully assess the changes in the corporate giving of the acquired firms, the changes must be compared to those of the control group of non-acquired Milwaukee corporations.

Contributions of Non-Acquired Companies

As shown in Table XIV, total United Fund contributions of the non-acquired Milwaukee firms rose from $263,726 in 1958 to $352,934 in 1968--a gain of 34 percent. During the same period, the employment of these firms rose about 11 percent. Therefore, approximately one-third of the growth of giving may be attributed to corporate growth, two-thirds to other factors, including the addition of the Red Cross and increased generosity.

The average corporate gift per employee, weighted, rose from $14.56 in 1958 to $17.58 in 1968. However, the average gift in 1968 was down from $18.25 in 1963.

Acquired Versus Non-Acquired Corporate Contributions

Table XV presents growth indices for the various groups of firms studied. Interestingly, the greatest growth of total corporate giving to the United Fund was among the six firms acquired in the 1959-1963 period. The slowest growth was among those acquired by out-of-state companies since 1963.

Table XIV

CORPORATE GIVING TO MILWAUKEE UNITED FUND
BY NON-ACQUIRED COMPANIES, 1958-1968

	1958	1963	1968
Thirty Firms, Non-Acquired			
Total Gift	$263,726	$335,745	$352,934
Average Gift	8,791	11,192	11,764
Total Employment	18,109	18,430	20,074
Average Employment	603	614	669
Average Gift per Employee, Unweighted	$ 8.91	$ 11.51	$ 11.32
Average Gift per Employee, Weighted	14.56	18.25	17.58

Table XV

CORPORATE GIVING TO MILWAUKEE UNITED FUND
BY ACQUIRED AND NON-ACQUIRED COMPANIES

	6 Acquired Firms	24 Acquired Firms	30 Acquired Firms	30 Non-Acquired Firms
Indices of Total Giving:				
1958	100.0	100.0	100.0	100.0
1963	119.9	112.0	113.5	127.3
1968	138.7	110.3	115.6	133.8
Indices of Contributions per Employee, Weighted:				
1958	100.0	100.0	100.0	100.0
1963	125.6	111.8	114.5	125.3
1968	108.8	116.8	112.5	120.7
Indices of Employment:				
1958	100.0	100.0	100.0	100.0
1963	95.5	100.2	99.0	101.8
1968	127.6	94.5	102.7	110.9

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Comparing the 30 acquired companies to the non-acquired companies, one finds that the acquired group increased its contributions about 16 percent during the ten years. The increase of contributions by the non-acquired corporations was more than twice as great--almost 34 percent. However, the acquired companies, prior to their mergers, were not increasing their contributions as rapidly as the non-acquired group. For example, in the 1958-1963 period, the 24 firms subsequently acquired increased their corporate gifts 12 percent, while the 30 non-acquired firms increased theirs more than 27 percent.

During the ten-year period, corporate contributions per employee rose more rapidly among the 30 non-acquired corporations. Their contributions increased about 21 percent, while the contributions of the 30 acquired firms rose about 13 percent. Therefore, it appears that generosity rose most rapidly among the non-acquired companies. This measure of generosity rose least among the six corporations which had been merged for the longest period of time.

Employment growth was greatest among the six firms acquired during the 1959-1963 period--28 percent. It was least among those acquired since 1963. Their employment in 1968 was 5.5 percent less than in 1958 and 5.7 percent less than in 1963.

During the ten years, the growth of employment among the 30 non-acquired firms was about four times as great as among the 30 acquired firms--10.9 percent as opposed to 2.7 percent.

Conclusion

Considering both corporate growth and generosity (the latter measured by giving per employee), the United Fund of Milwaukee fared best among the 30 non-acquired firms. However, the pre-merger gifts for the 24 companies

acquired since 1963 indicate that their contributions were growing less rapidly than those of the 30 non-acquired firms. In other words, their giving might not have risen substantially even if they hadn't been acquired by out-of-state corporations.

On the other hand, one would not have expected their corporate contributions to decline, as they did between 1963 and 1968. Also, one would not have expected the 5 percent decline in employment experienced by the 24 companies.

The total United Fund contributions by all Milwaukee firms rose from $2,174,994 in 1958 to $2,874,942 in 1963 and to $3,080,078 in 1968. The 36 percent increase during the ten years is slightly greater than that of the 30 non-acquired firms and substantially greater than that of the acquired companies. However, this may not be a fair comparison because total corporate giving would include new firms as well as those existing in 1958.

Average corporate giving per employee rose from $9.12 in 1958 to $13.14 in 1963 and $13.46 in 1968. The increase during the ten years was 36 percent. Therefore, neither the acquired nor non-acquired firms in the sample increased their corporate contributions per employee as rapidly as all corporate contributors in Milwaukee. However, the control group of non-acquired companies increased its contribution per employee more than those companies that were acquired. Because the latter were trailing in their contributions prior to acquisition, the only major conclusion to be reached is that United Fund contributions in Milwaukee apparently have been adversely affected by out-of-state acquisitions because of decreased rates of growth following the merger of several Milwaukee companies.

Chapter VIII

SUMMARY, CONCLUSION, AND RECOMMENDATIONS

The most pronounced finding of this study is that it is difficult to generalize about the social and economic consequences of the current merger movement. Many of Wisconsin's acquired firms have experienced an increased rate of growth since their mergers. The communities of these firms have enjoyed expanded employment and payrolls (and consequently, increased property and personal income tax revenues), and greater contributions to charitable causes. On the other hand, many other acquired firms, especially those merging with conglomerates headquartered in other states, have experienced a substantial decline in employment and payroll growth.

While the typical firm acquired between 1963 and 1967 has continued to expand, its growth since the acquisition has been less than that of the years immediately preceding the acquisition. In general, the employment and payrolls of companies acquired by Wisconsin corporations have fared better than those of companies acquired by out-of-state corporations.

As the above suggest, it is readily apparent that some mergers have been highly successful, whereas others have been unsuccessful. It would benefit private industry and society if greater care were exercised in merger decisions.

While the analyses of this study are based solely on mergers involving Wisconsin firms, there is a good possibility that the Wisconsin experience is representative of other states that do not house the headquarters of a

substantial number of conglomerate corporations. In other words, the findings of this study, at least qualitatively, may be representative of the experience in many other states.

In order to draw an overall picture of the social and economic consequences of the merger movement in Wisconsin, it is helpful to compare the results of the six studies which compose this research report. In several instances, two or more of the six studies investigated the same consequence of corporate acquisitions.

Comparison of the Results of the Opinion Surveys

If one compares the results of the four surveys described in Chapters II-V, several interesting observations can be made. In Tables XVI through XVIII, survey responses were divided into three categories--favorable, neutral, and unfavorable. If it is assumed that a "no opinion" response reflects a basically neutral attitude toward the survey question, then one can include responses of this type within the "neutral" category. This procedure was followed in compiling the tables.

Table XVI is a comparison of estimates of the general public's attitude toward mergers. The three columns show the public's attitude as indicated by (1) the general public survey, (2) the Chamber of Commerce survey, and (3) the newspaper executive survey. In the latter two surveys, the respondents were asked to estimate the public's attitude concerning mergers. In the general public survey, the interviewees were asked if the community was better or worse off because of mergers.

As shown, there is a rather striking similarity between the Chamber of Commerce and newspaper executives' estimates of public attitude toward mergers.

Table XVI

ATTITUDE OF THE GENERAL PUBLIC TOWARD MERGERS

	As Determined by Survey of General Public	As Estimated by Chamber of Commerce Officials	As Estimated by Newspaper Executives
Favorable	45%	48%	53%
Neutral (or no opinion)	29	37	34
Unfavorable	26	15	13

The dominant opinion was a favorable public attitude toward mergers. While the survey of the general public produced a similar result, it produced a proportion of unfavorable attitudes that was almost twice as large as that estimated by the Chamber of Commerce and newspaper executive surveys. However, only 26 percent of the general public respondents indicated an unfavorable attitude.

Table XVII shows comparative survey results concerning opinions on the growth and employment of specific acquired companies. Similar questions concerning the impact of the mergers on employment were asked of respondents in the general public, Chamber of Commerce, and newspaper executive surveys. In the management survey, the respondents were asked if there had been any change in the rate of growth of their firms since acquisition.

There is substantial agreement among the four groups surveyed. In each case the majority of the mergers evaluated had no perceivable effect on employment growth. Furthermore, in each survey the percent of respondents evaluating mergers with an apparent favorable impact on employment greatly outnumbers the percent who estimated a negative impact.

Table XVII

OPINIONS CONCERNING THE EFFECT
OF SPECIFIC MERGERS ON EMPLOYMENT

	General Public Survey	Chamber of Commerce Survey	Newspaper Executive Survey	Management Survey
Favorable Effect on Employment	37%	40%	38%	35%
No Change in Employment	50	52	54	60
Unfavorable Effect on Employment	13	8	8	5

The evaluations given in Table XVII are basically correct, even though the result varies considerably from the findings of the more comprehensive and detailed employment history outlined in Chapter VI. The majority of the acquisitions of Wisconsin firms have not greatly altered the rate of employment growth. Without the precise measurements used in Chapter VI, one would have difficulty ascertaining changes in the growth of many of the acquired firms.

While the favorable and unfavorable opinions on employment growth gathered in the four surveys were not always correct, a fairly high proportion of the companies evaluated by the respondents have had a favorable growth rate since their merger. Also, in the Chamber of Commerce and newspaper executive surveys some of the companies involved were Wisconsin corporations which had acquired other companies in and out of the state. Therefore, it is not surprising that these respondents had more favorable reports than the general public and management groups. Interestingly, the smallest percentage of favorable reports was received from the presidents and officers of acquired corporations.

Table XVIII offers a comparison of survey opinions concerning community contributions of acquired firms. The executives in the management survey were asked if there had been any increase or decrease in their company's financial contributions to the local community as a result of merger. In the Chamber of Commerce and newspaper executive surveys, the respondents were asked to estimate the impact of specific mergers on "the firm's commitment to the community and its financial support of civic projects."

Table XVIII

COMPARISON OF OPINIONS
CONCERNING COMMUNITY CONTRIBUTIONS
OF ACQUIRED FIRMS

	Management Survey	Chamber of Commerce Survey	Newspaper Executive Survey
Favorable Effect on Community Contributions	45%	31%	38%
Neutral or No Effect	35	59	48
Unfavorable Effect on Community Contributions	20	10	14

The responses reveal that the Chamber of Commerce officials and newspaper executives are fairly close in their estimates of community contributions. In both of these groups, the dominant attitude was that mergers have had little effect on corporate contributions to the community. Moreover, in both groups the number of respondents who indicated a favorable impact of mergers on community contributions was approximately three times as great as the number who perceived an unfavorable effect. As might be expected, the management group was somewhat more generous in its estimates

of the effect of mergers on community contributions. However, a high proportion of the executives included increased payrolls in their appraisal of community contributions. Interestingly, the highest proportion of decreased contributions was obtained in the management survey.

In summary, there was a remarkably high degree of similarity in the opinions expressed by the four survey groups, even though the respondents were highly dissimilar. The predominant conclusion to be derived from the surveys is that most mergers do not have a readily perceivable impact on the growth of employment and the community commitment and financial contributions of acquired Wisconsin companies.

A second conclusion to be derived from the four surveys is that the social impact of acquisition is more often favorable than unfavorable. While this conclusion may be correct for the specific mergers discussed in the four surveys, it apparently does not represent the total picture in Wisconsin.

Another general conclusion is that the effects of mergers vary greatly from one case to another. Some of the acquisitions discussed by the respondents had a highly favorable impact on the local community; in other instances just the reverse was true. Therefore, it is highly difficult to generalize about the social and economic effects of corporate mergers in Wisconsin.

Other Findings of the Opinion Surveys

The survey of the presidents and other officers of Wisconsin companies acquired by out-of-state firms indicates the following:

1. The two most prevalent reasons for being acquired are to reduce estate tax problems (highly important among privately held businesses) and to increase the financial resources of the firm. In addition, the ability to sell the company without immediate taxation of capital gains and other financial advantages were frequently mentioned.
2. Most companies that had merged for non-financial considerations (such as improved marketing) have not realized the anticipated advantages. In addition, most of the companies have not experienced greater growth since their acquisitions--an indication that the merger has not improved the management and financial strength of the company.
3. Despite the lack of greater growth, financial advantages to the company were the most frequently mentioned benefits derived from the merger.
4. The disadvantages resulting from the mergers were primarily organizational in nature, such as friction between the management of the acquired company and the parent corporation.
5. Changes in sources of supply may represent the greatest loss to Wisconsin's economy resulting from acquisitions by out-of-state firms. Most of the acquired firms covered by the survey now use the financial institutions,

5. (continued)

   legal services, and accounting services of their parent companies. Apparently, there is less tendency to change sources of goods than sources of services.

In addition to conclusions already outlined, the Chamber of Commerce and newspaper executive surveys indicate the following:

1. Most mergers involving Wisconsin's larger corporations have been the acquisition of a Wisconsin firm by an out-of-state firm.
2. In most cases there have been no dramatic changes in the number of management personnel and the location of corporate headquarters as a result of merger. However, some Wisconsin communities have lost the home offices of local companies that have been acquired. This occurred in one out of every five out-of-state mergers covered by the two surveys.
3. In a few instances, the acquisition of a local firm has resulted in its complete removal from the community.

The survey of the general public and employees of acquired Wisconsin companies shows the following:

1. A significant proportion of the public was unaware of the corporate mergers in their community.
2. A majority of the employees of acquired companies felt that they were better off as a result of the merger.

3. Only one-third of the employees felt that their employer was any stronger or the company better managed as a result of the merger.

Findings of the Employment and Payroll Study

The most complete of the six studies of this report was the study of the pre-merger and post-merger growth of employment and payrolls of 227 companies. Because of the size of the sample and the magnitude of the differences between in-state and out-of-state mergers, the following conclusions are well established as far as mergers in the 1963-1967 period are concerned:

1. Fifty-five percent of the acquired companies have had a slower rate of employment growth since their merger. In this analysis, the pre-merger period was December, 1960, through December of year prior to merger; the post-merger period was December of the year of merger through December, 1968. Both in-state and out-of-state mergers had more declines than advances in employment growth in the post-merger period. Fortunately, Wisconsin's economy has expanded rapidly in recent years, more than offsetting any losses due to those mergers having an adverse effect on employment growth in Wisconsin. For example, seasonally adjusted unemployment in December, 1968 was only 3.3 percent of the state's work force, less than the national average.

2. The post-merger growth rate of the aggregate employment of the companies acquired by Wisconsin firms was less than the pre-merger growth rate. The average annual pre-merger rate was 4.23 percent; the corresponding post-merger rate was 1.04 percent. The lesser rate of growth may have been due to efficiencies brought about by the mergers, the transfer of employees to non-Wisconsin locations, or slower corporate growth following the acquisition.
3. The growth of aggregate Wisconsin employment of companies acquired by out-of-state corporations declined substantially more than that of those acquired by in-state corporations. The pre-merger aggregate growth rate of firms acquired by out-of-state firms was 6.02 percent. Following the mergers, their growth rate declined to -.48 percent-- 108 percent less than in the pre-merger period. The data, plus information from survey of acquired companies, indicate that several parent corporations have failed to take advantage of the opportunities provided by the acquired companies. Undoubtedly, opportunities still exist for increased investments which would generate expanded employment and payrolls in Wisconsin communities while increasing the profitability of the companies.

4. Fifty-three percent of the acquired companies have had a slower rate of payroll growth since their mergers. Apparently, mergers have depressed the growth of payrolls in several companies, especially large firms acquired by out-of-state corporations. Given the advance of wages and salaries in recent years, one would have expected more payroll than employment advances among the acquired companies. The fact that this frequently did not happen in companies acquired by out-of-state firms would lead one to believe that their acquirers have transferred a portion of the higher salaried employees to a location outside Wisconsin. Such transfers mean a loss of talent, retail expenditures, and personal income taxes in the economies of Wisconsin's communities and the state.
5. The average annual growth of aggregate payrolls among companies acquired by Wisconsin firms has declined 30 percent since the mergers. The pre-merger rate of payroll growth was 8.96 percent; the post-merger rate was 6.31 percent. However, the 6.31 post-merger payroll growth compares favorably with their 1.04 percent post-merger employment growth.
6. The average annual growth of aggregate payrolls among companies acquired by out-of-state firms has declined 65 percent since the mergers. The pre-merger payroll growth rate was 10.47 percent; the post-merger rate was 3.68 percent.

7. The majority of the firms acquired by conglomerates have experienced substantially reduced employment growth. In general, Wisconsin firms acquired by conglomerates and quasi-conglomerates were rapidly expanding businesses. Their average annual growth of employment from 1960 to the year preceding the merger was 8.4 percent. While nine of the 24 firms involved enjoyed an accelerated employment growth following their acquisitions, the average post-merger growth of the 24 firms was -1.3 percent. If acquisitions by quasi-conglomerates are not included in the calculation, the average pre-merger employment growth rate rises to 11.6 percent and the post-merger rate declines to -1.8 percent.
8. The 24 companies acquired by the conglomerates and quasi-conglomerates had an average annual payroll growth of 11.5 percent between 1960 and the year preceding the merger. The post-merger growth of payrolls was 2.8 percent. Despite the substantial decline in payroll growth, ten of the acquired companies had a larger post-merger than pre-merger rate of payroll growth. In other words, some acquisitions by conglomerates have contributed substantially to the economic prosperity of the state.

Considering these conclusions, it is apparent that Wisconsin's economy has fared far better among those companies acquired by Wisconsin firms than among those acquired by out-of-state conglomerate corporations. The changing

rates of payroll growth are especially significant because they affect both the prosperity of employees, the sales of Wisconsin's retail industries, and the tax revenues of the state. In other words, any change in the rate of payroll growth induced by a merger has a multiplier effect above and beyond its immediate effect on the company's employees.

Findings of the United Fund Study

The comparison of United Fund contributions of 30 Milwaukee companies acquired by out-of-state corporations with the contributions of 30 similar companies that have not been acquired reveal the following:

1. The total United Fund contributions of the six companies acquired in the 1959-1963 period rose more rapidly than those of companies acquired since 1963. In addition, they rose more rapidly than the contributions of the non-acquired companies.

2. The total 1968 contributions of the 24 companies acquired in the 1963-1968 period were less than their contributions in 1963.

3. The total 1958 to 1968 rise of United Fund contributions of the 30 acquired companies was less than half as large as the increase of the non-acquired companies. Contributions of the acquired corporations rose 16 percent during the ten years, while those of the non-acquired companies rose 34 percent. However, the pre-merger growth of contributions indicates that the 30 acquired firms would not have

increased their giving as much as the non-acquired companies even if there had been no mergers.

4. The total growth of employment of the acquired companies was considerably less than the non-acquired companies.

Recommendations

Because the effects of mergers vary widely, care must be exercised in any effort to prevent potentially undesirable acquisitions. Many mergers have been socially advantageous, and general anti-merger legislation might prevent both undesirable and beneficial mergers. For example, one would not want to preclude mergers which are needed by companies in industries with rapidly rising economies of large scale. To prevent such mergers would promote inefficiency and weaken the competitive position of the state's industry.

Existing state and federal statutes should be sufficient to prevent those horizontal and vertical mergers that are likely to be socially undesirable. As a practical matter, it would be difficult for Wisconsin, or any other state, to outlaw conglomerate mergers as long as they are legal nationally. Furthermore, some conglomerate mergers are desirable. For example, the conglomerate has the potential advantage of allocating the merging firms' resources to those ends having the greater needs, thus increasing profitability and service to society. However, national legislation is needed to prevent the undesirable financial maneuvers used by some conglomerates to finance the acquisition of other companies. The large but thinly financed conglomerate is likely to be in a precarious position during a period of economic weakness. A substantial number of

such companies could easily endanger the total economic system, to say nothing about their possible effect on competitive processes and other undesirable consequences.

At the state level, several steps can be taken to prevent undesirable mergers and promote local economic development:

1. Greater emphasis should be placed on pre-merger investigations by those who are contemplating a merger. Many companies, especially acquired firms, have merged without adequately considering all alternatives and without sufficient knowledge of what the merger entails. Surprisingly, post-merger evaluations are often more intensive than pre-merger investigations.[7] Just the opposite should be true. Better and more extensive pre-merger investigations would increase the probability of success and reduce the number of unsuccessful mergers. Consequently, both private industry and the society would benefit.

   Companies about to be acquired should investigate the post-merger history of any other companies acquired by the potential acquirer. To facilitate investigations, Wisconsin's businesses should be provided with a checklist or manual to aid them in evaluating merger proposals. Many companies might find it feasible to utilize professional services to assist in pre-merger evaluations.

2. Industry should be encouraged to consider the likely future growth of the company and other potential social and economic consequences when evaluating a merger proposal. While personal economic

[7] Post-merger evaluations are, among other reasons, necessary to evaluate the assets of the companies for financial management and tax purposes.

considerations are bound to be major in any merger decision, management and owners should also consider the future welfare of their employees and the community.

3. Wisconsin suppliers, and especially the service industries, should be especially alert to preserving their relationships with Wisconsin's businesses. Financial institutions might make a concerted effort to increase the supply of capital available to Wisconsin's industry, thus reducing one incentive for entering a merger. When an acquisition does occur, the suppliers of the acquired company should establish rapport with the parent company and effectively communicate information relating to the value of their services. In so doing, some suppliers will be able to obtain additional accounts, rather than losing an existing account.

4. The state might consider legislation to reduce the estate tax incentive for mergers. Estate taxes are considerable, and privately held businesses are sometimes sold because the financial security of the heirs would be endangered upon the death of the owner. Perhaps estate taxes could be spread over a period of years, thus reducing the likelihood of forced sales in order to pay estate taxes.

5. When a Wisconsin company is acquired, the management of the acquiring company should be visited by representatives from Wisconsin, welcoming the company as a new

corporate citizen to the state. The visitation team might consist of one or more members of the Board of Economic Development and perhaps executives from Wisconsin companies supplying the acquired company with goods or services. Government officials from the state or community of the acquired company might also be represented. In addition to welcoming the company to Wisconsin and discussing the advantages of the state, the team could discuss any locational problems which the parent company might have. Such an effort should help to increase the acquiring company's commitment to Wisconsin, and might lead to the location of additional corporate facilities in the state.

APPENDIX VII

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CABLE ADDRESS
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May 22, 1975

The Honorable Sam Nunn
United States Senator
Room 110
Russell Senate Office Building
Washington, D.C. 20510

Dear Sam:

I have been intending to contact you regarding matters of legislation of interest to several of our clients and your constituants generally, and had hoped to talk with you when you spoke at the Atlanta Bar Association, or at the Phi Delta Theta Alumni Club Founders Day dinner in early April. You didn't appear to have time following the Bar luncheon and an illness in the family (Robert E. Cheshire, Juvenile Judge, Colquit County, my father-in-law) resulted in my missing the Phi Delta Theta dinner.

I felt that your talk at the Bar meeting was both enjoyable and informative. Your comments with respect to competition by the Government with private borrowers in the money market rang a bell with regard to the problem some of our clients are having. Simply stated the matter, (more fully discussed hereinbelow) is that many small business domestic internation sales corporations ("DISC's") are finding it difficult to invest accumulated DISC income in qualified export assets, the broadening of permissable or qualified investments would permit more investment by such DISCs and greater DISC investment could help stimulate the economy.

DISC RECEIPTS AND ASSETS.

As you are no doubt aware, a corporation which meets the requirements of Section 991 et seq. of the Internal Revenue Code of 1954, as amended, can obtain special tax treatment. Ninety-five (95%) percent of its gross receipts must be "qualified export receipts" as defined in Code §993(a), and ninety-five (95%) percent of the adjusted basis of its assets, on the last day of its taxable year, must be

"qualified export assets" as defined in Code §993(b). Once the successful DISC has expanded capital and inventory (often purchased from a related supplier) to the virtual maximum, it has available limited "investment" assets (see Code 993(b) (1)-(9)).

As regards "obligations issued, guaranteed or insured by the Export-Import Bank of the United States or the Foreign Credit Insurance Association," such must be acquired from the issuer, not a prior holder. Obligations of Export-Import Bank have not been available. We are helping our clients to attempt to determine the availability of FCIA obligations, but are concerned that these also may be virtually unavailable. An alternative to the above is stated in §993(b)(8)--obligations issued by the Private Export Funding Corporation (PEFCO). I have contracted Frank Nee, Controller of PEFCO regarding this and other investments. He advised that the next issue of PEFCO obligations would probably bear an interest rate of about five (5%) percent (as contrasted with recent issues around 7%) and would mature in 30 to 270 days. An additional alternative to these foregoing investments is the "producers loan" (Code 993(d)). Producers loans have the advantage of being longer term (up to five years). From the standpoint of the small business DISC, producers loans have disadvantages: the small DISC affiliated supplier (if any) may not require much capital and loans to unrelated suppliers require credit evaluation, documentation, credit administration, and other activities and financial risks which the small business DISC is not equipped, and does not desire, to handle.

DISC TAXATION.

The DISC is not a taxpayer. Its shareholder(s) are taxed pro rata on corporate earnings and profits adjusted in accordance with Code 995 (a). Generally, with a small business DISC this would be one-half of the amount of qualified receipts, plus all interest received from producers loans, and all income which is not qualified export receipts and is in excess of 5% of the DISC's gross receipts for such taxable year (the so called distributions to meet qualification requirements described in Code 992(c)). The interplay of the latter and the "qualified asset" and "qualified receipts" requirements is that generally a DISC which can meet the requirements of having had seventy (70%) percent of

its gross receipts consist of qualified export receipts and 70% of its assets on the last day of each month consist of qualified export assets can make deficiency distributions for "outside investment" and still qualify as a DISC. Because of this, some DISCs, by careful planning, may be able to derive considerable income from relatively large investments in non-export type assets without disqualification.

SMALL BUSINESS DISC.

There is no definition of a "small business DISC", but for various reasons there might well be. The DISC affiliated with large publicly or privately held manufacturing, production or service corporation is different than the small DISC which is not affiliated with a manufacturer, producer or service corporation, or is affiliated with a small manufacturing, production or service enterprise which may be a partnership, proprietorship, subchapter S corporation or small, closely held corporation. In these latter "small business DISCs" the shareholders are often the shareholders, partners or proprietors of the related manufacturing, production or service enterprise. Quite often the small business DISC and its affiliate are small but sound organizations which do not have large and sophisticated management, organization and administrative and accounting procedures necessary to enable management to determine whether or not the DISC is maintaining status. They often are not aware of marginal pricing and other sophisticated accounting techniques which would enable them accurately to allocate facilities, inventories, costs and other factors to export activities. Also, they do not have the management and administrative resources necessary to enable them to evaluate and administer "qualified" DISC investments, such as loans to non-affiliated producers or Export-Import Bank, FCIA or PEFCO obligations.

PERSPECTIVE

You indicated in your talk to the Atlanta Bar Association that the economy obviously needs stimuli, especially in the form of capital investment or expansion which in turn will create new, or cause re-employment for existing jobs. You also mentioned concern that the proposed administration and congressional programs for economic stimulation would be funded by additional government borrowing, which borrowing will be in competition with borrowing in the public sector possibly causing undesirable increases in interest rates just when the economy is beginning to recover.

Many estimates of the magnitude of accumulated DISC income available for investment have been made. Your office has better access than we to reliable information in this regard. The fact of the matter is that there is a lot of money sitting relatively idle, or utilized in unproductive ways and which could be made available to help stimulate the economy. DISC shareholders could make such funds available by distributing the same, paying full, current taxes thereon, and investing and paying full, current taxes on the investment income. This, however, would result in financial hardship to DISC investors, especially the small business DISC investors.

Additionally, there have been suggestions that the DISC legislation is more "give away to big corporations"" and should be abolished or drastically modified. This is, in our opinion, an oversimplified view. In our experience, clients with few or no exports, through the utilization of DISCs, have been able to promote, make and expand exports of U.S. products and contribute to a positive balance of payments. Furthermore, these clients are not "Fortune 500" or multinational companies often accused of a lack of patriotism and of greed--these are small Georgia corporations, owned by Georgians, employing Georgians and respected in their communities.

PROPOSALS.

We feel that there are ways in which Congress can at the same time act in the best interests of the small businessman, promote exports and benefit the economy as a whole. Proposed alternatives are:

1. Modify DISC legislation to permit DISCs to make investments in assets, and receive income, not now included within the definition of qualified export assets and qualified export receipts.

2. Modify DISC legislation to include within the definition of "qualified export assets" obligations of the United States in the form of short and medium term obligations.

3. The benefit of one or both of the above might be limited to "small business DISCs" defined as those with less than five hundred thousand dollars receipts or accumulated DISC income or less than one million in assets.

4. Alternatively, and simply as an aid to small business DISCs, the Small Business Administration, or relevant government or private agency issuing obligations which DISCs are permitted to acquire, could be required to establish programs to encourage and assist small business DISCs in making such presently available qualified DISC investments.

COMMENT.

Variations of the proposals suggest themselves: Numbers 1 and 2 might be limited to investments made during times of economic emergency as declared by the Executive or Legislative branch of the government. In view of the tax savings available to DISCs, a lower return on investment than that established in the free market could be expected to result or would result. For example, when the U.S. Government must borrow at a nine percent interest rate on the open market, a six percent interest bearing obligation should be attractive to a DISC. Investments for a medium term, for example five years, should be permitted in order that small business DISCs which are not, and do not, have the resources to be actively engaged in managing investments will be able to participate. It might be charged that these proposals are "tax benefits" at a time when such are unpopular. However, we feel that the cost to the government in taxes will be more than offset by the value of the opportunities for stimulated economical growth and reduced costs of governmental borrowing (with less liklihood of secondary inflationary effects in the public sector from high rate government borrowing).

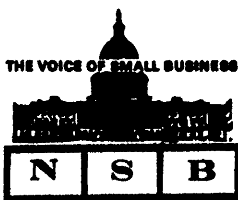
The foregoing is a brief, and of necessity, simplified discussion and presentation of suggestions. We feel that because of your involvement with small business, your desire to help stimulate the economy by responsible government policies and your continuing efforts on behalf of your constituants, you will be interested in considering, in more detail, the possibilities presented herein. We would appreciate hearing your reactions and comments regarding the above. If we can assist, or request our clients to assist, you in this matter, please do not hesitate to contact us.

Very truly yours,

James G. Killough
For McClain, Mellen, Bowling & Hickman

JGK:mw
cc: Congressman W. S. Stuckey, Jr.
Congressman Andrew Young

APPENDIX VIII



NATIONAL SMALL BUSINESS ASSOCIATION
Jefferson Building • 1225 Nineteenth St.,N.W.
Washington, D.C. 20036 • Telephone (202) 296-7400

June 18, 1975

Mr. Herbert L. Spira
Assistant General Counsel
Senate Select Committee on Small Business
424 Russell Senate Office Building
Washington, D.C. 20510

Dear Herb:

You will recall that during our testimony yesterday we promised to provide a supplemental statement on the 10-year carryforward/carryback recommendation. A copy of the supplemental statement is enclosed. Thank you for taking care of this for us.

Sincerely,

Herb

Herbert Liebenson
Staff Vice President - Governmental Affairs

HL:sh
enc.

SUPPLEMENT

TO STATEMENT OF

NATIONAL SMALL BUSINESS ASSOCIATION

SUBMITTED TO THE

SENATE SELECT COMMITTEE ON SMALL BUSINESS

AND

SENATE FINANCE SUBCOMMITTEE ON FINANCIAL MARKETS

ON TAX REFORM LEGISLATION TO BE PROPOSED

JUNE 17, 1975

EXTENDED OPERATING LOSS CARRYBACK AND CARRYOVER PERIOD

Under present law businesses, as well as individuals, are permitted to temper the effects of non-profitable years by averaging their income over a period of years. The general rule allows business losses incurred in a particular year to be carried back 3 years and forward 5 years with the result that operating losses may effectively offset income over a nine year period which includes the loss-year. The present law has proved ineffective in achieving its intended purpose in times of severe recession. In order to correct the demonstrated inadequacy of the present law, it is proposed that a 10 year loss carryback/carryover be enacted.

(1) Some industries and many businesses have been particularly hard-hit by the economic back-wash created by the 1973 oil embargo and the subsequent shortages and high prices of oil and related products.

The monthly economic statistics from Washington and the daily financial pages of the newspapers suggest that the economic situation in the United States may be continuing to deteriorate. Recent statistics indicate that nationwide unemployment probably will soon reach 10 percent. These economic waves, however, are not affecting all U.S. businesses equally. Some businesses are reporting either record profits or sales, or both, while others, both large and small, have been experiencing a depressionary level of business activity - both sales and profits. For these hard-hit businesses, the reduction in operations has produced prolonged and widespread unemployment, severe capital shortages, and strained lines of credit. This is the sector of the U.S. economy that, obviously, most needs immediate Congressional attention.

Appearing last Winter before the Ways and Means Committee, in connection with the Tax Reduction Act of 1975, a panel of economic experts on hard-hit industries supported the desirability of extending the net operating loss carryback period because this would generally make funds available where the need is greatest. As one member of the panel put it: By making funds available to those taxpayers with the greatest need gives "you the best chance of getting a bigger bang for the buck." 1/ This would result in the speedy refund to needy businesses of taxes paid in past years. These refunds would be immediately plowed back into the economy, at the most critical time, thus preserving jobs and stimulating business in general, in addition to providing

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1/ Hearings before Comm. on Ways and Means, House of Representatives, 94th Cong. 1st Sess., on President's Authority to Adjust Imports or Petroleum; Public Debt Ceiling Increase; and Emergency Tax Proposals, Jan. 22-30, 1975, p. 659-660

badly needed financial transfusions to those businesses which have been most adversely affected by the energy revolution. 2/

The opinion of these economic experts, calling for the extension of the net operating loss carryback period, is as applicable today as it was last Winter. Such an amendment would permit struggling businesses, whether small or large, new or old, to receive an immediate infusion of cash. This would reduce shortages of working capital and lessen the pressure on lines of credit. The companies receiving tax refunds under such a provision would, of necessity, immediately return these funds to the economy and, thereby, reduce unemployment and preserve existing jobs.

(2) Liberalized investment tax credits or the reduction of corporate tax rates does not make available any funds for badly needed capital expenditures to companies with currently unusable operating losses.

Although the Tax Reduction Act of 1975 provides tax benefits to profitable companies and relief to low income individuals who have suffered the most from the present economic situation, it included no short term assistance for hard-hit businesses. That Act channeled most of the benefits for business into increasing the investment tax credit, which, except in unusual cases, directly and immediately aids only those companies that are realizing substantial profits. A tax reform bill that does not address itself to the financially squeezed businesses, those that have borne the brunt of the current economic downturn, would be a very poor piece of legislation.

(3) The economic policy supporting a net operating loss carryback and carryover would be best effectuated with a more flexible carryback/carryover period.

The economic justification for the loss carryback and loss carryforward provisions is to provide that businesses with cyclical years of profits and losses should not pay higher taxes over such years than less cyclical businesses which have approximately the same average income over the same period of time.

Under present law, a business, like an individual, is permitted to temper the effects of non-profitable years by averaging its income over a period of years. The general rule is that business losses in one year may be carried

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2/ H. Rep. No. 94-19, 94th Cong., 1st Sess., on H.R. 2166, pp. 85 and 98.

back three years and forward five years to offset profits in those years. On seven occasions in the past, the Congress has recognized the economic desirability of modifying this general averaging rule to provide greater flexibility and equity in averaging profitable and loss years.

A close examination of the prior Congressional action reveals that the underlying rationale for liberalizing carryback and carryover provisions in each case was identical: Congress simply decided that it was unfair to exact an income tax from a taxpayer when in economic fact that taxpayer had not realized any income. Stated otherwise, the prior legislation shows a definite Congressional recognition of the business fact that hard-hit losing industries have an acute need for funds immediately, while they are incurring losses, not in the future, when they are earning profits against which loss carryovers may be applied. In many cases, the immediate utilization of operating losses can be the difference between survival and insolvency. A more flexible operating loss carryback/carryover period would be in keeping with the policy intent behind the original enactment of the loss carryback and carryover provisions.

While a loss carryover does provide benefits, it is the loss carryback which yields the immediate benefit of a tax refund when the taxpayer is in urgent need of the cash at the time it is incurring the loss. Obviously, such refunds are immediately plowed back into business operations, thus permitting continued operations and preventing further deterioration of the economy.

It has been recognized that extending the carryback period is particularly useful since it promptly provides liquid funds for a business experiencing economic reverses. Statement of Senator Gaylord Nelson (see also Statement of Senator William Proxmire), Cong. Rec. 32089-32091 (November 9, 1967)).

(4) Effect on tax revenues would not be significant.

The immediate "overpayments" produced by an extended operating loss carryback period represent merely a refund of "overpayments" of prior year income taxes based upon the use of a more realistic business cycle for the determination of the true amount of net income.

At the time that the proposal to extend the net operating loss carryback period was considered by the Committee on Ways and Means, when it was considering the Tax Reduction Act of 1975, the Staff indicated that, while its immediate effect would be a reduction in current revenues, there would be

an increase in tax revenues in future years, because there would be a decrease in the amount of net operating loss carryforwards. Under present law, carryforwards would be utilized directly by the taxpayer or indirectly through mergers.

(5) Importance of preserving the carryover of losses to properly reflect income resulting from business cycles.

As a matter of equity, full offset of losses treats alike those taxpayers who stand in like positions over a period of time. Carryovers ameliorate the harsh and somewhat arbitrary consequences of the annual accounting approach toward computing income. Carryovers are essential in the case of new businesses, fast growing businesses which suffer extraordinary losses, as well as for companies which have been marginal struggling businesses for a long period prior to incurring losses. It would be inequitable not to permit taxpayers to carryover operating losses in these situations.

In addition, as above noted, full offset of losses contributes to the counter-cyclical effect of taxes. An absence of loss offsets, or a limitation on their use, tends to increase cyclical instability.

(6) Appropriate safeguards would prevent trafficking in loss carryovers.

It is widely known that the complex and elaborate rules of sections 381, 382, 269 and 482, while they have substantially reduced the acquisition of loss companies by profitable companies, they have not eliminated the trafficking in loss carryovers in certain situations. Of course, the adoption of a more liberal carryback would reduce the trafficking in carryovers because there would be less of a loss to carry forward. By the same token the more extensive the carryback the more completely the carryover abuse possibility is eliminated. Since no trafficking abuse potential exists with respect to carrybacks this presents additional justification for a more flexible carryback period.

Possible safeguards for consideration might include:

Limitations on the deductibility of loss carryovers where a profitable business acquires a loss business; and in the reverse situation in cases where the shareholders of the profitable company receive a specified percentage of the stock of the loss company into which the profitable company

is merged, e.g., none of the carryover of the loss company would be allowed where the shareholders of the profitable company receive at least 50% of the shares of the surviving company; where the shareholders of the profitable company receive less than 50% of the surviving company, the loss carryover of the losing company which could be offset against future profits of the profitable business would be reduced by two percentage points for each one percent of the shares received of the surviving company.

(7) Other arguments which may be amplified depending on particular industry.

(a) More flexible carryover and carryback provisions would preserve competition by refunding taxes to enable the smaller or harder-hit competitors in particular industries to develop products and facilities in greater competition with the industry leaders.

(b) Some industries, and supporting businesses, require huge amounts of capital at the present time to adapt to the new economic era into which we have recently been thrust. After earning negative profits and borrowing up to capacity, an extended loss carryback period would truly be badly needed "pennies from heaven".

(8) Recommendation

What may have been adequate anti-recessionary tax legislation in the Tax Reduction Act of 1975 to help stimulate the economy is not what is needed for structural long term tax reform purposes, particularly considering the extraordinary nature and causes of the economic problems created by the 1973 oil embargo and the huge price increases resulting therefrom, e.g.:

(a) The economic recession hit all developed countries who are in any way dependent on other countries for oil.

(b) The price of oil has soared and is expected to continue to increase.

(c) Not only the price of oil but the supply itself is not certain.

(d) Continued high prices will result in a decreased demand for goods for the indefinite future which will result in a continued high level of unemployment and depressed business activity for certain industries related to and dependent upon oil (e.g., automotive manufacturers and suppliers, utilities, recreational oriented businesses, transportation related businesses, etc.)

The carryback/carryover period should be amended to provide any carryback/carryover period elected by the taxpayer not to exceed a total of ten taxable years which may consist of either the ten taxable years immediately preceding the taxable year of such loss, the ten taxable years immediately following the taxable year of such loss, or any combination of successive taxable years immediately preceding and successive taxable years immediately following the taxable year of such loss. This extended carryback/carryover period should be available to taxpayers with respect to loss years ending on or after the 1973 oil embargo.

APPENDIX IX

July 11, 1975

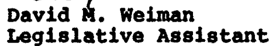
Mr. Herb Spira
Senate Select Committee on
Small Business
424 Russell Office Building
Washington, D.C. 20510

Dear Herb:

Attached are several articles outlining problems confronting family farming in America. In many ways, these articles parallel the statement submitted by Gil Rohde earlier last month.

To supplement the record, if it's not too late, the Committee may want to include them.

Cordially,



David M. Weiman
Legislative Assistant

cc: Gilbert C. Rohde

Enclosures

DMW:sas

54-397 1042

Suite 1200, 1012 14th Street, N.W., Washington, D.C. 20005 — Phone (202) 628-9774

[From the Missourian, Apr. 3, 1975]

INSIGHT CATTLEMEN CORRALLING RECORD LOSS—OUTSIDE INVESTORS LOSING TAX SHELTER IN BEEF INDUSTRY

(By Cheryl Tevis, Missourian staff writer)

Any TV western fan worth his rawhide has seen the show about the greenhorn who arrives in the Old West to seek his fortune as a cowboy. Although the Eastern dude acquires all the trappings of his trade, the audience knows that he is doomed to failure because he doesn't know anything about raising cattle. After all, times were tough in the Old West, and only the seasoned cattleman could expect to survive.

Today, one condition of life remains the same for the modern cattleman: Times still are tough. Experts agree today's cattleman is encountering his most severe losses since 1953–54. The question of who will survive in 1975, however, is more difficult to resolve than the plot of a stock TV script.

Changes within the cattle-feeding industry during the past decade have altered the conditions for economic survival. Today, the future of the traditional cattleman is threatened by the emergence of a new breed of dude cattlemen equipped with a distinct advantage. Although the contemporary tinhorn cattleman still knows nothing about raising cattle, such skills are insignificant in comparison to more important criteria.

For instance, a net worth of more than $50,000 and a federal income tax bracket of 50 per cent or above are more important than certain skills. Anyone with sufficient financial resources can own cattle today and rely on the expertise of the commercial custom feedlot to care for them.

"Some owners never see their cattle," says Jerry Weydert, manager of Hampton Feedlots, a corporation-owned commercial custom feedlot near Triplett, Missouri.

Who are these non-traditional cattle-feeders and why are they in the business of feeding cattle?

"They come from all walks of life," says J. P. Hampton, founder of Hampton Feedlots.

A Texas study found in 1969–70 that 57 per cent of the custom cattle in feedlots were owned by farmers and ranchers, 19 per cent by feedlot officers and directors, almost 9 per cent by packers and 15 per cent by "others" (primarily outside investors).

Experts estimate that during 1973, 25 to 50 percent of fed cattle were owned by investors who were not dependent on cattle for their main income. By mid-1973, a survey indicates that outside investors were financing a fourth of the nation's fed beef.

Many of these outside investors ventured into cattle feeding via the vehicle of the public limited partnership fund. According to this arrangement, the investor buys a share in the ownership of a fund offered by the general partner, usually a cattle-feeding firm. Economic researchers have compiled evidence that reveals that a high percentage of the public limited partnership funds is tax-shelter money.

Behind the scenes of today's troubled cattle-feeding industry lurks the uncertainty of the role of the tax-shelter investor in the cattle industry's present financial difficulties.

"The impact of the tax-shelter investor on the industry may have deepened the present cattle-feeding period of losses," say V. James Rhodes, University agricultural economist.

Economists generally agree that tax-sheltered investment in any industry acts to expand production.

How can this have been detrimental to the cattle-feeding industry?

"The big feedlots were able in 1970–73 to obtain large amounts of investor capital," says Rhodes. "The big lots needed such capital in order to sustain high rates of growth, in order to keep increasing their market share and bid feeder cattle away from Corn Belt Feeders.

"But the total industry didn't. Indeed, it was too much capital running after feeder cattle in 1973 that contributed to those astronomical feeding losses of 1974."

Rhodes and Joseph C. Meisner, his University colleagues, contend that non-farm sources of funds were used to continue bidding high prices for feeder

cattle even when expected returns in cattle-feeding already were squeezed by high feeding costs. They base their conclusions on more than two years of research.

The explanation for this phenomenon lies in the objectives of the high-income investor. A 1915 treasury department ruling allows farmers to declare their expenses as they are paid and claim income only when received. The investor obtains this privilege by his share in a limited partnership fund. For tax purposes, a "partnership" arrangement in agriculture can be classified as "farming."

By prepaying for feed and other expenses of cattle-feeding in the latter part of a year of relatively high income, the investor can create heavy expenses, which he deducts as net losses. When the cattle are sold the following year, the returns can be reinvested in more cattle and feed and saved for a lower-income tax bracket year.

Tax savings as a result of such income deferral allows the possibility of realizing a profit, even if cattle-feeding produce zero economic returns. For example, the investor can make money after taxes with a drop in his marginal tax bracket.

Internal Revenue Service farm-tax reports in 1970 show that three times as many individuals with basic incomes of $50,000 or more reported farm losses than reported farm profits, according to United States Department of Agriculture economic researchers. Data indicates a distinct tendency for the larger farm loss returns to be located in tax regions containing major cities.

As early as 1972, leaders in the cattle-feeding industry warned that the outside capital with tax-savings considerations likely would disrupt the normal supply adjustment patterns of the beef industry.

Today, experts have traced the imprint of investor funds to the loss-column ledgers of cattle inventories. The giant commercial custom feedlots of the Southwest have been most heavily affected. Cattle-on-feed reports continue to show a decline in the Southwest and most feedlots are operating at one-third of capacity.

What happened?

"Many of the investor funds are busted or nearly so," say Rhodes.

Outside investors got more than they bargained for when the cattle industry hit an embankment of high grain prices, excessive feeder-calf costs and price controls. The prolonged low prices in the industry caused some investors to lose their entire investment in cattle-feeding.

Although the outside investor did not enter cattle-feeding to find his fortune, he did not plan to lose money. Most investors lost most of their cattle investment, although that was usually only 15 per cent of their annual gross income.

What will be the future role of the outside investor in cattle-feeding?

"We don't know how long it will take for the present investor losses to be forgotten, but they will be," says Rhodes. "When the well-to-do investor faces a certain 50 per cent loss to the government if he pays his taxes, that song of the broker can begin to sound convincing again," he says.

Meisner agrees. In spite of the continued low prices in the cattle industry, he says he has received a report of the sale of $8 million in one cattle-feeding partnership fund during the fall of 1974.

"Our tax laws produce a class of people who can benefit from tax shelters. Unless the tax provisions affecting cattle-feeding are changed, the big lots will be peddling tax-sheltered funds again," says Rhodes.

What form should tax reform take?

Several alternatives for agricultural tax reform have been proposed. Some experts, such as Charles Davenport, law professor at the University of California, advocate elimination of the practice of cash accounting for farmers as the simplest and most effective solution to the problem.

This would prohibit farm taxpayers from deducting production cost inputs from their taxable income at the time of purchase. Experts point out that cash accounting is easily juggled to manufacture losses which are not pure economic losses.

It allows individuals to give the appearance of a tax loss without an actual loss of money.

Few farmers, however, support this proposal. Advocates argue the high tax-bracket investor with a sizeable non-farm income gains much more from cash accounting methods than the small farmer.

Another proposal retains cash accounting, but places a limit on the amount of farm losses that an individual could deduct from non-farm income. Further suggestions include elimination of the sale of limited partnership funds and a narrowing of the definition of the word "farmer."

What are the consequences if no tax reform is enacted?

The impact of special tax deductions and concessions is not confined to the farm sector. Meisner says taxes saved by high income investors in cattle-feeding can cause a higher tax burden to the lower income family. According to USDA research, agricultural tax subsidies of all kinds cost the U.S. taxpayer about $1.2 billion in 1974 alone.

"Are today's hard-pressed, recession-ridden consumers willing to continue the policy of indirect subsidization of high income individuals to produce the nation's beef?" asks Meisner.

The present income tax policy also favors the large cattle-feeding firm, says Rhodes. This is because feedlots under 30,000-head cannot justify the enormous costs of sponsoring public funds for investor partnerships.

Although he concedes tax reform would not eliminate the current concentration of cattle-feeding within the giant feedlot. Rhodes says tax reform might help to renew competition in cattle-feeding and preserve it in other agricultural commodities.

Rhodes and Meisner agree that the re-emergence of outside investors in cattle-feeding would award the commercial feedlot in the Southwest and unfair advantage over the small farmer-feeder in the Midwest.

The result?

Instability within the beef industry during the past two years already has resulted in beef shortages and record-high beef prices in 1973. Rhodes and Meisner predict the supply of cattle-on-feed and cattle price patterns may be even more volatile than if the industry remained in the hands of the traditional farm and ranch cattle feeder.

They point out that the sophisticated urban investor with no permanent stake in facilities or lasting interest in the business is susceptible to other tax-shelter investment alternatives, such as petroleum or real estate.

What will be the future of the small cattle-feeder if investors replenish their funds in the large feedlots?

"This country obviously has too much feedlot capacity in 1975. Any competitive industry with too much capacity usually encounters losses as the various units compete to keep their facilities full. If there is a part of that industry that has a definite competitive edge on the rest of the industry, then that part may prosper and expand while other producers are being driven out of business," concludes Rhodes.

[From the Des Moines Register, Apr. 20, 1975]

MANY FARMERS AT DEBT LIMIT; SOME REFINANCING

(By Arlo Jacobson)

The manager of a north-west Iowa farm co-operative, a Sioux City banker specializing in agricultural loans, and officials at the Federal Reserve Bank of Chicago all understand what the U.S. Department of Agriculture apparently does not: Many farmers are up to their limits in debt and are fearful of the future.

Farmers themselves have been expressing this fear in a grassroots movement this spring to cut back grain acreage, hopefully to raise on-farm prices.

The farmer co-operative headquartered at Gilmore City, and serving farmers in four communities, is a case in point in the debt situation. A check of the co-op's balance sheet shows that 42 per cent of accounts receivable are 90 days or more in arrears.

That amounts to approximately a quarter of a million dollars in overdue debt at a time when the co-op needs $300,000 to pay for farm chemicals its members will need to produce 1975 crops.

REFINANCING

It is exactly what the Bank for Co-operatives in Omaha, Neb., was talking about when it recently sent out a letter to its co-op member-borrowers to keep a close watch on accounts receivables.

"We're getting more and more fellows up to the point of borrowing up to the limit of their lines of credit," said Owen A. Riddle, agricultural loan officer for Security State Bank of Sioux City.

"We've seen more and more farmers turn to refinancing their land this year to pay for 1975 operating expenses. It's been a real problem.

"It's not at all uncommon for a fellow to have more than $100,000 borrowed—not including the mortgage on his farm. At 9 per cent or 10 per cent interest, you could make a pretty comfortable living just on the interest paid.

"One thing they're afraid of is being forced into refinancing their farm. It's one of the last resorts, like putting a second mortgage on the house, but it's one of the ways we've been able to continue (loans) on some of these operations."

Riddle pointed out that the tragedy here is that many of the farms were originally financed on 5 per cent and 6 per cent loans.

RENTERS

Refinancing balloons this up to a current figure of perhaps 10 per cent.

"What they're doing is using the appreciated land value to continue operation," Riddle said. "And that's the only thing that's keeping some of them in operation.

"But what happens to the renter? He has nothing to turn to."

An analysis made by the Federal Reserve Bank of Chicago, which has financial transactions in Iowa and several other states, is based on a survey of 700 agricultural bankers.

In summary it says that the demand for farm loans during the fourth quarter of 1974 exceeded the year-earlier level. In addition to the strong loan demand, a growing proportion of district bankers indicated . . . a slowdown in the rate of loan repayments and a continued rise in loan renweals and extensions.

Overall, 37 per cent reported the rate of loan repayment was down from the year-earlier level compared to only 6 per cent the previous year.

Similarly, 41 per cent indicated loan renewals and extensions exceeded year-earlier levels . . . up 10 per cent from a year ago.

LOAN CARRYOVER

In conjunction, a high proportion of banks reported that loan carryover—loans expected to be repaid in 1974 but still outstanding on Jan. 1, 1975—was larger than normal.

Gary L. Benjamin, the Federal Reserve Bank's agricultural economist, said it appears that banks will continue to finance a greater proportion of purchased inputs since credit extensions by merchants and dealers are expected to continue more restrictive than normal.

The increased borrowing needs anticipated for 1975 coupled with the larger loan carryover are likely to result in more "debt ceiling" problems for many rural bankers, Benjamin said.

Nearly two-fifths of the bankers surveyed indicated that such conditions would increase the number of their farm customers with overline credit needs—credit needs in excess of the bank's legal lending limit to individuals.

And more than one-half of the banks indicated the combination of large borrowing needs and increased carry-over would increase the number of farm customers who are at their own debt capacity with respect to their net worth.

OVER-EXTENDED

Farmers who are late in paying their feed bills seem to fall into several classes, according to Chuck Anderson, manager of the co-operative that serves Gilmore City, Bradgate, Rolfe and Pioneer in Humbolt and Pocahontas Counties.

One group consists of the cattle feeders who lost a large portion of their assets when low cattle prices hit at the same time as high prices for feed.

Another group is made up of those who through bad weather conditions lost a large part of their crops. Still another class is farmers who had a good year or two and used the cash to expand their operations—some to the point of over-extension.

The group in the least trouble, but still a problem to lenders, consists of those who watched grain prices rise and fade in 1974, and are still holding onto their crops hoping for the price to rise again.

"Our accounts receivable compared to a year ago are not at all that much different." Anderson said. "The problem is too much money in the older category—over 60 and over 90 days old."

Anderson said the co-op's accounts receivable at the end of March totaled about $580,000, with 42 per cent over 90 days old.

The figures on the same date a year ago showed $644,000 in accounts receivable, with 82 per cent over 90 days old. "With that $250,917 over 90 days old," he mused, "it's no wonder we can't pay $300,000 in chemical bills I've got on my desk."

The co-op has to pay 8.25 per cent on its borrowings from the Bank of Co-Operatives, and during peak periods will have accounts receivable up to $1.1 million. "For instance we've got one cattle feeder that owes $1,700, and that's the lowest amount he's ever owed us. The problem is that every dollar of that is over 90 days old. And he's just not doing any more business, just not feeding any more cattle.

"Before, he was always buying feed and selling cattle. We carried more dollars in the account, but it was current."

Anderson cited another feedlot that owes a $125,000 feed bill, and has lost a quarter million dollars feeding cattle. Refinancing is under way to cover most of the amount owed.

"The co-op has enough of the farmer's corn and soybeans in storage to cover most of the balance due, but prices are not going up, so the account is losing ground."

The grain in storage has a current value of about $28,500, Anderson said, but the balance due is $35,000.

The farmer can gain some ground, he said, by going to his banker to borrow 90 per cent of the value of the grain, since the bank charges 9 per cent interest, or three-quarters of a per cent per month. The co-op on the other hand charges 1.5 per cent per month on accounts, or 18 per cent a year.

"Borrowing from the bank would save him $150 to $175 a month just on interest," Anderson said. "We're in it to serve these people," he said. "If we can save them money, it's part of the job we're being paid to do."

[From the Kansas City Star, Apr. 21, 1975]

MORE FARMERS SEEK CREDIT AS NET INCOME DECLINES

WICHITA, KANS.—Net farm income, which hit a record $32 billion in 1973, has been cut nearly in half by the squeeze of higher production costs and lower prices, a top Farm Credit Administration official said here.

Dr. Gene Swackhamer, deputy FCA governor, told a farm credit conference at Wichita that the net annual income of farmers now is projected at about $18.4 billion.

The projection, released by the Commerce Department, is a further drop in the $20 billion figure issued by the U.S. Department of Agriculture last winter. Net farm income in 1974 declined to about $27 billion following the 1973 peak.

"That's a substantial decline in farm income," Swackhamer told newsmen and officials of the Farm Credit Banks of Wichita. "Think of that in terms of your own salary. That's a big drop in less than two years."

The effect has been to force more farmers into seeking credit, resulting in skyrocketing demand for loans and a general tightening of the farm credit system, he said.

Swackhamer said it appears there will be adequate amounts of money available in the near future to finance agricultural operations, but farmers already deep in debt will find tough going in the credit market.

The national recession has forced lending agencies to look more closely at every request for funds, Swackhamer said.

"Farmers who have shown good management, can produce accurate financial records and plans, and who are not already financially overburdened or overextended seldom have difficulty in obtaining credit," he added.

Swackhamer said there are signs that the national economy has begun to pull out of its slump.

"The recovery clock is ticking," he said. "The savings rate is up substantially and that's the basic bloodstream of investment funds."

Manufacturing inventories are being cut back, opening the possibility for increasing production, he added. Government actions such as the tax rebate plan and tax credits for new home buyers also will work to pump new life into the economy, Swackhamer said.

"The tax rebate will boost consumption at least a little," he predicted. "It may not happen as rapidly as some people believe, but any time you send someone a check, they're going to spend part of it."

The federal government's deficits probably will not create any immediate credit shortage, though the deficit requires $2 billion each week, Swackhamer said.

"To date we have had little trouble from crowding out because of the deficits," he said. "It hasn't been a serious detriment to farm credit so far and I do not see it as a serious problem for the next year or so."

Officials of the Farm Credit Banks of Wichita, which serve farmers and stockmen in Kansas, Oklahoma, New Mexico and Colorado, agreed with Swackhamer's analysis and offered evidence from their own experience.

William May, vice-president and secretary of the Federal Land Bank, said land bank associations in Kansas set lending records in the first quarter of the year with 912 loans worth $51.4 million, an increase of 102 per cent from one year earlier.

Land Bank loans in the 4-state area also accelerated sharply in the first quarter, hitting $135.2 million for an increase of 71.4 per cent, May said.

Farmers also are being forced to take out larger loans to finance their operations, he added. In Kansas, the average loan has jumped from $44,470 last year to $70,963 in the first quarter of the year.

Land Bank President G. A. Wiles said the bank also has noted a rise in the number of delinquencies on farm loans.

Nine months ago, delinquencies totaled about 1.32 per cent of the bank's nearly 42,000 loans, but the rate had increased to 2.51 per cent by March, Wiles said.

In addition to the tightening of credit, farmers also may face new rises in the interest rates they must pay for short term credit, said Alton B. Cook, newly-elected president of the Federal Intermediate Credit Bank.

Cook said indications in bond markets are that interest rates already have bottomed out and may start rising again later this year.

[From the St. Louis Post Dispatch, June 18, 1975]

How Monetary Policy Affects American Farmer

(By Brewster Jackson, Financial Editor)

American farmers do not receive any long-run benefits of an expansive monetary policy by the Federal Reserve System, an official of the Federal Reserve Bank of St. Louis has concluded in an unusual analysis of the interaction of monetary policy and agriculture.

Speaking to the St. Louis Society of Financial Analysts yesterday, Clifton B. Luttrell, assistant vice president, said that because farming as an industry is well integrated into the rest of the economy, "over the longer run, prices of farm resources, farm products, and nonfarm goods and service rise at about the same rate as a result of expansive monetary actions."

Farm expenses and farm incomes both rise with the general price level, Luttrell said, and no real gains accrue to farmers.

On the other hand, in the short run, prices of farm products adjust faster and farm output adjust slower than prices and output in the nonfarm sector.

"Farmers accept relatively lower prices rather than unemployment when monetary actions are restrictive and receive relatively higher prices in the early stage of expansive monetay actions," Luttrell noted. "The apparent gain to farmers during the expansion phase, however, is largely an illusion since the terms of trade between agriculture and the nonfarm sector return to their earlier relative positions."

Luttrell pointed out that in the long run those who are net debtors benefit from inflation and from unanticipated expansive monetary actions. Those who are net creditors lose.

But since there is no assurance that most farmers are net debtors during their lives, more may be losers than gainers from unanticipated general price increases, Luttrell said. "Furthermore, changes in the growth rate of money, which cause relatively wide fluctuations in farm income, greatly increases the risks in farming and result in higher food costs to consumers.

In the area of interest rates, Luttrell noted that expansive monetary policies temporarily tend to reduce the interest rates farmers pay, but the anticipated inflation caused by such actions leads to higher interest rates over the long run.

"Consequently, any effort on the part of the monetary authorities to reduce interest rates today by increasing the growth of money will result in higher rates a few months ahead. The increased stock of money will have an impact on prices and the expected higher rate of inflation will result in higher interest rates."

Although farm financing costs over the long run will parallel closely nonfarm financing costs, in the short run interest rates charged farmers do not rise or fall as rapidly as rates charged other borrowers, Luttell pointed out.

Interest rates on most farm loans, he said, were about the same or higher than rates an most business loans in early 1972. But after the increase in rates in early 1974 business loan charges rose faster than those charged to farmers.

The fact that interest rates charged farmers tend to be lower than those charged others may be due to the lower lending margins of the Farm Credit Banks during periods of higher interest rates, Luttrell said. Smaller commercial banks—the major farm lenders—also are reluctant to change rates, although this reluctance may be weakening, he noted.

[From the Kansas City Times, July 5, 1975]

Taxes Complicate Keeping Farm in the Family

(By Jean Haley)

Rich Hill, Mo.—A few years ago when I. L. Gibson wanted to plant peach trees on his big farm near here, his wife told him he was too old. The 87-year-old man chuckled this week as he recalled how he set out the trees and they grew and died—and he's still enjoying life.

That attitude hasn't changed, but Gibson thinks sometimes about death. Now a widower, he decided he wanted to give his four children some money—a total of more than $100,000.

But then he learned he would owe more than $15,000 in federal gift tax.

Gibson, like older persons all over Missouri, Kansas and the rest of the United States, had a seemingly simple desire—to give his children some of the wealth he had accumulated in his lifetime.

He ran into the complicated web of federal estate taxes, federal gift tax and capital gains, to say nothing of the eventual cost to probate his estate.

The question is not how to escape taxes, he learned, but how to pay the least. "I've got my land worked out in my mind—that's settled," he said. "But what little dab of cash I've got—well, my kids helped accumulate it. My wife helped, of course. I've thought about dividing up what I don't need to go on. But I understand if you give away any money you have to pay taxes on it. That's something I can't see any sense to.

"When you accumulate anything, you pay taxes on all of it as you get it; then you have to pay taxes on it to give it away. Pretty soon taxes will be as much as it's worth."

Gibson started small in 1930 when he moved to Rich Hill, but now he owns most of the 800 acres he and his two sons farm. Some of it he bought for $60 an acre. A few years ago a nearby farm sold for $600 an acre. Most of it is good rich farmland that produces abundant crops of soybeans, corn, wheat.

Gibson said he changed his mind about making a will because "people get into wills and they get to having trouble." And he doesn't like the idea of talking about it with a lawyer.

When he and his wife were married 60 years ago, he didn't have to think about such things. "The first year we were married, we ran into a drought and we didn't make anything," he said. "On an acre of tomatoes, we didn't get one ripe one; on an acre of cucumbers, we got 60 cents worth.

"Then we moved to the hills (in southwest Missouri) and started milking cows and that didn't work out too good.

"We went to Nebraska and rented a farm, and I wanted to borrow some money to buy some brood sows and cows. I went into the bank and they didn't know me from the other fellow. The banker told me when I was ready to come back. I went back, and he just handed me a checkbook and said, 'We'll fix it up later.' That was the last year of World War I.

"I and the wife worked hard. The first year we had a good crop. We rented another half section. Then the prices went down. It took us the next five years before we could pay any of our debts. We paid it, though.

"You go through life that way. You run into lots of losses. It an't all gains."

The Gibsons built the first new home they ever owned in 1970, a large, brick, ranch-style house. Mrs. Gibson died the next year.

He "retired" a few years ago. He is now the cook for the family, takes care of a large garden, cans the vegetables. It's not that he wanted to quit working, he said, but that it would be dangerous for him to be out in the field trying to handle the self-propelled combine, huge tractors and other farm machinery.

He and his wife took two vacations.

"One year we went to Yellowstone National Park," he recalled. "We went through the Black Hills, to the park and down to Colorado. One time I and her went down to Arkansas—Hot Springs and on down there. That's the only vacations we took. There's not too many farmers take vacations."

Many older persons tell similar stories about a lifetime of frugality, the desire to give the fruits to their children. To judge what method of disposing of property will cost them the least in taxes, people must consider tax rates—the federal estate tax is graduated, like the income tax. On a taxable estate of $5,000 or less, the tax rates is 3 per cent; on a taxable estate of $10,060,000, the tax is $6,088,100 plus 77 per cent of anything above that amount.

The gift-tax rate also is graduated and generally is lower than the estate-tax rate. State inheritance-tax rates vary from state to state, but in Missouri and Kansas they are low enough for direct descendants that they require relatively little thought in estate planning.

Families also need to consider such things as gifts "in contemplation of death," the property tax basis and whether the heirs will farm or develop the property.

While farmers are not alone in dealing with death taxes, referred to ironically by some as the "privilege of dying," they have some unique problems. These usually include lack of cash, methods of assessment, keeping the farmstead in the family. And overshadowing it all is the rapid and steady increase of the value of land.

The U.S. Department of Agriculture reports that in 1974 the average value of land in Kansas was $265 an acre, an increase of 30 per cent over the previous year. And in Missouri the average was $374, an increase of 29 per cent over 1973. The average price in Missouri in 1960 was $115.

That figure lumps rich bottom land and irrigated land with the worst hills and arid acreage, however. Good farm property is well above those averages. For examples Dr. Robert Bevins, University of Missouri economist, has some incomplete reports on farm sales in 1974 and reported that in six sales in Cass County the average price was $684 an acre, and three sales in Jackson County the average was $1,021 an acre.

An unofficial record for land in Saline County in Missouri was set in December when 121 acres of rich farmland went for $1,390 an acre, and state government figures indicated that between $1,500 and $1,900 an acre was being asked for Missouri River bottom land.

A Johnson County, Kansas, lawyer doubts that there is any land in Johnson County that sells for less than $1,000 an acre. In some places in Kansas irrigated land is a bargain at $600 an acre and hard to find at any price.

Most authorities agree that some serious informed planning is necessary when the estate is more than $60,000 if you are single and $120,000 if you are married. This is because there is a personal exemption of $60,000 allowed on the estate of every U.S. citizen or resident, plus a marital deduction of up to half of the estate allowed to the surviving spouse tax free.

James Logan, former dean of the University of Kansas law school and now in private practice in Johnson County, has done some specialized work in farm estate problems. He estimated that less than one-third of farmers have wills, let alone have done any estate planning. He described the "shock" displayed by the typical farmer client—the widow or older couple that recently learned of estate taxes.

"A widow who lives down here by Gardner or Spring Hill comes in here and she says, 'I suddenly discover my 160-acre farm is worth $160,000. Can you tell me how much taxes I'll have to pay on my death?' " Logan said, "I whip out this chart and say, 'You're going to have to pay $20,700 worth of taxes.' " She goes into shock.

"My answer is: There's very little the widow or widower can do about if he or she doesn't have a wife or husband to use the marital deduction. The only option you have is to give away parts of it now.

"If you make an outright gift of parts of any property but you die within three years, the law creates a presumption very hard to rebut that it was given in contemplation of death and brings it back into your estate."

If the widow meets that test and gives away part of the property, she likely will be taxed at a lower rate since gift-tax rates are only three-fourths as high as estate-tax rates on equal values of taxable transfers after the exemptions. On the top $40,000 of her estate, the widow is taxed in the 28 per cent bracket, so she can save 30 cents on the dollar by giving it away.

She cannot keep the income from anything she gives away—called a "reserve life estate," because that will be taxed as if she kept it. In addition she must consider what her tax basis is—if she and her husband paid $100 an acre for the property and it now is assessed at $1,000 an acre, the children will pay a capital gains tax, in addition to the gift tax, if they sell the land.

In choosing between holding farm property and pay estate tax or giving it away and letting the children pay capital gains, it should be considered whether the property will be held and farmed or sold to a developer. If it is to be farmed, it may be cheaper for the family to pass the farm on as a gift.

But if it is to be sold immediately, the capital gains tax must be weighed against the estate tax that will be paid upon death. There is no capital gains tax assessed when property goes through an estate and the property gains a new tax basis.

More and more, farmers are using the same techniques to deal with death taxes that other businessmen and persons with money are using. It would not have been necessary 20 years ago. There are many variables in how much, what, when and to whom farmers will want to dispose of their property, and some legal advisers stress one method over another. But here are some general options:

The gift—An individual may give up to $3,000 a year to each person tax free. There is also a lifetime tax-free exemption of $30,000. Above that, gifts are taxed progressively.

The corporation—Form a Subchapter S type corporation consisting of not more than 10 shareholders with only one kind of stock. The shares represent interests in the land. It facilitates passing the land from one generation to the next and can help keep the farm property in one unit. Tax-free gift shares can be given to children if not more than $3,000 is given to each heir a year.

The trust—There is a marital deduction of half of the gross estate allowed to the surviving spouse if the estate is in a taxable form. Put half of the estate into a trust fund. The income goes to the surviving spouse with the provision that the capital will go to other heirs upon the death of the second spouse. If the husband dies first, estate taxes will be paid on the total worth of the estate, but when the wife dies it will be assessed only on her one-half interest.

For example, on the widow's 160-acre farm worth $160,000, if this technique had been used, the taxes upon her husband's would have been the same. Upon her death, however, her estate taxes would have amounted to only $1,600 because her estate would have been only $80,000.

The marital deduction and the outright gift are considered to be the major tax-saving devices.

The fact that the value of farm property has increased so greatly in the last decade has led some persons to assert that the personal exemption for farmers should be raised. The estate taxes on just an average farm, they say, can be high enough to force the heirs to mortgage or sell the property to pay the taxes instead of continuing to work it.

There are now 14 bills in Congress seeking to raise the exemption to $200,000, including legislation proposed by Rep. William Randall (D-Mo.) and Rep. Jerry Litton (D-Mo.).

"The problem is that wealthier farmers have a lot of legal opportunities and options available to them," Litton observed. "These legal maneuvers are not available to the family farmer. A farmer dies and his heirs wish to continue to farm. With the small $60,000 exemption, it often means by the time the heirs pay the tax on this farm, they have to sell off such a substantial portion that they're no longer left with an economic unit."

Randall added: "The exemption is not realistic or reasonable or fair with land as inflated as it is today. Farmers say, 'I've worked hard to accumulate what I have—it's been a struggle to buy land, get it clear—why should my children have to put another mortgage on the farm because of a large estate tax?' "

Others disagree. The small businessman is in nearly the same spot, so, they ask, why should the farmer be allowed a special exemption?

However the laws might be changed. Gibson is trying to figure out what to do today. He concedes he might see a lawyer.

"It's purt near a case you have to," he sighed, running his hand through thin white hair. "It's got me puzzled. I never knowed it was going to get into such a mess. The way it looks to me, about all a fellow can do is just keep on making more money."

He added as an afterthought: "Yeah, I need a truck. . . I guess we'll just keep on buying more stuff."

APPENDIX X

NATIONAL BUREAU OF STANDARDS SPECIAL PUBLICATION 388, PROCEEDINGS OF THE CONFERENCE ON THE PUBLIC NEED AND THE ROLE OF THE INVENTOR, JUNE 11-14, 1973, MONTEREY, CALIF. (Issued MAY 1974)

New Enterprise Generation

Richard S. Morse

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The national environment for innovation is examined: in government, industry, the university, and the public.

The administration is concerned for the environment of science and technology, but centralized leadership and responsibility for long-range analysis and planning are absent. New rules and policies, or new legislation by Congress are needed.

Industry has been trying new methods in the management of R. & D., both in establishing centers for entrepreneurship within the company, and providing venture capital to acquire new technology outside the company. The key to success in these enterprises is the entrepreneur who can judge the market and bring a new product into public use.

Universities should study the mechanisms that industry is using; there is need for research in these areas, and a need for a coupling of effort between the university and the industrial community. The university can also play an important role in teaching entrepreneurship.

The President should delegate authority either in the Executive Office or in the Department of Commerce to review the problems of invention, innovation, and entrepreneurship for the generation of new enterprises. New approaches should be tried to expedite the public use of technology and a closer relationship among government, industry, and the university.

Key words: Entrepreneurship; environment for innovation; government policy for innovation; industry R. & D.; new enterprises; university R. & D.

In the early days of the Commerce Technical Advisory Board, or C.T.A.B., which was organized by Dr. Hollomon, then Assistant Secretary of Commerce—Science and Technology, a number of studies were conducted with respect to important national problems in which science and technology were relevant. One of the better reports generated by C.T.A.B., "Technological Innovation: Its Environment and Management," dealt with most of the topics with which we are concerned today and has been widely read since its publication in January 1967. The success of the early Commerce Technical Advisory Board was not just the fact that it comprised an interested and concerned group of people with diverse backgrounds such as we have at this meeting, but after we wrote a report a serious attempt was at least made to implement the recommendations. Such an attitude is very important in Washington. There is hardly a subject of national concern that has not been studied by one or more committees and reports published. I hope something will happen as a result of this meeting, but special techniques are necessary to initiate action in government.

Many of our discussions relate particularly to problems of the inventer and I in no way wish to deprecate his role in society. It is perhaps, however, more appropriate to discuss the "innovation process." This process often involves the inventor in one of its early phases, but when you come right down to it there aren't very many individual, successful, lone inventors in the United States. The total "innovation process" should be better understood and placed in perspective relative to our national environment. If this meeting is going to have any future impact, we should think in terms of specific recommended changes in the environment within which the innovation process operates in America. Such changes may take the form of new rules, policies or regulations to be adopted by exec-

ing Departments or Agencies or new legislation by Congress.

The role of the entrepreneur is becoming recognized as an essential ingredient of our changing technological society. The term "entrepreneur" means a "ball carrier," i.e., a motivated individual who takes an idea whether it be in the form of a product, process or technique and assumes complete responsibility for its effective and rapid introduction into public use. He usually does this within an industrial organization or in concert with venture capital and some form of new enterprise activity outside the firm. Venture capital is also now established as an organized business operation. Quite often neither the inventor nor the entrepreneur subsequently demonstrates the ability to run "the company" or "the business" as it becomes a large viable enterprise. In Boston, for example, there is a successful, technically based company which was founded by a typical inventor/entrepreneur. This founder has now resigned as President and his title is "Inventor-at-Large." He just wants to get back and invent; he probably still will be pretty good at it and the company is undoubtedly better off to employ his talents in non-management areas.

There is a very definite lack of understanding with respect to the total innovation process within the Government, our less innovative industries and universities. The mechanism by which the innovation process operates, particularly in terms of new enterprise generation, is relatively unknown in many parts of the country. The availability of venture capital varies greatly between different sections of the country and financial and legal expertise tends to be concentrated in relatively few sections of the United States. The role of science, alone, as a stimulus for the creation of employment has been grossly misrepresented. There is certainly no evidence to support the thesis that greater support of R. & D. necessarily means either a higher standard of living at the national level, improved profits for an industrial company or a higher employment level. New technology is brought to the marketplace by a "people transfer process," not by reports or merely more money for science per se. The "Entrepreneur" operating in the proper environment is primarily responsible for making things happen in the technology transfer area.

Government leadership in the area of innovation or new enterprises has been almost totally absent. The C.T.A.B. report on "Technological Innovation: Its Environment and Management" was published in 1967 and yet little definitive government action has been taken to implement its recommendations.

The Technical Services Act failed to recognize the real mechanisms by which new technology is introduced into the marketplace and, hence, failed to produce any significant, useful results. No one individual in Washington apparently has the appropriate authority and responsibility for promulgating action to render the innovation process more effective. Certainly, the record of the Small Business Administration is unimpressive and almost all of the major SBIC's involved in financing of new technical ventures, except those associated with banks, have now been abandoned.

The National Science Foundation has only recently been concerned with any phases of the innovation process and, historically, has had a history of supporting more basic science in our universities. Recent NSF and NBS programs are moving in the direction of developing a better understanding as to how science and technology may be brought into public use. Success in this area will require people in these agencies with a broad background in the management of technology, new innovative mechanisms for its commercialization as well as new contracting procedures. Neither the National Academy of Sciences nor the National Academy of Engineering has addressed itself to the general problem of creating a national environment necessary for technical innovation and more effective application of science. Maybe our new Assistant Secretary of Commerce—Science and Technology can assume greater responsibility in this area. There is no better mission for the Commerce Department than to recognize the tremendous importance of technology as an essential ingredient in the competitive position of the United States in world trade, a solution to many domestic problems and the creation of a higher level of employment.

This country will never compete in the world markets on the basis of cheap labor and our most successful exports have generally been based on the application of combined management and technical skills. We used to talk about the Japanese as being copiers, but no competent industrialist says that

today. Until recently, innovation in Japan was relatively unknown, individualism was suppressed, and a worker tended to go with Mitsubishi or some other large corporation and was pretty well indentured for life. Honda, Sony, Nippon Steel and Toyo Kogyo, the maker of the new Mazda car, and major Japanese shipbuilders represent new, technically based enterprises with an impressive record of innovative management operating with aggressive and effective government support. In this country, the Federal Government tends to be a watchdog over big business. In Japan, the government operates in partnership with industry in an attempt to enhance productivity and industry's ability to compete in the world markets. The Germans had the Wankel engine a long time ago, but we now see Japan assuming a position of technical leadership in this and other areas where Germany and America were once the principal competitors. The United States has no monopoly on new technology and the flow of science and of technical ideas is now very rapid throughout the world.

It might be interesting to review some aspects of the current national environment. First, the Government, industry, and the public have become disillusioned with respect to science and technology. Regardless of the reasons, this is, in fact, apparent. Certainly the idea that our massive Apollo Space Program would suddenly create jobs and solve problems associated with our declining quality of life has been greatly oversold. The NASA Technological Utilization Program has certainly not been successful. The technological achievement of Apollo was certainly outstanding, but large numbers of highly qualified people were taken out of the economy and few of them can ever get back into the current competitive business environment. Neither NASA, nor Congress, really understood the mechanisms by which so-called "space technology" might have been employed for the benefit of the public and the useful, practical applications of this tremendous technical and management achievement were greatly exaggerated and misrepresented.

Industry is becoming more concerned with the costs of R. & D. and our more innovative industries are making radical organizational changes in their research organizations. In general, they are decentralizing research and development work in order to get better coupling with the marketplace. In the current, highly competitive world-wide business climate few industries can now afford the luxury of the older "central lab" established on the theory that products will "come out of basic research." Notable exceptions, such as Bell Labs, etc., are fortunately still operating.

A few years ago a survey of the Fortune 500 determined that about 60 percent of these large, industrial companies were going into the "venture capital" business or at least thinking about it. The reasons are interesting. Non-innovative, large companies cannot hire first-class entrepreneurs. The incentive for this new business activity was not the idea of just making money via the investment route. Our larger organizations had decided to go outside the firm via the venture capital route as a means of attracting the entrepreneur and developing windows on new technology that was not otherwise easily available. Innovative companies in this country now recognize that the development of new technical products or entry into a new market area is highly dependent on the efforts of a very few talented entrepreneur-managers with a specific mission. They want the "ball carrier," who is technically innovative, market oriented, to develop a product and go do something with it. Unfortunately, many of our major companies don't even know the word "innovation," and there are wide variations in management attitudes and approaches to commercial development within American industry. Change in the management of R. & D. is taking place in more innovative companies on a very large scale at the present time.

Many companies are doing their product development by establishing centers of entrepreneurship within the firm. Many of these same companies are also engaged in so-called, "external entrepreneurship." The concept of "external entrepreneurship" involves the use of venture capital to permit the acquisition, by a variety of mechanisms, of an interest in the small, technical enterprise. One of our major oil companies, for example, has funded inventors and small companies in new technological fields both here and abroad with provision for a minority position in the new enterprise. A major chemical company insists on a majority position, or 100 percent control. A wide spectrum of experiments are now going on in industry, perhaps on a scale larger than most people realize. This is good. The key to success is the entrepreneur and, particularly, his

ability to judge the market at the right time—and later manage a business. Science, technology and money are usually of secondary importance to the other essential ingredients to successfully launching a new product.

Less innovative industrial sectors of the country should review the mechanisms employed by more successful companies in their efforts to enhance the effectiveness of R. & D. and product development activities through the use of new organizational mechanisms. The experiments that some of these innovative companies are doing are very interesting, although it may be too early to determine their degree of success. These new concepts should be carefully monitored, research on the process undertaken and reported. R. & D. is not only very expensive, but there is always a great shortage of really first-class, innovative managers, scientists and engineers, and entrepreneurs.

Student attitudes have changed. Students in today's world aren't anti-business, but they're anti-non-innovative business. They don't care if it's a big company or a small company; they are perfectly willing to work with Texas Instruments or 3M because they view those companies as being innovative where an entrepreneur-employee can participate in the action. Surveys of students, knowledgeable people, and major company executives reveal consistent attitudes when asked to name the 10 most innovative and most non-innovative U.S. companies. The non-innovative companies are generally unsuccessful in attracting any of the talented graduates of our better universities. Companies have an image and this is important in attracting those employees that will determine their future and customers in a competitive business.

In the venture capital area, there are more sources and amounts of venture capital available today than at any time in the past. On the other hand, there is less and less interest in funding so-called "start-ups," the inventor or the zero phase company, if you want to call it that. The reason is very simple: the venture capitalists are doing very well with enterprises that are already "in business." They are making very good deals and getting a large part of the equity.

Recent trends in our tax structure and SEC regulations should be of concern to anyone interested in the generation of new business enterprises and the respective roles of venture capital and the entrepreneur. We now have a narrower gap between the tax on capital gains and personal income. This means that there is less incentive for the wealthy individual investor to back a new technical venture and, historically, the small, new enterprise and the "inventor" tends to be funded by friends and individual sources of risk money. We have also had a radical change in rules governing stock options, all of which act to the detriment of founders and key employees of a new business. It appears that the changes in such regulations, while made in an apparent effort to forestall inappropriate benefits for executives of large companies have, in fact, primarily harmed the small company. The new company can never compete with the large organization in terms of salary, pensions, benefits or assurance of employment. Stock options were the one incentive to permit a new company to attract those few key individuals who clearly determine success or failure of the firm. The so-called qualified stock option plan is now essentially worthless for a small company with unlisted stock, and other compensation mechanisms are required. All of these changes were made on the theory of people in Washington that somebody was getting away with something, without having the knowledge of the impact of such action on a small venture. If a small company wants to hire a real first-class manager from GE or Du Pont, it can't offer security. It can't offer salary. It can offer a very exciting life and feeling of accomplishment. Unfortunately, it is getting very difficult to now offer the prospect of capital gains under present IRS and SEC rulings.

The R. & D. organization of the Federal Government is also undergoing change. We have now initiated a general attitude of relevance with respect to R. & D. and this is perhaps long overdue. President Nixon has decentralized the position of Science Advisor, a concept perhaps not as disastrous as the academic community believes. Historically, the President's Science Advisor and PSAC have frequently become far too heavily involved in "project" analysis and the details of technical programs rather than a concern for policy and the environment of science and technology. These changes should be viewed not with alarm, but constructively. If we can attract the proper qualified people, the new system will work.

The newly proposed Office of Technology Assess-

ment will be established within and by Congress. If Congress proceeds to operate in the R. & D. area rather than do long-range analysis and planning as an aid to its funding and legislative responsibility, such action should be viewed with concern. If the NSF and other Executive Departments and Agencies can maintain a high level of scientific, technical and management competence, the Executive and Legislative branches of government now have an opportunity to jointly enhance the usefulness of science and technology. Perhaps NSF and the newly proposed Office of Technology Assessment will also recognize the need for introducing specific changes in the national environment for entrepreneurship.

Our universities have a great opportunity to study these new mechanisms that industry is using for expediting the product development cycle within the firm and the support of new enterprises outside the firm. There is an urgent need for more information and research work in the field and many good thesis opportunities. We should also have a closer coupling between the university and the industrial community such as now takes place in some limited areas. Studies at the Sloan School at MIT a few years ago identified some 250 companies that had been generated out of MIT and its associated laboratories, such as the Draper and Lincoln Laboratory. The total MIT complex is now currently operating a total budget of about $250 million a year and unlike the attitude of most academic institutions, MIT has encouraged its faculty and staff to be concerned with the public application of research activities and recognize that MIT has a responsibility to the local community as well as the nation as a whole. The country's first and largest publicly owned venture capital corporation had a net worth of about $500 million at the time of its recent merger with another industrial corporation. A very large number of the new enterprises in which this organization had invested were a direct result of people and/or technology associated with the MIT community and over 90 percent of this net worth of $500 million comprised ownership in such MIT related ventures.

In an effort to expedite the so-called technology transfer process, generate new, technically-based enterprises, employment, and, hopefully, bring benefits to both the community and MIT, the MIT Development Foundation, Inc. was established as a Massachusetts Charitable Corporation on April 3, 1972. This organization represents a form of experiment that, hopefully, will provide a new mechanism for expediting the public use of some of the research activities conducted by MIT and perhaps other institutions in the Boston area, alumni, or independent inventors. The Foundation operates as a separate corporation with a majority of the directors appointed by the MIT Corporation. The Foundation was organized for the benefit of MIT, although it may collaborate with other universities or institutions. Initial financing of this "Experiment in New Enterprises" has been by MIT and a series of sponsors, currently including: Air Products & Chemicals, Inc., Cabot Corp., Dow Chemical Co., Dresser Industries, Inc., Eastman Technology, Inc., Exxon Corp., The First National Bank of Boston, John Hancock Mutual Life Insurance Co., Johnson & Johnson, Macmillan, Inc., Monsanto Company, Martin Marietta Corp., G.A. Saxton & Co., Inc., Alfred P. Sloan Foundation, Texas Instruments, Inc.

Most of these organizations are interested in supplying venture capital for new ventures and, perhaps more important, assisting in the critical market appraisal process faced by the Foundation in its analysis of new technologies to determine their potential usefulness. The industrial sponsors of the Foundation certainly view this operation as an experiment, but they are interested in developing windows on new technologies and most of them have an organized division or department whose sole responsibility is to lend some form of financial support as well as marketing and management assistance to new, technical ventures outside the firm.

An important function of the Foundation involves support of a continuing research program to develop a better understanding of the technology transfer process, the role of the entrepreneur, venture capital, improved coupling mechanisms between industry and the university, and teaching in the field of "New Enterprises," their organization, financing and management.

The MIT Development Foundation has now analyzed over 75 projects and identified four potential new ventures which may be worthy of funding as new business enterprises. In each case, it is intended that the Foundation will keep an equity position for the benefit of MIT. A potential manager/entrepreneur is first identified by the Foundation and then a new company is organized with him assuming responsibility for its business plan and subsequent

successful implementation. This is an example of a new organization which should permit the operation of an effective coupling mechanism between the industrial and academic sectors of society. No doubt other approaches should be tried in an effort to expedite the public use of technology and closer relations between government, industry and our universities.

Problems associated with innovation, invention and entrepreneurship for the generation of new enterprises have been inadequately understood by either the Executive or Legislative Branches of the Federal Government. Because of our changing internal environment as well as our deteriorating competitive position vis a vis new, emerging, industrial countries, the President should delegate appropriate authority and responsibility either within the Executive Office or to an appropriate Department, such as Commerce, to review this general problem and make appropriate recommendations with suggested mechanisms for their implementation, either by Executive action or initiation of necessary legislation.

In the 1967 report, "Technological Innovation: Its Environment and Management," for example, it was suggested that a change in IRS regulations be initiated to permit a longer loss-carry-forward period for small companies in order to overcome disadvantages which accrue to a small operation vis a vis those of a large corporation. Because of the recent changes in the structure of our personal income taxes, we now have a diminishing discrepancy between taxes and capital gains and income with the potential threat of minimizing incentives for venture capitalists to invest in ventures. Special incentives may be required whereby, for example, special tax credits are permitted to encourage investment in new companies, particularly those with a high technological base. For some time so-called "1244 stock" has made it possible for investors to make deductions in cases of business failures, but this mechanism has never been widely employed, nor been effective as a means for stimulating venture capital from the private sector. Neither Congress, nor our operating departments, have clearly understood the appropriate role of the patent system as a mechanism for encouraging the commercial applications of Government-sponsored R. & D. We still do not have any uniformity of contract patent policies governing the use of inventions by government contractors, nor have all branches of the Government clearly recognized the need for exclusive licensing to encourage necessary development work with private funding to expedite certain product development activities. Some of our most competent industrial talent has always remained unavailable to government programs in peace time because of our patent policy and contractual difficulties in doing "business" with the Government.

Rules and regulations of both the SEC and the IRS have radically changed the incentives of qualified stock options which, historically, have represented an essential ingredient in the ability of the new enterprise to attract and hold key technical management personnel so essential for its success. Within our own Government laboratories, there are, no doubt, many potential useful ideas, products and processes, but no effective mechanism has been employed for their commercial exploitation by industry.

While entrepreneurship is probably an inherent characteristic of an individual, it appears that the teaching process can enhance a latent interest in qualified individuals. A few of our graduate schools such as the Sloan School at MIT have been teaching courses in R. & D. Management and New Enterprises for over a decade. More of such activities should be undertaken by the academic community, particularly in close collaboration with industry. Our universities should also conduct experiments in an effort to find new methods for the more effective public utilization of this country's great technical resources, including the science and technology generated within the university and by the Government.

The concept of "relevance" has now been clearly enunciated by the Administration as a fundamental guide to be employed in the development of R. & D. policy and program. We also, however, need greater support from the Federal Government by our regulatory agencies in the Executive and Legislative Branches. Hopefully, as a result of this meeting, the President will delegate responsibility to an appropriate Department head within the Executive Branch to review this situation and make recommendations for action in the near future.

Discussion

J. Rabinow: I predict that a market analysis is completely useless when the invention is really new. In really new innovations there's no way of knowing; that is, nobody could predict what radar would have done, what the computer business would have done; maybe the transistor was an exception, we'll hear from Shockley and he'll tell us; maybe that was a case where they could see the future clearer. My contention is that you cannot predict logically, that invention comes, sometimes, completely illogically. Do you want to comment on this?

R. Morse: Well, I would agree with you, Jack; perhaps I didn't put my comments in the right perspective. I meant to say that the normal industrial method of operating to meet their market needs or their growth problems, are associated first with identifying the market.

M. Harris: Recent studies show (many of you know the Sussex Study of Chris Freeman and other groups, and they're very large studies) that a lot of very important developments did not fail because of technological failures, they failed because the people either did not understand or did not know the marketplace. I don't want us to write off the man who has the great single invention, but I also want to warn all of us who are interested in taking one of these inventions that unless we do understand the marketplace, we haven't got a chance.

J. Rabinow: I agree with you also. That's absolutely correct that many inventions fail because of, not technology, but because the market wasn't ready. That doesn't mean that it could have been predicted; it simply means that the market cannot absorb all of the inventions that people can put on the market, and I think that's inherent in the system. I think this is the dice we play. The only thing is that the inventor should know what the odds are, and unfortunately, he doesn't.

INDUSTRIES

The credit crunch moves down on the farm

A bad harvest this year could make it difficult for farmers to pay their debts

"I thought I could outsmart the market, but I just got pinched," says R. Tom Bramer, a southern Illinois soybean grower. Bramer, like many other U.S. farmers, tried a ploy last week he thought would net him a rich income. He had borrowed from his bank to pay for seed, fertilizers, labor, and other expenses and intended to repay the loan after his 1974 harvest. It would have been easy if soybean prices stayed high. But after peaking in mid-October, commodity prices skidded, falling nearly 20%.

Bramer elected to withhold his crop from the market in the hope that prices would recover. Today, he still has about half of his 1974 harvest. "The bank has been good about not pressuring me," he says. "But this spring they told me to refinance, and now I have to pay off the 1974 loan and worry about paying my loan for 1975 as well."

Many other farmers are in the same bind. After watching commodity prices rise through most of last year as a result of the unprecedented world demand for U.S. farm products, they decided to hold on to their harvests in the hope that prices would rise even more during the winter. When just the opposite happened, they were unwilling to sell at a loss and so were unable to pay off their bank loans. As a result, extensions of 1974 farmers' loans have risen more than 40% from last year and new indebtedness has leaped as farmers scramble to buy more time.

Legal limits. The figures are staggering. While net farm income in 1974 fell 37% to $28.9-billion, farm indebtedness increased about 25%. In January, the last published reporting month, farm credit associations saw their outstanding loans climb 29%, to $9.6-billion, above 1974. Federal land bank associations, which hold mortgages on more than 35% of all farmland in the country, saw their loan totals soar 26% to more than $14-billion. New loans in January rose a sharp 18% to $250-million. In the Midwest farm belt alone, land bank loans increased 42% to $67-million in January. And rural banks in the five Midwestern agricultural states comprising the Seventh Federal Reserve District saw loans jump 20% in April to $298-million.

Farmers and feedlot operators should have no big problem paying off their debts if commodity prices firm up and crop yields are good this year. But any shortfall in crop production this summer and fall could leave many of them hard-pressed. Just as important, some rural banks are finding themselves unable to meet the credit demand of farmers as they bump up against legal lending limits.

"Demand for credit is outreaching anything we have experienced in the past, and our good farm customers are having to leave us because we are unable to meet their credit needs," says Edward F. Mauldin, chairman of the First Colbert National Bank in Sheffield, Ala., which has total assets of $19-million. Adds Raymond J. Doll, senior vice-president of the Federal Reserve Bank of Kansas City: "Credit demands are going to continue to go up."

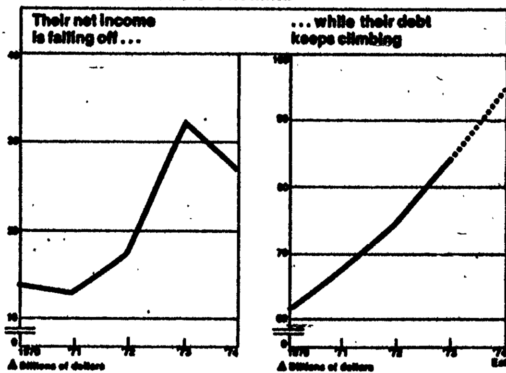
To be sure, not all rural banks are facing an immediate credit squeeze nor are all farmers unable to satisfy their credit needs. So far, the problem is most acute in cotton-growing areas of the South, in the corn and soybean belt of the Middle West, and in areas with large numbers of cattle feeders. But a trend appears to be developing that causes concern.

"The first signs were this year. And by next year we could see a major capital crisis in agricultural loans," predicts an economist at the University of Minnesota. "No one is talking much about it, but I'm afraid many farmers who have not paid off last year's debt will be squeezed if they don't get good crop prices this year. Then we'll see foreclosures and repossessions."

Tight credit. The credit problem is compounded by the fact that farmers' costs have continued to rise while the prices they get for their crops slide. Although fertilizer prices have softened somewhat from their highs last year, seed prices are now up to $52 per bu. for corn vs. about $6 a few years ago. (A bushel of seed corn will plant about five acres.) Equipment costs have climbed so that the average U.S. farmer now has more than $36,000 invested in tractors, harvesters, and other machinery. In all, the cost of planting an average acre of land in the farm belt is now more than $100, compared with $89 only two years ago.

Moreover, farmers are losing one of their traditional sources of credit—the small-town retailer. "We are insisting everyone pays up within 30 days now," says a farm supply store manager in Kearney, Neb. "It used to be we'd let good customers ride for 90 days."

"A lot of farmers just don't have the cash to pay off their old debt and meet their current obligations. They had to come back to refinance this year," says Ed H. Spetman, Jr., president of the



Data: Federal Reserve Board

The Fed's Doll: "Credit demands are going to continue to go up."

Banker Spetman: "A lot of farmers had to come back to refinance this year."

Council Bluffs (Iowa) Savings Bank, an $85-million institution located in Pottawattamie County, where farmers lead the nation in terms of revenue per acre of farmland. "Furthermore, the farmers' net worth has dropped. We are having some problems going in right now to rescue their positions."

Financing. Bankers are reluctant to concede that they are unable to supply all the cash their farm customers want this spring. But the number of loans on which rural banks must get help from their correspondent banks in regional money centers, such as Kansas City and Denver, is increasing. "I ought to get a direct phone line to Denver," jokes one Kansas banker, "because I'm taking a good chunk of my business there to handle the overlines." Most rural banks are state chartered and have tight lending limits for individual borrowers. They must pass on to regional banks a share of the loans to avoid exceeding legal restrictions.

Bankers are also encouraging customers to switch from short- to long-term financing. And many farmers are securing funds to pay off old debt as well as to finance current crops by mortgaging land and equipment, much of which had been paid off after the high-profit years of 1973 and 1974.

"Farmers have tremendous equity in their land," observes the Fed's Doll. "It enables them to stretch out their payments and makes their day-to-day living a little easier."

However, mortgaging land to provide cash is not unlike a corporation selling its assets to stay afloat. Some bankers are privately concerned that the agriculture industry is only postponing a crisis—not avoiding it—by mortgaging its assets to stay afloat.

"We're very worried about it internally," concedes one Minneapolis banker. "As long as farmers get a good crop price, there's no trouble meeting their payment schedules. But what happens if there is a marginal crop?"

"At least they're not mortgaging their land to the hilt," says Oliver A. Hansen, president of Liberty Trust & Savings Bank in Durant, Iowa. "They still have equity. And none of us expects two bad crop years in a row."

Some farmers are mortgaging their assets to stay afloat

The boom is over. Moreover, farmers are somewhat protected by land values, which continue to rise despite the recession and lower crop prices. But it appears that the land-value boom of 1973 has ended and demand for farmland has begun to slacken. The Federal Reserve Bank of Chicago says that for the first quarter of 1975 farmland prices increased only 2% from last year, the smallest quarterly increase in three years. As a result, land values at the end of April were only 14% above a year ago.

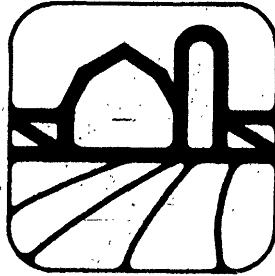
No one is yet saying that farmers are about to run out of cash, and only the most pessimistic agribusiness analysts predict massive foreclosures reminiscent of the Depression. But the warning signs are appearing.

"The farmer is in a vulnerable position," warns John Cluck, executive vice-president of First National Bank of Perryton, Tex. "Once you start lending to a farmer, there is no quitting place. You just try to make a wide selection and hope the weather and prices are good. But you've got to watch him pretty closely and exercise more conservatism." ■

APPENDIX XII

CD-79 JULY 1974

FARM REAL ESTATE MARKET DEVELOPMENTS



ECONOMIC RESEARCH SERVICE • U.S. DEPARTMENT OF AGRICULTURE

FARM REAL ESTATE MARKET DEVELOPMENTS
March 1973 to March 1974

CONTENTS

	Page
Summary	3
List of Figures	5
List of Tables	6
Market Developments	7
Farm Real Estate Transfers	8
Financing Land Transfers	9
Market Participants	11
Nonfarm Influences on Farm Real Estate Markets	13
Cash Rents	14
Farm Mortgage Lending	15

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The basic data contained in this report were obtained from two main sources. Index numbers of average value per acre are based on estimates provided by USDA crop reporters through the Statistical Reporting Service. Semiannual surveys directed to farm real estate brokers, local bankers, county officials, and others provide information pertaining to actual farm sales and general indications of local market conditions. The assistance of both groups is gratefully acknowledged.

SUMMARY

Farm real estate values may rise 15 percent during the year ending March 1, 1975. While this would be sharply above average gains of recent years, it would trail 1974's record increase because of less optimism over prospects for farm income and agricultural exports.

The index of farm real estate values rose a record 25 percent for the year ended March 1, 1974. The index reached 187 (1967=100), which converts to a 9.35 percent annual rate of increase over the last 7 years.

Major factors behind the most recent increase include unusually high commodity prices and net farm income in 1973, and considerable buyer optimism over the long-term outlook for farm income. Also, a rapid rate of inflation in the general economy contributed to some shifting of investment funds into farm real estate as an inflation hedge. Rising interest rates appeared to have little limiting effect on land markets during the year as the use of borrowed funds to purchase land increased sharply.

The total value of farm real estate reached $324.2 billion and the average value per acre $310, a $63 rise from a year ago. Value per acre ranged from nearly $2,100 in New Jersey to $65 in New Mexico. Most Corn Belt State averages were in the $600-$800 range.

As a result of the jump in average value per acre and, to a lesser extent, continued increase in farm size, the value of farm real estate in an average operating unit now exceeds $125,000.

The number of voluntary and estate sales of farm real estate of 10 acres or more remained unchanged from last year at 125,000. However, because the number of farms declined, the transfer rate for voluntary and estate sales combined increased to nearly 1 transfer per 20 farms or ranches, the highest rate since 1948. Average size of these transfers increased 15 percent, which accounts for the 5.5 million-acre increase over last year's 36.3 million acres that were transferred. Total value of transfers was estimated at $14.2 billion, up $3.6 billion over last year.

Although the majority of properties sold were operated as complete units just prior to sale, only about half of these properties were purchased for use as complete units. On the other hand, only 37 percent

of all tracts sold were part of another farm before sale, but 55 percent of the tracts purchased were to become part of another farm. Part-time farms accounted for only 10 percent of all sales but 12 percent of all purchases.

The percentage of all transfers which utilized debt financing matched last year's 86 percent, but the ratio of debt to purchase price for these purchases dropped to 75 percent from last year's 78 percent.

Sellers continue to be the major suppliers of loan funds for farmland purchases. This year they supplied over 44 percent of all loan funds. Federal land banks provided over 25 percent. Insurance companies, commercial banks, and "other lenders" (primarily FmHA) each furnished about 10 percent of the total loan volume. Primary lenders provided over 90 percent of all loan funds, while secondary lenders (those holding second mortgages or second deeds of trust as security) provided the rest.

The percentage of all farmland acreage purchased by privately held corporations (primarily incorporated family farms) has shown a steady increase in recent years and they now account for 18 percent of acreage purchased. The percentage of acreage sold by privately held corporations has increased over time, but at a slower rate. There has thus been a net increase in acreage held by privately held corporations since 1972. Publicly held corporations, however, have just held their own since 1972. Individuals dominate the market, buying 64 percent and selling 69 percent of the acreage.

About 5 of 6 farm properties purchased are expected to remain in farm use at least 5 years. Most of those expected to move to a nonfarm use within 5 years will be used as rural residences and subdivisions.

Survey respondents also furnished information on farmland purchases for immediate nonfarm use. These purchases were much smaller (127 acres) and their per acre price much higher ($788), on the average, than properties purchased for farm use. Forty percent of the acreage purchased directly out of farm use was scheduled for either rural residence or subdivision usage.

Despite rising interest rates, loan volume by major farm mortgage lenders continued to show substantial growth. New money loaned by Federal land banks for the year ended May 31, 1974, totaled $2.9 billion—more than a fifth above the preceding year's volume. Life insurance companies loaned 30 percent more new money in the first quarter of 1974 than in the first quarter of 1973.

Rents for pasturing cattle on privately owned land increased 16 percent from last year. Nationwide, the rent on March 1, 1974, averaged $4.95 per head per month. In the 11 Western States, a 27 percent increase pushed rent per head to $5.82. Decline in feeder calf prices could result in a downward shift in these rents by next March. Cropland rent increases per acre varied from 50 percent in North Dakota to 13 percent in Michigan.

LIST OF FIGURES

Figure		Page
1	Percentage increase in average value of farm real estate, March 1973 to March 1974	7
2	California crop reporting districts	9
3	Percentage of land transfers on which debt was incurred	10
4	Farm real estate debt as a percentage of market value on transfers with debt	10
5	Distribution of loan funds for farmland transfers by specified lenders	11
6	Percentage of farmland acres transferred by type of business organization	12
7	Types of farming areas	17
8	Farm production regions	17

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LIST OF TABLES

Table		Page
	MARKET DEVELOPMENTS	
1	Indexes of average values per acre	18
2	Indexes of average value per acre, grazing land	19
3	Indexes of average value per acre, irrigated land	20
4	Indexes of average value per acre, dry cropland	21
5	Expected land price changes (reporters' opinions)	22
6	Average dollar value per acre	23
7	Total value of farm real estate	24
8	Total value of farm buildings	25
9	Average value of farm real estate per operating unit	26
10	California average land value per acre by agricultural use	27
	FARM REAL ESTATE TRANSFERS	
11	Inquiries for farmland (reporters' opinions)	28
12	Farms offered for sale (reporters' opinions)	28
13	Rate of farm real estate transfers	29
14	Number of farm real estate transfers	30
15	Number, acres, and value of voluntary and estate sales	30
16	Average size and price per acre of transfers	31
17	Intended method of operation of land after transfer	31
18	Method of operation of land before and after transfer	32
	FINANCING LAND TRANSFERS	
19	Availability of credit (reporters' opinions)	32
20	Changes in interest rates (reporters' opinions)	33
21	Percentage of farmland transfers credit-financed	34
22	Ratio of debt to purchase price, credit-financed transfers	35
23	Percentage of primary and secondary loan volume extended by specified lender, 1974	36
24	Percentage of total loan volume extended by specified lender, 1969-74	37
25	Number of credit-financed voluntary and estate transfers	38
	MARKET PARTICIPANTS	
26	Percentage of transfers, acres, and value by type of business organization of buyer and seller	39
	NONFARM INFLUENCES ON FARM REAL ESTATE MARKETS	
27	Percentage of land purchases, acres, and value by probable use of property 5 years after purchase	40
28	Acres per sale and price per acre by probable use of property 5 years after purchase	41
29	Current average value per acre by probable use of property 5 years after purchase, by region	41
30	Current average value per acre by probable use of property 5 years after purchase, by acre-size class	41
31	Transfers of farm real estate for immediate nonfarm uses	42
	CASH RENTS	
32	Cash rents for pasturing cattle on privately owned land	43
33	Cash rents per acre and rent-to-value ratios	43

OUTLOOK

Farm real estate values are expected to continue upward for the next year, but at a slower rate than the record 25 percent rise recorded in March 1973-March 1974.

The prospective easing—to perhaps a 15 percent rate—stems from the anticipated $6-8 billion drop in realized net farm income from last year's record $32.2 billion (revised), as well as from uncertainty over future export demand for farm products. These concerns seem to have dissipated some of the super optimism voiced by land buyers last year. However, 70 percent of those queried expect farmland prices to advance through next spring.

Both the record advance of the past year and the prospective increase far exceed the over 9 percent annual rate of advance since 1967.

MARKET DEVELOPMENTS

The 25 percent average increase in farmland values reported for the year ended March 1, 1974, established a new record for appreciation in land values. Only two other periods since 1912 have shown rates of increase exceeding 20 percent—March 1919 to March 1920 and November 1972 to November 1973.

For the most part, the record increase can be attributed to unusually high farm income and high commodity prices in 1973 coupled with considerable buyer optimism over the long-term outlook for farm income. Also, a rapid rate of inflation in the general economy contributed to some shifting of investment funds into farm real estate as an inflation hedge. Rising interest rates appeared to have little limiting effect on land markets during the year as the use of borrowed funds to purchase land increased sharply.

As a result, State land values increased by 11 to 36 percent (figure 1). Washington posted the slowest rate of gain at 11 percent; North Dakota led all States with a 36 percent increase.

The national index of farm real estate value per acre rose to 187 (1967=100) (table 1.) However, index values by States varied from 131 in California to 299 in Nevada, reflecting strong differences in factors contributing to individual increases among States. It should be noted that the average acre of land in California sells for 5.5 times the price of the average acre in Nevada (table 6). Thus, a 10 percent increase

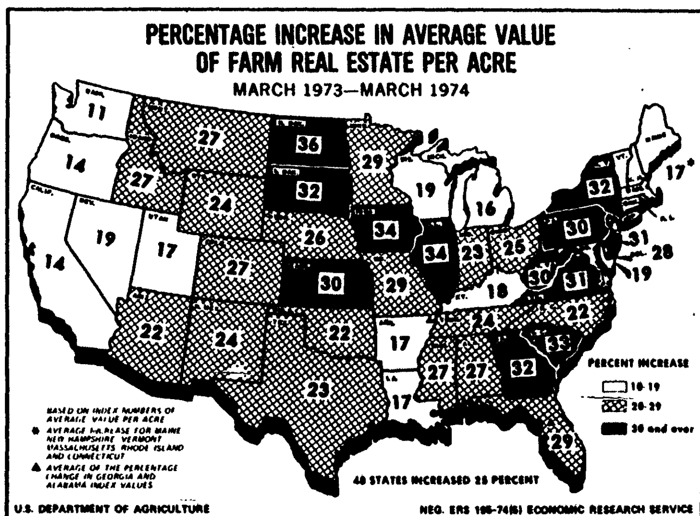

Figure 1

in California's average value would be equal to $55 versus $10 in Nevada.

In the Western States, grazing land values increased most rapidly—20 percent (table 2)—followed by dry cropland at 19 percent (table 4) and irrigated land at 17 percent (table 3). Since 1964, grazing land values have increased 140 percent, dry cropland 92 percent, and irrigated 45 percent. In part, this reflected the strong upward trend in livestock consumption in recent years and thus the increased pressure on grazing land prices relative to cropland.

Nationwide, 70 percent of the reporters are expecting at least a 5-percent increase in land prices for the year ending next March (table 5). Only 2 percent expect a price decrease. At this time, we are looking for about a 15 percent advance in land prices through next March.

Average Farmland Value Exceeds $300 Per Acre

The average value of an acre of farmland increased $63 reaching $310 per acre as of March 1, 1974 (table 6). An average farm operating unit was valued at $125,500 (table 9). The total value of farmland reached $324.2 billion (table 7). At the extremes, an acre of farm or ranchland in New Mexico averaged $65 and reached almost $2,100 in New Jersey. However, in New Jersey and other Northeastern States, a substantial part of the value is established by nonfarm demand for land. In New Mexico, grazing land with sparse vegetation represents most of the land in farms and ranches.

For farm operating units, three states, Kentucky, Tennessee and West Virginia, all having a large number of part-time and retirement farms, had averaged values of less than $60,000. At the opposite extreme, Arizona's irrigated farms and ranches averaged $756,000.

Farm building values rose almost $11 billion during the latest year and their current value is estimated at $56.3 billion (table 8), or 17 percent of the total value of all farm real estate.

Most California Land Values up Sharply

Because of the wide variation in land value and land use in California, and because sufficient observations are available for a more detailed analysis, California land value data are published by crop reporting districts and use categories (table 10 and fig. 2). The data show that for the first time in several years, irrigated land values in Southern California (Dist. 8) rose rapidly—breaking a long-term downward trend. In fact, land values in nearly all areas of the State rose during the year—most exceptions were in the irrigated land uses in California's Northern East Central region (Dists. 1, 2, 3 and 6). As a result, the 14 percent increase in land values was the strongest rate recorded for the State since the year ended March 1, 1951.

FARM REAL ESTATE TRANSFERS

Most reporters in the March 1 real estate survey indicated that the demand for farmland had remained strong. Sixty percent indicated that the number of inquiries for farmland had increased (table 11). The most notable shift in reporter opinions occurred in the Northeast and in Florida where 20 to 30 percent respectively said fewer people were looking for farmland. On the supply side of the market, reporters generally indicated little change to some decrease in the number of tracts offered for sale (table 12). The strongest declines in offerings from March 1973 appeared to occur in the tobacco and wheat types of farming areas (fig. 7). Although offerings were the same to lower, transfer rates increased slightly over the year, reaching 58.3 per thousand farms (table 13). This was the most rapid rate of transfer since 1948. Voluntary transfers reached 41.2 per thousand farms, also the highest rate since 1948. Total transfers for all reasons were estimated at 151,200—the largest number since 1962 and about 5,500 more than in the previous year (table 14).

With an increasing rate of transfers and declining number of farms, the number of voluntary and estate transfers of all sizes was estimated at about 128,000—unchanged from last year, the same as in 1973 (table 15). However, they were 15 percent larger in acreage (table 16) and accounted for 41.8 million acres, up about 5.5 million acres from last year. With the larger average size and a $48 per acre increase in price, the total value of these transfers was estimated at $14.2 billion, or $3.6 billion more than a year earlier.

A slight increase was noted in the percentage to be used as complete farms, and the proportion of add-on and part-time farm purchases dropped slightly (table 17). This is consistent with the observed increase in average size of tract transferred during the year.

Even though farm enlargement was the major reason for purchasing, the majority of tracts sold (53 percent) were operated as complete farms just prior to sale (table 18). But only slightly over half of the sale properties that had been operated as complete units were purchased with the idea of retaining them as complete units (28 of 53 percent).

Nearly 55 percent of all farmland purchases were to be added to existing operations. Properties purchased by farm enlargement buyers included over 4 of every 10 complete units (22 of 53 percent), most of the sale parcels which were part of another farm (29 of 37

CALIFORNIA

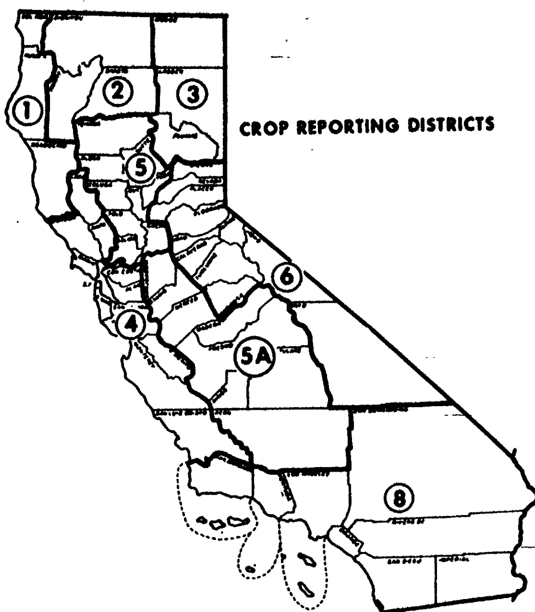

Figure 2

percent), and 40 percent of all part-time farms (4 of 10 percent).

Ten percent of the properties sold were part-time operations just prior to sale. However, 12 percent of the properties purchased were to be operated as part-time farms. Many of these purchases probably resulted from the strong demand for farm real estate for rural residences.

FINANCING LAND TRANSFERS

Availability of credit (loan funds) for financing land transfers improved between October 1973 and March 1974, according to reporters in our March farm and rural land survey. The majority (58 percent) indicated no change, but for every reporter who said availability of credit was lower than 6 months ago, 2 said it was higher (table 19).

Interest rate increases were reported to have slowed considerably. Only 39 percent of the reporters believed that interest rates had increased between October 1973 and March 1974, whereas 87 percent last fall had thought that interest rates had increased from March 1973 (table 20). The majority of reporter (56 percent) thought that interest rates had not changed much from last fall's level.

Beginning with 44 percent in 1944, and after a fairly steady increase in the percentage of all farmland transfers which involve financing, the rate reached a record-high 86 percent in 1973 and it was matched this year (fig. 3 and table 21). The ratio of debt to purchase price for these credit financed purchases, however, dropped to 75 percent from last year's 78 percent (fig. 4 and table 22). Apparently, many purchasers were willing and able to assume a larger equity position in land purchased as a result of realizing the high net incomes in calendar year 1973.

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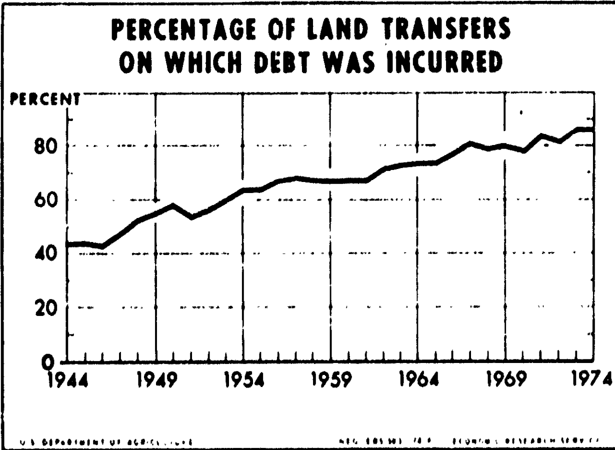

Figure 3

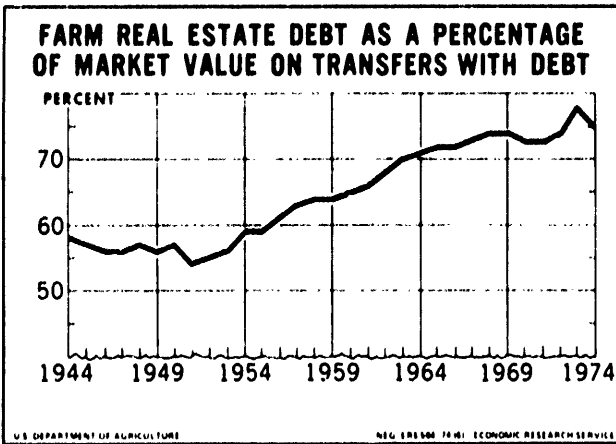

Figure 4

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Primary and Secondary Loan Sources

Primary lenders furnished over 9 out of every 10 dollars borrowed to buy farmland (fig. 5 and table 23). Secondary lenders (those holding second mortgages or second deeds of trust as security) furnished the remaining 8 percent.

Sellers continued to be the dominant source of loan funds for farmland purchases. They furnished over 44 percent of all loan funds for the year ended March 1, 1974 (32 percent through contracts for deed and 12 percent through mortgages and deeds of trust).

Federal land banks were the largest institutional source of loan funds, furnishing over 25 percent. Insurance companies, commercial banks, and "other lenders" (primarily FmHA) each furnished about 10 percent of the total loan volume.

Seller mortgages were a particularly important source of secondary loan funds. Second mortgages (and second deeds of trust) given by sellers accounted for 4.1 percent of total loan funds but close to half of the secondary loan funds. "Other" lenders (primarily FmHA) provided over 40 percent and commercial banks the remaining 9 percent of the secondary loan funds. (No secondary financing was provided by insurance companies, Federal land banks or sellers through contracts because of the nature of their loans.)

Two significant changes in the distribution of loan funds since the late 1960's have been the sharp drop by insurance companies and the sharp increase by Federal land banks in the percentage of loan volume provided to finance farmland transfers. The 11 percent currently being provided by insurance companies is only slightly more than half the percentage they accounted for in the late 1960's (table 24). Conversely, the 25 percent provided by the land banks in 1973-74 was approximately twice the percentage of funds they provided in the late 1960's.

The number of credit financed farmland transfers was down 2 percent for the year ended March 1, 1974, compared with a year earlier. However, acres in these sales were up 29 percent, the value of these sales was up 38 percent, and the debt incurred to finance the purchases was up 33 percent (table 25).

MARKET PARTICIPANTS

To measure the extent of, and changing trends in market activity by firms with different forms of business organization, reporters were asked to state the form of business organization of both buyer and seller for each transfer reported. A summary of these replies is shown in figure 6 and in table 26. (Data on

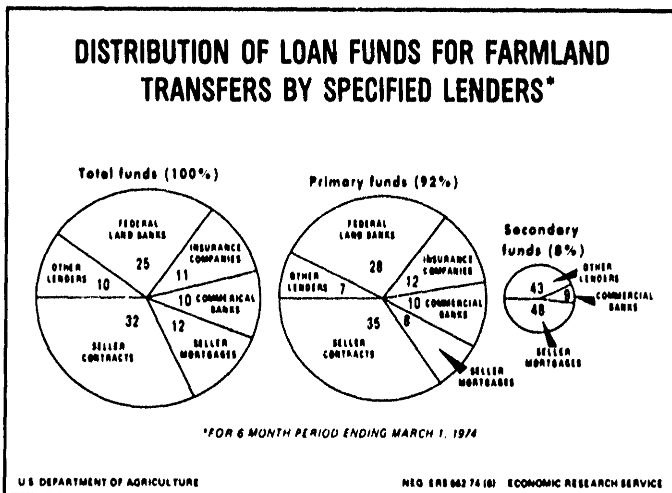


Figure 6

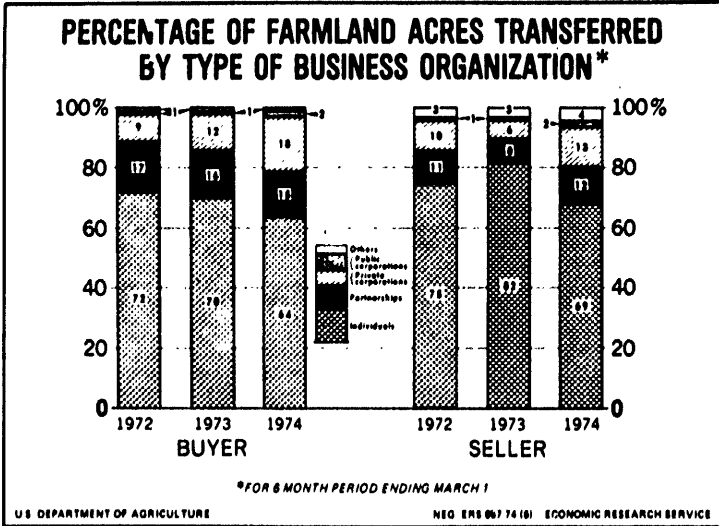


Figure 6

the number of sales, acreage and value are shown in table 15.) The bottom row of each part of the table shows the percentage of sales, acres or value purchased by each type of business organization. Data in the final column show the percentage of tracts, acres or value sold by each type of business organization. The arrangement of the table shows how farmland was transferred among various types of business organizations. For example, 76 percent of the sales during the 6-month period ended March 1, 1974, involved individuals selling to individuals. Individuals sold another 7 percent to partnerships, 3 percent to privately held corporations, 1 percent to publicly held corporations, and 1 percent to "others" for a total of 87 percent of all sales.

Percent of Acreage Purchased by Privately Held Corporations Up Sharply

The percentage of all farmland acreage purchased by privately held corporations has doubled since 1972 and is up one-half from last year. These farms (primarily incorporated family farms) purchased 18 percent of all farmland acreage transferred during late 1973 and early 1974 (table 26B).

The percentage of all farmland acreage sold by privately held corporations is also up over each of the 2 preceding years. However, there has been a net increase in the acreage held by private corporations over the past 2 years. They sold only 13 percent of all acreage but bought 18 percent in 1974. In 1973, they sold 6 percent and bought 12 percent.

The percentage of parcels purchased by privately held corporations has remained a constant 4 percent since 1972 (table 26A). However, their percentage of the total value of farmland purchased increased from 9 percent in 1972 and 1973 to 13 percent for the reporting period ended March 1, 1974 (table 26C).

Individuals Dominate Transfer Activity

Individuals remained the dominant type of buyer with 64 percent of the acreage, but their percentage was down from 70 percent in 1973 and 72 percent in 1972. The percent of all farmland acreage sold by individuals dropped to 69 percent from last year's 82 percent and 1972's 75 percent.

Although the percentage of transfers bought and sold by individuals has remained fairly steady since 1972, the percentage of the total value of farmland they buy and sell has slipped several percentage points.

Purchases by Publicly Held Corporations Offset by Sales

Publicly held corporations increased the percentage of total farmland value purchased to 3 percent in 1974 from 1 percent in 1972 and 1973. Similarly, though, the percentage of the value of farmland sold by large corporations in 1974 jumped to 3 percent from 1 percent in 1972 and 1973.

Percentage of transfers bought and sold remained at 1 percent each year from 1972. Percentage of acres bought and sold moved up to 2 percent in 1974 following 2 years at 1 percent.

It is noteworthy that every level and every change in market activity by publicly held corporations on the purchase side has been matched on the sale side for each of these 3 years.

Partnership Activity Mixed

Partnerships purchased a slightly higher percentage of the transfers this year than last (10 compared with 8), and sold a slightly lower percentage of all tracts (5 compared with 7). However, the percent of the total acres purchased declined slightly from 16 to 15 percent, and the percentage of the acres sold rose from 8 to 12 percent.

Partnerships purchased an increasing percentage of the total value of farmland (17 compared with 15), while the percentage of the total value sold by partnerships has remained at 10 percent since 1972.

"Other" Category Sales

The "other" category form of business organization has reportedly sold at least 3 times more tracts, acres, and value of farmland than it has purchased since 1972. However, these statistics are believed to reflect the classification of many estate sales as sales by "others" rather than by heirs or executors of the estates of deceased individuals. If this is so, then sales actually by "others" (lenders following foreclosures and governmental agencies mainly) would likely approximate purchases by "others" (governmental or quasi-governmental agencies) for highways, parks, and grazing associations.

NONFARM INFLUENCES ON FARMLAND MARKETS

Only a small percentage of farmland purchased each year is for immediate nonagricultural use (housing, highways, etc). However, the market price of a considerable portion of land in crop and livestock production is reported to reflect, at least partially, the value of this acreage in alternative nonagricultural uses. The alternative uses, however, may be either competitive with or complementary to current agricultural usage. That is, the physical appearance of most acreage in many parcels may remain unchanged even though purchased for nonfarm use. Examples of competing uses would include subdivisions, and commercial or industrial sites. Complementary uses could include rural residences and certain types of recreational uses.

To assess the effect of intended land usage after purchase on the price paid, and to assess the characteristics of farm properties purchased for various uses, farmland purchases were stratified into two groups. One group was comprised of purchases of farm real estate primarily for agricultural use. The other group was comprised of purchases of farm real estate primarily for nonagricultural uses. Comparison of the relative importance of these 2 types of transfer markets should not be made from these data because reporters were only requested to furnish information on the 5 most recent sales of each type.

Transfers for Primarily Farm Use

Nationwide, the distribution of probable uses of farm real estate transfers reported this year compares closely with that reported last year (table 27).

Most Purchases To Remain In Agricultural Use

Five of every six purchases were expected to remain in agricultural production at least 5 years (table 27A). These tracts accounted for 91 percent of the acres (table 27B) and 87 percent of the value of farm real estate transferred for farming purposes (table 27C). Both the percentage of the acreage and percentage of the value are down slightly from last year.

Conversion to rural residence use was expected to account for over half of the remaining tracts (9 of 17 percent), but only 2 percent of the acreage and 4 percent of the value.

Subdivision use was slated for 3 percent of the tracts, followed by forest, mineral, recreation, commercial or industrial, and "other" use, all with 1 percent or less.

Tracts Slated For Future Nonfarm Uses

Farm real estate purchases that were expected to be converted to a nonfarm use within 5 years were generally smaller in size than those tracts expected to remain in a farm use. Tracts expected to remain in farm use averaged 361 acres (table 28). This exceeded the average size of 6 of the 7 nonfarm uses. (Only the 371-acre average size of subdivision use was larger than the "agriculture only" use category.)

The average price of 5 of the 7 nonfarm uses exceeded the average price of those tracts expected to

remain in agricultural use. The average purchase price by use varied from $263 per acre in forestry to $1,173 in commercial or industrial use. The average price of farmland expected to remain in farm use was $331 per acre.

Average Price of Farm Tracts Highest in Northeast

The average price of sales reported in the Northeast region jumped $150 from last year's level (table 29). The $694 average sale price in the Northeast was followed closely by the $687 figure reported for Corn Belt sales. The Corn Belt region, however, topped all regions in average value of farmland purchased for long-term farm use with nearly a $700 per acre average.

Because of the value of farmland for farm use in the Corn Belt exceeded its value in "all uses," the price enhancing effect of nonagricultural influences was concluded to be slight in this region. Conversely, average value of sales for "all uses" in the Mountain region exceeded the average value of the 84 percent sold for "agriculture use only" sales (table 27A) by 13 percent, $141 divided by $125 (table 29). Thus, it was concluded that land values in this region were strongly influenced by potential nonagricultural uses.

Price Per Acre Drops As Size Increases

The larger the acre-size class, the lower was the price per acre for both "all uses" and "agriculture only" transfers (table 30). In the "all uses" category, the average price per acre in the 10-49 acre size class was 6 times greater than the average price per acre in the 1,000 acres and above size class. There was a similar, though less definite trend for the other 6 probable use categories.

As expected, properties expected to move into commercial or industrial uses sold for the highest average price, $1,173 per acre. This was more than twice the average for the rural residence and subdivision probable use categories.

Transfers for Primarily Nonfarm Use

To gain more insight into how farm real estate (land and buildings) purchased for nonfarm use is to be used, reporters were requested to provide information on the 5 most recent sales for immediate nonfarm use. Information on over 4,000 such sales was furnished.

Rural Residence and Subdivision Uses Dominate Purchases

Most real estate purchases for immediate nonfarm uses were to be used for housing. Purchases for rural residence use accounted for nearly 4 of every 10 purchases, and subdivision use accounted for one-fourth (table 31A). The remaining third were split (in decreasing order) among commercial or industrial, recreation, "other," forest, and mineral uses. The percentage distribution of purchases among uses this year compares closely with that for last year.

Price Per Acre Up; Average Size Down

Farm real estate to be converted directly into a nonfarm use brought an average of $788 per acre. This was up 17 percent from the $671 in 1973. Price per acre rose for 5 of the 7 uses. Mineral and "other" use categories were the exceptions.

The average size of transfer leaving farm use this year was 127 acres, 20 percent smaller than 1973's average of 159 acres.

One-fourth of Acreage to Subdivision

Slightly over 1 acre in 4 purchased out of agriculture was placed in subdivisions, including rural acreage subdivisions (table 31B). Rural residences took up another 14 percent of the acreage. Therefore, housing uses accounted for 4 of every 10 acres but nearly 2 of every 3 transfers slated for shift to a nonfarm use.

Forty Percent of Value to Subdivisions

The average per acre price of transfers for subdivision use ($1,225) trailed the average for commercial or industrial use (1,749). However, because nearly two and one-half times more acres were involved in transfers for subdivision use, subdivision use accounted for 41 percent of the value transferred compared with 25 percent for commercial or industrial uses.

CASH RENTS

Pasture Rents Up 16 Percent; Downturn Expected

Nationwide, rents per head for pasturing cattle on private land averaged $4.95 per month as of March 1, 1974—up 16 percent from a year ago. In the 11 Western States the rate of increase was even sharper—up over 27 percent from a year earlier to $5.82 per head per month (table 32). Strong and increasing demand for red meat during the 1960's, early 1970's, and into 1973 was reflected in meat and meat animal prices. As a result, cash rents paid for pasture and grazing land were bid up to record levels in 1973.

Declines from these record rental rates can be expected by March 1975. Feedlot operators, after

sustaining economic losses in 1973 and facing high feed costs this year, will offer lower prices for feeder calves. In turn, cow-calf producers who rent pasture will bid less vigorously for pasture than they did last year when feeder prices were much higher.

While producers will probably start cutting back on cow numbers (through heavier culling of brood cows and placing fewer replacement heifers in herds), the total inventory number is expected to be up by next March.

Cropland Rents Up 13-50 Percent

The 50 percent increase in gross cash rent per acre for cropland in North Dakota led the increase reported for the 11 States in the Northern Plains, Lake States and Corn Belt regions (table 33). All but 2 of these States—Michigan with 13 percent and Ohio with 18 percent—reported increases of at least 20 percent.

Iowa's average $57 gross cash rent per acre topped all States and resulted in a 7.4 gross rent-to-land value percentage ($57 per acre average gross rent divided by $774 per acre average value of cropland rented for cash).

Among these States, rent-to-value ratios varied from 5.0 percent in Ohio to 8.9 percent in North Dakota. While gross rents per acre were up in each of the 11 States, rent-to-value ratios declined in 6. Implied is that the rate of increase in average value of land rented was greater than the rate of increase in average gross rent in these 6 States.

Most of the increase in gross rents reflected a brisk price rise for most crops and, at the same time, comparatively modest upward pressures on prices paid for production items. Thus, income above variable production costs increased substantially during 1973 and caused rents for cropland to be bid up by March 1974.

Slower rates of increase in cash rents paid appear likely from March 1974 to March 1975 as net farm income is expected to be less favorable than in the previous year. For rents to increase while net farm income falls may appear illogical. However, cash rents are typically negotiated at least several months in advance of planting. Therefore, rents received for much acreage in 1973 appear to have been below what many tenants would have been willing and able to pay. Although net income is expected to be down from last year, it will still be well above the level received prior to 1973. And with crop prices continuing to average above pre-1973 levels, competition for crop land can be expected to remain strong.

FARM MORTGAGE LENDING

Although interest rates remained high through the first quarter of 1974 and increased in the second quarter, volume loaned by major farm mortgage lenders was continuing to exceed the volume for the same period a year earlier.

New money loaned by the Federal land banks (FLBs) for the year ended June 30, 1974, totaled $2.9 billion, a record, or 21.5 percent above the preceding year's volume. For the first half of 1974, new money loaned totaled $1,682 million, 20 percent above the same period in 1973. New money loaned by the FLB's in May totaled $305.4 million, a record for any month in FLB history. As of June 30, 1974, total land bank loans outstanding reached $12.2 billion—up from $10.9 billion on December 31, 1973.

The average loan closed by the FLB's was $59,300 for the year ended in June, up from $51,400 in the previous year. For June, loans closed by FLB's averaged $63,800, compared with $51,700 a year earlier.

Life insurance companies remained active in farm lending into 1974 with new money loan volume in the first quarter up 30 percent from the same quarter a year earlier. However, repayments to insurance companies were unusually large and the volume of loans outstanding remained unchanged during the quarter. At the end of March, life insurance company loan volumes outstanding were 7 percent above a year earlier. With continuing high short-term interest rates, many companies are facing an increased demand for policy loans, and a further sharp rise in policy loan demand can be expected into the third quarter. To some extent this will reduce the quantity of funds available for farm lending by these firms. Over the last several years, the number of farm mortgage loans held by insurance companies has been declining and their average size of loan has increased quite rapidly. In part, this reflects the lower costs of servicing larger loans as well as the increased competition from the FLB's for the more modest sized commercial farm loan.

Growth in loan volume of life insurance companies is largely regulated by the demand for policy loans, and by the companies's portifolio preferences. With rapidly rising real estate prices and larger loan requests, the number of individuals that can secure insurance company loans is reduced. Since January 1970, the number of insurance company farm mortgage loans oustanding has declined from 177,000 to 132,000, or 25 percent. On the other hand, FLB loans outstanding have increased from 402,439 to 421,303, or an increase of 5 percent. The average size of life insurance company loan acquired during the first quarter of 1974 was $192,000, compared with $77,200 in the first quarter of 1973. For the year ended March 1, 1974, the average size loan acquired was

$165,000, up from $115,000 the previous March. Although data on lending activity by other lenders are not available for the first quarter of this year, market observers in general report that the demand for funds remained strong at commercial banks. Also, sellers and other individuals continued to supply a large volume of funds.

Loan Fund Outlook for the Second Half of 1974

The demand for mortgage funds is expected to remain strong through the third quarter. However, continuation of this strong demand into the fourth quarter hinges largely on this year's crop production and prices. On the supply side, some insurance companies facing a strong demand for policy loans will likely reduce their farm mortgage lending activity. In addition, in those States where usury limits on mortgage interest rates are lower than market rates, insurance companies are likely to restrict themselves to servicing current borrowers. On balance, outstanding loan volume held by insurance companies at the end of 1974 is expected to change very little from what it was in January. However, Federal land bank loan volume outstanding could be up by 25 percent ($2.5 billion) above the January figure.

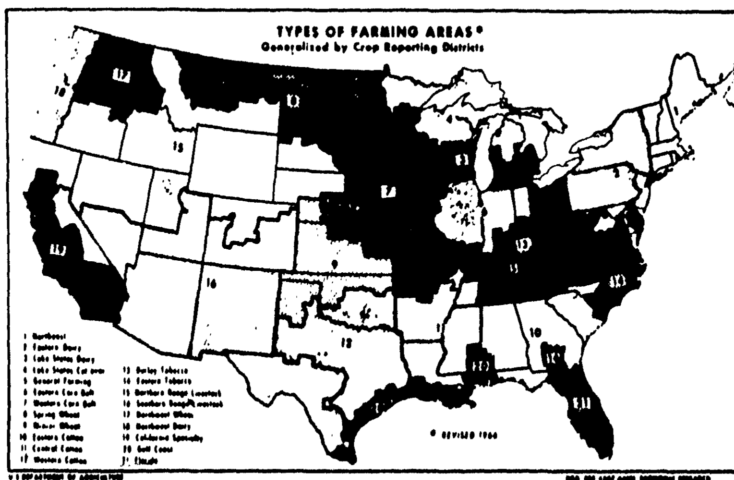


Figure 7

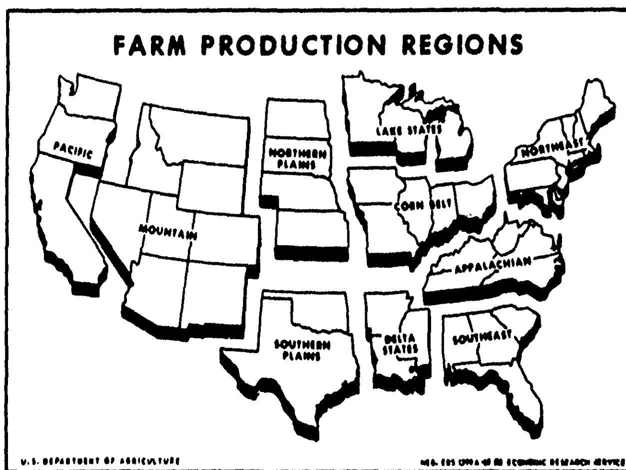


Figure 8

TABLES REVISED TO JULY 1975 BY ECONOMIC RESEARCH SERVICE, USDA

TABLE 6.—FARM REAL ESTATE VALUES BY STATE: AVERAGE VALUE PER ACRE GROUPED BY FARM PRODUCTION REGION, MAR. 1, 1970–75

State	1970	1971	1972	1973	1974	1975
Northeast:						
Maine [1]	$161	$183	$206	$235	$276	$310
New Hampshire [1]	239	287	323	368	432	485
Vermont [1]	224	256	288	328	385	433
Massachusetts [1]	565	623	702	799	939	1,055
Rhode Island [1]	734	807	910	1,036	1,217	1,367
Connecticut [1]	921	1,025	1,155	1,316	1,546	1,737
New York	273	292	344	390	516	610
New Jersey	1,092	1,171	1,364	1,599	2,099	2,569
Pennsylvania	373	396	430	518	675	810
Delaware	499	559	574	663	851	1,037
Maryland	640	699	752	8	1,056	1,153
Lake States:						
Michigan	326	331	366	433	503	531
Wisconsin	232	257	278	336	401	451
Minnesota	226	231	243	275	354	461
Corn Belt:						
Ohio	399	413	438	507	636	718
Indiana	406	426	441	512	629	783
Illinois	430	491	527	590	788	952
Iowa	392	392	418	482	648	801
Missouri	224	236	259	289	374	394
Northern Plains:						
North Dakota	94	96	99	111	151	207
South Dakota	84	85	89	97	129	160
Nebraska	154	157	171	195	246	289
Kansas	159	161	176	203	235	314
Appalachian:						
Virginia	286	312	352	404	528	591
West Virginia	136	151	175	208	271	313
North Carolina	333	378	407	483	589	638
Kentucky	253	268	297	333	394	441
Tennessee	268	279	311	363	449	516
Southeast:						
South Carolina	261	284	341	375	501	575
Georgia	234	258	297	340	448	505
Florida	355	376	398	[2] 454	[2] 586	[2] 656
Alabama	200	229	239	274	347	383
Delta States:						
Mississippi	234	239	242	269	342	382
Arkansas	260	257	288	321	376	387
Louisiana	321	352	386	411	483	532
Southern Plains:						
Oklahoma	173	183	197	225	275	318
Texas	148	155	172	194	238	241
Mountain:						
Montana	60	63	68	76	97	113
Idaho	177	189	208	234	298	357
Wyoming	41	42	47	54	67	76
Colorado	95	103	116	138	176	189
New Mexico	42	44	47	53	65	69
Arizona	70	76	87	93	114	115
Utah	92	103	115	124	145	155
Nevada	53	63	73	87	103	103
Pacific:						
Washington	224	225	234	262	290	322
Oregon	150	166	185	204	233	249
California	473	471	485	496	566	646
48 States	195	203	219	247	310	354

[1] The average rate of change for the 6 New England States was used to project dollar values for each of these 6 States for 1972–74.

[2] Estimated on basis of Georgia and Alabama index values.

TABLE 7.—FARM REAL ESTATE VALUES BY STATE: TOTAL VALUE GROUPED BY FARM PRODUCTION REGIONS, MAR. 1, 1970–75

[In millions of dollars]

State	1970	1971	1972	1973	1974	1975
Northeast:						
Maine [1]	283	315	340	370	428	481
New Hampshire [1]	146	173	183	194	224	252
Vermont [1]	429	485	527	578	670	752
Massachusetts [1]	396	430	472	522	605	679
Rhode Island [1]	51	56	60	66	77	86
Connecticut [1]	498	555	603	662	767	861
New York	2,772	2,915	3,400	3,820	5,012	6,031
New Jersey	1,132	1,189	1,378	1,599	2,099	2,557
Pennsylvania	3,319	3,510	3,771	4,494	5,861	7,110
Delaware	336	372	379	435	556	676
Maryland	1,793	1,948	2,067	2,408	2,851	3,098
Lake States:						
Michigan	3,883	3,910	4,282	5,029	5,802	6,121
Wisconsin	4,201	4,608	4,952	5,966	7,088	7,927
Minnesota	6,512	6,636	6,958	7,864	10,113	13,157
Corn Belt:						
Ohio	6,819	7,022	7,443	8,577	10,748	12,145
Indiana	7,136	7,530	7,801	9,049	11,121	13,846
Illinois	14,643	14,584	15,508	17,295	23,054	27,765
Iowa	13,150	13,164	13,979	16,145	21,683	26,800
Missouri	7,269	7,594	8,306	9,250	11,934	12,590
Northern Plains:						
North Dakota	4,045	4,130	4,271	4,783	6,519	8,927
South Dakota	3,815	3,887	4,047	4,439	5,878	7,306
Nebraska	7,076	7,210	7,838	8,935	11,258	13,224
Kansas	7,842	7,952	8,652	10,018	13,064	15,468
Appalachian:						
Virginia	3,047	3,289	3,687	4,192	5,429	5,961
West Virginia	589	644	730	852	1,108	1,280
North Carolina	4,244	4,813	5,039	5,820	7,001	7,469
Kentucky	4,041	4,249	4,689	5,228	6,185	6,908
Tennessee	4,028	4,176	4,620	5,370	6,643	7,626
Southeast:						
South Carolina	1,827	1,962	2,327	2,531	3,332	3,822
Georgia	3,701	4,013	4,559	5,164	6,791	7,660
Florida	4,976	5,274	5,547	[2] 6,281	[2] 8,052	[2] 9,018
Alabama	2,725	3,085	3,199	3,616	4,549	4,987
Delta States:						
Mississippi	3,746	3,809	3,840	4,242	5,355	5,987
Arkansas	4,081	4,032	4,574	5,100	5,972	6,145
Louisiana	3,145	3,447	3,781	4,027	4,724	5,205
Southern Plains:						
Oklahoma	6,214	6,575	7,062	8,086	9,835	11,365
Texas	21,170	22,165	24,385	27,540	33,791	34,198
Mountain:						
Montana	3,748	3,939	4,229	4,724	6,001	6,977
Idaho	2,545	2,721	2,998	3,379	4,302	5,185
Wyoming	1,445	1,483	1,670	1,908	2,374	2,711
Colorado	3,471	3,780	4,260	5,061	6,442	6,951
New Mexico	1,959	2,073	2,204	2,436	3,005	3,182
Arizona	2,664	2,908	3,363	3,469	4,166	4,182
Utah	1,040	1,173	1,307	1,394	1,627	1,741
Nevada	571	670	787	927	1,102	1,104
Pacific:						
Washington	3,903	3,922	4,006	4,538	4,998	5,553
Oregon	2,707	2,985	3,324	3,641	4,127	4,402
California	16,956	16,735	17,143	17,441	19,841	22,590
48 States	206,115	214,095	230,504	[3] 259,464	324,159	370,065

[1] The average rate of change for the 6 New England States was used to project dollar values for each of these 6 States for 1972–74.

[2] Estimated by the average of the percentage change in Georgia and Alabama index values. Total may not sum due to rounding.

[3] Revised May 1974.

TABLE 8.—FARM BUILDING VALUES: TOTAL VALUE OF FARM BUILDINGS, BY STATES, GROUPED BY FARM PRODUCTION REGIONS, MAR. 1, 1970-75

[In millions of dollars]

State	1970	1971	1972	1973	1974	1975
Northeast:						
Maine	126	139	149	160	184	205
New Hampshire	66	77	80	84	97	108
Vermont	168	189	203	221	253	281
Massachusetts	132	137	149	163	188	209
Rhode Island	13	13	14	15	18	20
Connecticut	148	156	168	183	209	233
New York	1,084	1,096	1,265	1,406	1,824	2,171
New Jersey	212	200	229	262	340	409
Pennsylvania	1,115	1,127	1,199	1,416	1,829	2,197
Delaware	64	64	64	73	92	111
Maryland	423	446	469	542	636	685
Lake States:						
Michigan	1,134	1,103	1,195	1,388	1,584	1,653
Wisconsin	1,378	1,461	1,555	1,855	2,183	2,418
Minnesota	1,739	1,699	1,760	1,966	2,508	3,237
Corn Belt:						
Ohio	1,841	1,875	1,965	2,239	2,773	3,097
Indiana	1,720	1,830	1,880	2,163	2,636	3,254
Illinois	2,694	2,698	2,838	3,130	4,127	4,914
Iowa	2,236	2,185	2,293	2,616	3,469	4,234
Missouri	1,417	1,405	1,520	1,674	2,136	2,228
Northern Plains:						
North Dakota	651	653	666	737	991	1,339
South Dakota	542	521	538	586	770	950
Nebraska	856	815	878	992	1,238	1,441
Kansas	925	899	969	1,112	1,437	1,686
Appalachian:						
Virginia	762	783	870	981	1,260	1,371
West Virginia	190	194	218	251	323	370
North Carolina	1,163	1,266	1,310	1,496	1,778	1,875
Kentucky	1,095	1,113	1,214	1,338	1,565	1,727
Tennessee	995	965	1,058	1,219	1,495	1,701
Southeast:						
South Carolina	447	451	531	572	746	848
Georgia	825	843	948	1,064	1,385	1,547
Florida	517	559	582	[1] 653	[1] 829	[1] 920
Alabama	749	814	835	933	1,160	1,257
Delta States:						
Mississippi	817	766	764	836	1,044	455
Arkansas	722	694	778	857	991	1,008
Louisiana	481	465	507	536	624	682
Southern Plains:						
Oklahoma	740	756	805	914	1,102	1,261
Texas	2,202	2,283	2,487	2,782	3,379	3,386
Mountain:						
Montana	457	485	516	572	720	830
Idaho	400	416	453	504	637	762
Wyoming	168	169	189	214	264	288
Colorado	413	431	481	567	715	765
New Mexico	227	242	256	280	343	360
Arizona	189	215	238	250	296	293
Utah	168	182	200	211	242	258
Nevada	64	78	91	107	126	125
Pacific:						
Washington	782	745	764	844	920	1,011
Oregon	541	600	658	714	801	845
California	1,780	1,774	1,800	1,814	2,044	2,304
48 States	37,581	38,075	40,600	45,487	56,308	64,036

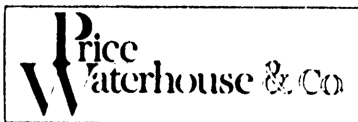
[1] The average rate of change for the 6 New England States was used to project dollar values for each of these 6 States or 1972-74. Total may not sum due to rounding.

TABLE 9.—AVERAGE VALUE OF FARM REAL ESTATE PER OPERATING UNIT, BY STATE, GROUPED BY FARM PRODUCTION REGION, 1971-75[1]

State	1971	1972	1973	1974	1975
Northeast:					
Maine[2]	$40,800	$46,200	$53,000	$62,500	$70,200
New Hampshire[2]	61,400	69,500	79,600	94,000	105,600
Vermont[2]	71,600	81,300	93,300	110,200	123,800
Massachusetts[2]	76,700	86,900	99,500	117,600	132,100
Rhode Island[2]	79,600	90,600	103,100	121,600	136,400
Connecticut[2]	126,200	143,300	164,600	194,400	218,300
New York	57,100	67,800	77,600	103,700	122,500
New Jersey	143,200	170,000	202,200	265,500	327,400
Pennsylvania	56,700	61,700	74,600	97,300	116,400
Delaware	103,000	107,800	127,000	162,500	203,300
Maryland	115,200	124,300	146,400	175,200	182,600
Lake States:					
Michigan	50,800	56,300	66,900	78,200	82,500
Wisconsin	47,400	51,400	62,500	75,000	84,700
Minnesota	61,400	65,500	74,600	96,000	124,900
Corn Belt:					
Ohio	63,600	68,100	79,100	99,100	112,000
Indiana	75,000	78,400	90,900	112,800	140,400
Illinois	119,900	128,600	144,500	194,200	235,700
Iowa	95,100	102,400	120,000	163,500	203,500
Missouri	56,200	62,300	69,900	90,200	95,200
Northern Plains:					
North Dakota	91,200	96,500	110,700	152,700	211,600
South Dakota	86,900	92,500	102,700	137,400	172,800
Nebraska	102,600	113,000	130,700	167,000	199,100
Kansas	93,400	102,800	120,500	157,200	188,300
Appalachian:					
Virginia	51,700	58,700	67,600	88,800	98,900
West Virginia	28,800	33,900	41,000	53,400	60,500
North Carolina	40,800	44,300	53,100	64,800	70,700
Kentucky	34,800	38,700	43,500	51,500	58,000
Tennessee	36,200	40,300	47,600	59,400	68,200
Southeast:					
South Carolina	50,500	61,200	67,900	91,300	104,700
Georgia	60,300	69,400	79,700	104,800	118,200
Florida	148,200	160,300	186,900	246,700	276,300
Alabama	43,600	46,300	53,700	68,500	76,100
Delta States:					
Mississippi	53,600	55,300	62,500	79,900	89,300
Arkansas	66,700	76,800	86,800	103,100	106,100
Louisiana	83,100	93,000	101,200	121,200	133,600
Southern Plains:					
Oklahoma	80,100	87,000	100,700	123,900	144,800
Texas	105,500	116,600	131,700	161,600	163,500
Mountain:					
Montana	161,600	176,900	200,700	257,000	306,300
Idaho	108,000	120,300	137,000	176,900	214,800
Wyoming	171,900	195,900	226,600	281,900	325,900
Colorado	137,400	157,500	190,300	246,500	265,000
New Mexico	183,400	198,200	222,800	279,600	296,100
Arizona	502,200	572,800	619,100	756,100	772,200
Utah	89,900	103,300	113,700	134,800	144,300
Nevada	333,100	391,400	461,100	548,300	549,400
Pacific:					
Washington	116,500	122,300	138,200	154,000	171,100
Oregon	104,000	117,500	130,600	150,300	160,300
California	222,500	231,500	235,500	267,900	305,100
48 States	80,000	87,400	99,600	125,500	143,900

[1] March 1 values (total value of farm real estate divided by number of farms projected from the 1969 Census of Agriculture).
[2] The average rate of change for the 6 New England States was used to project dollar values for each of these 6 States for 1972-74. Estimated on basis of Georgia and Alabama index values.

APPENDIX XIII



OFFICE OF FEDERAL SERVICES
1801 K STREET N W WASHINGTON D C 20006 · 202 331 6865

July 17, 1975

Senator Gaylord Nelson
Chairman, Select Committee
on Small Business
424 Russell Senate Office Building
Washington, D. C. 20510

Attention: Herbert L. Spira

Dear Senator Nelson:

Enclosed herewith are ten copies of a statement of our firm's views concerning the impact of federal taxation on small business. We would like to have the statement inserted in the record of the current hearings on small business tax needs.

We appreciate this opportunity to present our views and would be pleased to be of any assistance possible in this important matter.

Yours very truly,

James B. Swenson

Enclosures:
As above

SENATE SELECT COMMITTEE ON SMALL BUSINESS
HEARINGS ON SMALL BUSINESS TAX NEEDS
STATEMENT SUBMITTED BY
PRICE WATERHOUSE & CO.

We are pleased to have this opportunity to present briefly our views before this Committee in connection with your consideration of the impact of federal taxation on small business.

Price Waterhouse & Co. is a firm of independent public accountants which has a large and diverse professional accounting practice in the United States serving both large and small companies. A major part of our practice consists of advising small business as to financial, tax and accounting matters related to their operations. Through the performance of these services, we are cognizant of the problems that small businessmen encounter in attempting to obtain sufficient capital for a new enterprise or for expansion of a successful venture. An income tax system has an inherent bias against savings. Additional incentives to small business through changes in our federal tax structure can help to attract investors and to retain internally generated capital for continued growth.

Of particular concern are those small companies with innovative products or services so essential to the U.S. economy through the creation of additional employment and growth in national production. Many of these companies are in their formative stages or in the early years of their development and accordingly lack the financial resources to develop their organization, obtain or expand production facilities, and market their products or services.

Capital formation and capital recovery are essential to the growth of these small companies. Many sources of financing are closed to them. Financial institutions understandably are reluctant to supply intermediate or long-term financing as adequate security for such loans is usually not available. In addition, few equity investors are interested because of the risks of loss. Consequently, management of these companies consume a substantial part of their time and energy in attempting to arrange financing otherwise diverting them from the production and marketing of goods or services.

In recent years much attention has been directed towards the use of the tax system to aid small business. We participated in the work of the President's Task Force on Improving the Prospects of Small Business, which in its report of March, 1970 offered tax proposals with particular emphasis on the allowance carrying forward losses and the establishment of reserves to finance receivables and inventories during the early years of operation.

Our recommendations for the items to be given highest priority at this time are as follows:

I. Provisions to Encourage Establishment of New Enterprises

A. Proposals Previously Recommended:

1. Eliminate the limitation on the period for carryforward of net operating losses. Businesses should be permitted to recover their economic losses before incurring a tax burden. Frequently, new businesses require more

than five years to reach the point where they have established a solid market for their product or service and have turned the corner financially.

2. Establish allowable risk reserves to assist the financing of receivables and inventories. During the first years of the business' existence, a deduction should be allowed from taxable income of modest provisions for a "small business risk reserve." This would help retention of earnings in the early stages to finance receivables and inventories. It is a counterpart to initial and accelerated depreciation allowances where depreciable property is involved. Many small businesses are not capital-intensive but working capital-intensive. They need this assistance. The reserve deductions could be kept within limitations by limiting deductions to a percentage of tax basis receivables and inventories. To avoid abuses, amounts released from these reserves would have to be taxed at ordinary rates.

B. Provide a lower nominal tax rate on the net operating income of a new corporation during the early years of its existence, for example, the first three years. Such lower tax rate would be desirable to encourage the infusion of risk capital into business.

C. Permit the deduction of organizational expenses of partnerships and proprietorships. Deductions of similar expenses are presently permitted for corporations and there should be no distinction in treatment by reason of the form in which a business operates.

D. Provide more flexibility for Subchapter S corporations through increasing the number of permissible shareholders from ten to fifteen and revise some of the technical provisions which cause inadvertent termination of Subchapter S status. The implementation of these changes would provide small businesses with more flexibility in operations and enable them to attract additional capital investment. In addition, the present rules operate as technical traps which defeat the benefits which were intended when the Subchapter S provisions were enacted.

E. Increase the limitation on amounts allowable as ordinary losses under Section 1244. Section 1244 was enacted in 1958 and the limitations of $25,000 ($50,000 in the case of a husband and wife filing a joint return) contained in that section do not reflect the inflation which has taken place since 1958.

II. Provisions to Assist Small Business Growth

A. Increase the Section 179 limitation on assets qualifying for the additional first year depreciation allowance. Section 179 was enacted in 1958 and the limitations on qualifying assets of $10,000 ($20,000 in the case of a husband and wife filing a joint return) do not reflect the inflation which has taken place since 1958, nor does it meet the demand for accelerated capital recovery, a vital factor in the continued growth of the small business enterprise.

B. Provide for a permanent increase in the investment credit to an effective rate of 10% and a permanent increase in the amount of used property eligible for the investment credit. The Tax Reduction Act of 1975 provided for an increase in the investment tax credit percentage and the amount of used property eligible for the investment credit for the two-year period, 1975-1976. Such increases should be made permanent, inasmuch as it is difficult for businesses to plan their affairs with temporary provisions in the Code. Furthermore, the credit should be allowed in its entirety by eliminating the limitation with respect to taxable income and amending the carryover provisions permitting the credit to be refundable. This will provide for greater immediate recovery of capital expansion even though operating losses may be sustained.

C. <u>Provide for a permanent increase to $50,000 in the surtax exemption and a reduction in the tax rate to 20% on the first $25,000 of taxable income</u>. These provisions were contained in the Tax Reduction Act of 1975 and apply to all corporations only for the calendar year 1975. As indicated in the preceding recommendation, these changes should be made permanent so that businesses may avoid the difficulty of planning their affairs with temporary provisions in the Code.

D. <u>Provide for faster depreciation recovery by simplifying or eliminating the complex CLADR rules or adopt a simplified capital cost recovery system</u>. The adoption of either of these approaches would moderate the adverse effects of inflation on the real value of cost recovery allowances and on the capacity of small businesses to finance additions to their production facilities. In addition, such provisions would generally simplify the law and regulations surrounding capital cost recovery, thereby reducing the burdens and expense of compliance by small business taxpayers.

E. <u>Develop a simplified LIFO procedure for inventory costing</u>. Under the LIFO procedure a business may minimize the taxes it would otherwise be required to pay currently on inflationary profits. The technical provisions contained in the LIFO regulations place an extreme burden on most small -

businesses and in many cases discourage companies from adopting LIFO. We commend the recent statement by Frederic W. Hickman, Assistant Treasury Secretary for Tax Policy, concerning the development of a simplified LIFO procedure.

III. Provisions for the Continuation of Small Business Enterprises

A. Provide that Sections 303 and 6166 will apply where the closely-held business interest is more than 20% of the gross estate instead of the present 35/50% limitations. The reduction in these limitations will enable the successors to the interest in the closely-held business to continue the business rather than forcing a liquidation or sale of all or a part of the business in order to meet tax burdens.

B. Provide maximum limitations on the valuation of interests in small businesses for estate and gift tax purposes. Specific guidelines, perhaps limited to net book value, would reduce the burdens and expense of disagreements between the continuing owners of the business and the Internal Revenue Service and would encourage the continuation rather than the liquidation of the business interests.

The recommendations presented above represent some of the areas in which we feel the growth of small businesses can be encouraged through the tax structure and the adverse effects of inflation can be moderated. We appreciate the opportunity to present our statement to the Committee on this very important and timely matter. As the Committee formalizes its specific recommendations, we would be pleased to offer additional comments and suggestions representing our understanding of the needs of the small business community.

July 17, 1975

APPENDIX XIV

NATIONAL ASSOCIATION OF HOME BUILDERS

National Housing Center

15TH AND M STREETS, N.W., WASHINGTON, D.C. 20005

NATHANIEL H. ROGG
EXECUTIVE VICE PRESIDENT

TELEX 89 2600 TELEPHONE (202) 452-0200

July 23, 1975

The Honorable Gaylord Nelson
Chairman
Select Committee on Small Business
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

On behalf of the National Association of Home Builders, I should like to offer our comments in connection with the Committee's hearings on the effects of proposed tax reforms on the needs of small business.

NAHB is the trade association of the home building industry with a membership consisting of more than 73,000 firms in 602 state and local associations throughout the United States. A substantial number of NAHB's membership consists of small businessmen, operating both in incorporated and unincorporated form. For instance, about half of the builders of single family homes construct fewer than 50 units per year. Because of this orientation NAHB has an important stake in the work of the Select Committee.

Our interest in tax reform is further heightened as we search for ways to counteract the serious housing depression which presently besets our industry. In 1974 there were 1.35 million housing units started. This was 34.3% below the 2.06 million units started in 1973 and 43.2% below the 2.38 million units started in 1972. We now estimate there will be only 1.1 - 1.2 million units started in 1975, 10.4% below 1974. Help is urgently needed.

We believe tax law changes could play a major part in paving the way to a housing recovery, and with it, the survival of the many small businessmen and their employees who are engaged in home building and related businesses. Home building has, in the past, served to lead the country out of serious economic declines, and, it can do so again, if

given the proper stimulus. Unfortunately, the recently passed anti-recessionary tax cuts offered little assistance to small builders, or for that matter, to other small businessmen who face a continuing economic crisis.

Tax Measures Affecting All Small Businesses

A series of proposals which would liberalize the tax treatment of all small businesses was acted on favorably by the House Ways and Means Committee last year. These would be beneficial to small business homebuilders and we urge that your Committee recommend their enactment. These include:

(a) First Year Depreciation Allowance

Increasing from $10,000 to $15,000 the amount of property which may qualify for the additional first year depreciation allowance and elimination of the requirement that the property have a useful life of 6 years or more.

(b) Net Operating Loss Carryover

Increasing from 5 to 10 years the period over which net operating losses may be carried during the first 10 years of operation of a business.

(c) Close of Taxable Year on Partner's Death

Permitting the closing of a partnership's taxable year as of the date of death of a partner, instead of waiting until the close of the partnership's taxable year or the date his interest is sold, exchanged or liquidated.

(d) Subchapter S Corporations

Liberalizing the rules governing Subchapter S corporations. This includes increasing the number of shareholders from 10 to 15; permitting certain trusts to be shareholders; not counting the estate of a deceased spouse as a shareholder for purpose of determining the number of shareholders of a corporation; and termination of a Subchapter S election only upon a new shareholder's refusal to consent to the continuation.

The Honorable Gaylord Nelson
July 23, 1975
Page 3

Tax Measures Affecting Small Businessmen-Home Builders

With reference to Subchapter S corporations, we should like to suggest a further liberalization relating directly to small businessmen engaged in construction and operation of residential rental property. Under existing law, income derived by a small business corporation from residential rental property is treated as passive investment income, thereby disqualifying the corporation from Subchapter S treatment (where such income represents more than 20% of the gross receipts of such corporation). We believe that real property held in the conduct of the business of renting real property is property actively used in the conduct of a trade or business, and the income derived from such property should not be treated as passive income. Accordingly, we recommend that existing law be changed so as to permit small corporations engaged in the active operation of residential rental property to utilize the provisions of Subchapter S.

An additional tax incentive to home builders would be the extension of the investment tax credit to the construction of residential property. An increase in the investment tax credit was included in the Tax Reduction Act of 1975 as one of the major means of restoring the nation's economic health. However, its principal effect was to stimulate large industries' investment in plant and machinery and it is of little use to home builders.

We urge that the Committee endorse a proposal offered by Representative Henry Helstoski and considered during the mark up of the Tax Reduction Act by the House Ways and Means Committee. It would provide for a two-year period an investment tax credit for the construction of new residential units, whether single or multifamily. The credit would be based on a builder's actual construction costs, including materials, labor, and subcontractor costs, but not land, incurred during the taxable year. Such a credit would stimulate the construction of new residences and help revitalize the home building industry.

While this idea might appear a costly one, we believe that the new construction it would stimulate would be sufficient to more than return to the Treasury any tax loss. For each 100,000 new single family homes that would be constructed as a result of this incentive, we estimate that $405 million in additional Federal taxes would be generated directly as a result of the 370.6 million man-hours of employment these units would create. In addition, this activity would generate an indirect impact on the rest of the economy as a result of purchasing of materials and other supplies and services amounting to $405 million in Federal taxes. If construction activity were increased by 500,000

The Honorable Gaylord Nelson
July 23, 1975
Page 4

units above the present estimate of 1.1-1.2 million units to be built in 1975, direct and indirect Federal tax revenues would be approximately $4 billion. An increase to this level of activity of 1.7 million units is realistic and achievable. In fact, it represents the number of units needed just to meet new household formations each year.

We also recommend adoption of a proposal for the creation of an investment account for dealers in real estate. Such proposal would provide that a person who was a dealer in real property could receive capital gains treatment on the sale of real property held for investment provided the following requirements were satisfied: (1) within 30 days after acquisition, the taxpayer elects to identify the real property as property held for investment; (2) the taxpayer refrains from improving the property through expenditures of more than 15% of the market value thereof; and (3) the taxpayer holds the property for more than 18 months.

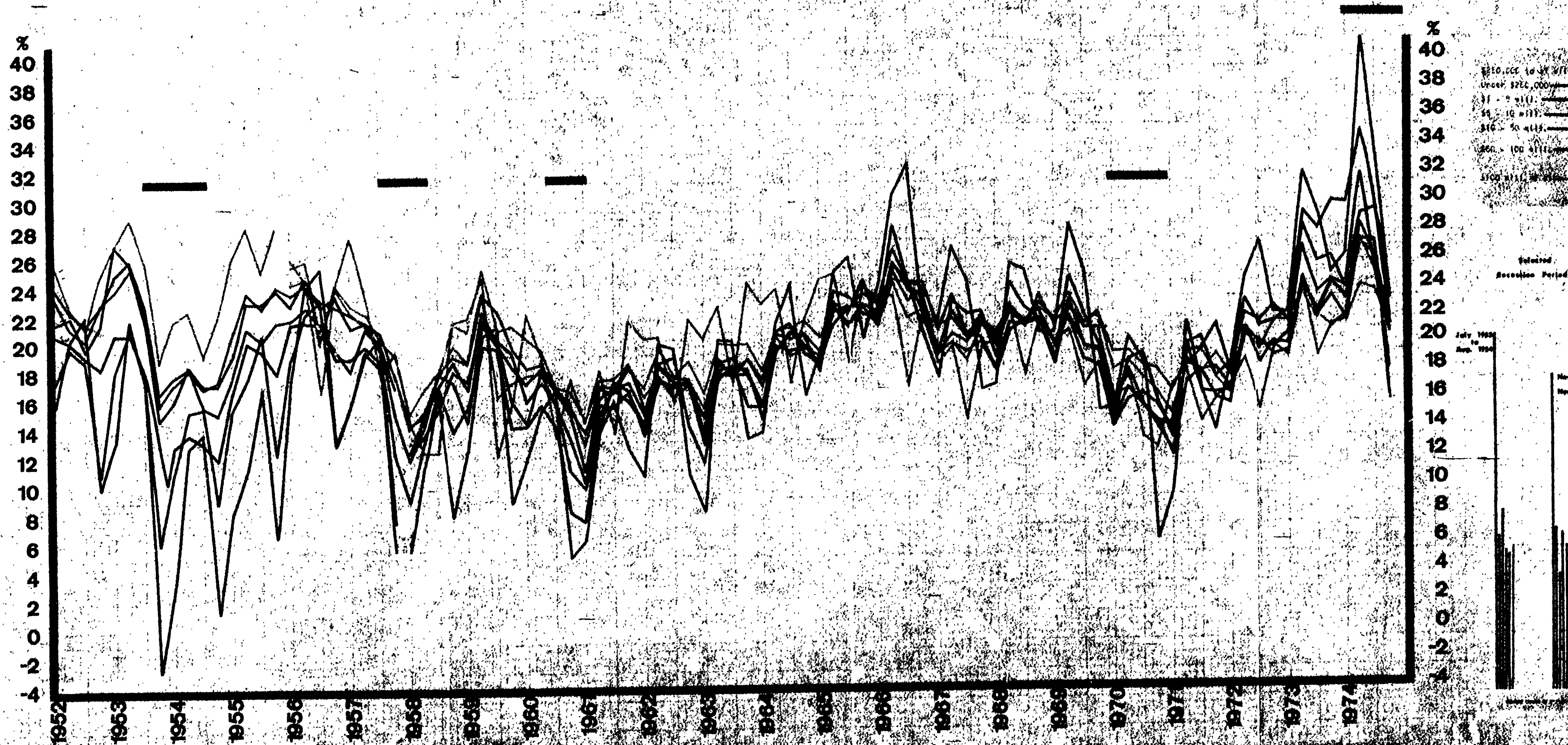
The home building industry has suffered longer and more severely during the current economic downturn than any other industry. Yet, it seems housing is still being used as an anti-inflationary weapon while other industries are receiving stimuli by tax laws in order to reverse the nation's recession. This is extremely unfair to the many thousands whose housing needs are unmet, but it is a grave economic injustice to the industry and the many small businessmen who comprise the large majority of our nation's home builders.

Sincerely,

Nathaniel H. Rogg
Executive Vice President

BEST COPY AVAILABLE

ANNUAL RATES OF PROFIT ON STOCKHOLDERS EQUITY
BY ASSET SIZE - BEFORE TAXES



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