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VOLUME AND STABILITY OF PRIVATE INVESTMENT

REPORT

OF THE

SUBCOMMITTEE ON INVESTMENT

OF THE

JOINT COMMITTEE ON THE ECONOMIC REPORT
CONGRESS OF THE UNITED STATES

PURSUANT TO

S. Con. Res. 26

PRESENTED BY MR. O'MAHONEY

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LETTERS OF TRANSMITTAL

To Members of the Joint Committee on the Economic Report:

Transmitted herewith is the report of the Subcommittee on Investment. This is the report of the subcommittee appointed in accordance with Senate Concurrent Resolution 26 to study—

(1) The problem of investment, including, but not limited to, (*a*) the role of investment institutions in the investment markets, in industry, and in the economy generally; (*b*) changes in sources of investment funds and the reason therefor; (*c*) availability and character of investment funds for national, local, and independent enterprise and the effect of such investment or lack of investment upon different classes or size groups in industry; (*d*) and needs, by industry, for various types of capital.

In following out the directive of Congress your subcommittee first sought to obtain factual and background material already available in various departments of the Government. Early in October a joint committee print of materials assembled by the staff of your subcommittee was distributed (1) to members of the joint committee; (2) to those who might be called upon to appear before your subcommittee; and, (3) within the limits of supply, to others interested in the investment problem. The volume entitled "Factors Affecting the Volume and Stability of Private Investment," contains chapters summarizing current thought and evidence on such matters as the role of investment in the 1929 depression, debt versus equity, the current position and financial problems of small business, taxes, depreciation, etc.

Your subcommittee held two sets of hearings, the first on September 27, 28, and 29, the second from December 6 to 16, inclusive. At the former there appeared selected representatives of small, intermediate, and large business to discuss what, in their judgment, constituted the nub of the investment problem, what types of further inquiry they considered useful and instructive for your subcommittee to pursue. At the latter your subcommittee heard representatives of insurance companies, investment banking, industry, labor, and others. It also met with the Small Business Advisory Committee of the Department of Commerce.

In transmitting this report we wish to express our appreciation to the numerous people, both inside and outside the Government, who assisted the subcommittee. We are especially indebted to Dr. William H. Moore, economist, and Mr. David E. Scoll, special counsel for the subcommittee, for their services.

JOSEPH C. O'MAHONEY,
Chairman of the Subcommittee on Investment.

MARCH 20, 1950.

To the Congress:

Transmitted herewith is a report of the Subcommittee on Investment of the Joint Committee on the Economic Report. This report

is one of four studies which have been prepared under Senate Concurrent Resolution 26 (81st Cong., 1st sess.), and represents the views of the subcommittee conducting the investigation. It is to be regarded solely as the presentation of a point of view by the subcommittee and does not in any sense represent a point of view or recommendations by the full committee. The subcommittee's findings will be given consideration by the full committee when it assembles to review the reports of the four studies authorized under Senate Concurrent Resolution 26 (81st Cong., 1st sess.).

JOSEPH C. O'MAHONEY,
Chairman, Joint Committee on the Economic Report.

MARCH 23, 1950.

VOLUME AND STABILITY OF PRIVATE INVESTMENT

INTRODUCTION

That capitalism and communism are now locked in an international struggle is recognized by all. This conflict of ideologies is the root of all our serious international difficulties. If there is to be a third world war this ideological conflict will be its cause. The solution of the conflict by peaceful means is the hope of all peoples who believe in individual freedom.

Capitalism is the economic system developed by the peoples who believe in individual freedom. Capitalism as a system and freedom as an ideal are dependent upon the diffusion of power in the making of decisions which involve the people's energies, their resources, and the order in which their wants are to be satisfied. One of the requisites to the attainment of such aims is that the direction of investment be left largely to individuals and that management, so far as modern conditions permit, be left to owners. Testimony produced at the hearings of the subcommittee points again to the tendency for private investment to be made less and less in terms of owner-management and more and more in terms of debt or of the equity securities of safely established concerns where management is divorced from ownership. When the expansion of private investment takes these forms the area of owner-management is contracted and control of the economy becomes concentrated either in private or public management groups. Concentration of power in private groups leads inevitably to pressure for expansion of the powers of government.

To strengthen the capitalistic system, or as it might better be called the system of private property, it is necessary to foster the investment of capital in private ownership under private control—private control as distinguished both from government control and from control by hired managers. The distinction between individual ownership and control, on one hand, and control by groups, on the other, must be kept clearly in mind if the danger of communism is to be clearly apprehended. Communism, for example, is an extreme form of collectivism managed by a government which feels compelled to enforce its decisions by police state methods.

There are, of course, other forms of collectivism in the modern world. One of these is that represented by ownership of large industrial empires by large numbers of individuals who do not themselves exercise directly the usual powers and authority inherent in ownership. This sort of industrial collectivism has been a necessary development of scientific and technological progress. Many of the commodities which the modern world demands and most of the tools which produce

these commodities are for the most part beyond the resources of individuals to own and manage as a private owner manages his own private property.

The dilemma of the modern capitalistic system calls for a reconcilement of the economic forces driving toward more and more central power in the economic field and the avoidance of its corollary of expanded power in the field of government. The expansion of private ownership and private management offers one approach to the solution of this dilemma.

If we wish to preserve and stabilize the system of private property it is necessary to understand the plain economic facts of the world in which we live. These facts were illuminated at the investment hearings. One of the most important is that private savings in the United States have reached the highest level in history and are being held primarily by a multitude of savers each of whom owns a comparatively small sum. In other words, although there are many more well-to-do people in the United States than ever before, their holdings and the circumstances in which their savings are held and used are such that they do not furnish the venture capital without which an expanding private economy of owners can be maintained. The savings of the little people are not being channeled into new ventures because the system by which that flow could be directed has not been established. The consequence is that the multitude of little savers, seeking safety, put their funds into institutional reservoirs by which, in turn, they are invested in debt securities of large enterprise.

Wealthy savers, likewise, tend to place their savings in safety-first securities. Testimony before the committee showed, for example, that a growing proportion of private capital is tied up in trusts which ordinarily do not invest in equity securities. Thus, the capital stock of even seasoned industrial companies with long and uninterrupted earnings records and large assets have been selling at prices representing a low multiple of earnings. Meanwhile, those who seek to finance the expansion even of successful small companies are unable to secure equity capital, not only for the same reason as the large and successful enterprises, but also because there is no system to direct the flow of equity capital from small investors to them.

Representatives of small businesses appeared before the committee suggesting legislation by which in some degree Government should insure, or guarantee, loans to small business. The statistics before us reveal that with total savings at an all-time high in 1948 the number of firms in operation was also at an all-time high, but that the percentage of failures had begun to show a steady increase during the last 3 or 4 years (table I). At the end of the war, new firms entered the business field at a rapid rate which rose from 11.7 percent (ratio of new to total equals 11.7 percent) in the first 6 months of 1944 to 23.7 percent in the first 6 months of 1946. Since that time the number of entries has been declining and the number of discontinuances increasing. The current situation is that although 394,700 businesses were established in 1948, the number of discontinuances amounted to 370,000.

TABLE I.—*Business failures in the United States*

[1935-39=100]

Year	Number	Liabilities	Year	Number	Liabilities
1934	102	148	1942	80	45
1935	104	138	1943	27	20
1936	82	90	1944	10	14
1937	80	81	1945	7	13
1938	109	110	1946	10	31
1939	125	81	1947	29	98
1940	116	74	1948	45	138
1941	100	60	1949	78	165

Source: Computed from Dun & Bradstreet data.

Meanwhile private investment, as distinct from Government investment has been such as to maintain a high level of employment. Nevertheless, unemployment figures have been rising. It is evident that the maintenance of maximum employment and the maintenance of free competitive independent business depend upon the investment of private capital in business and industry. This in turn means that unless the machinery is devised to channel the capital of the small savers into the ownership of business and industry, there will be an increasing dependence upon large concentrated business and industrial units on the one hand, and upon Government on the other.

This in turn explains the demand which arises for greater participation by Government in the financing of little and local business. When the crisis arises, those who are in distress, whatever the cause of their distress, turn to Government for aid when they cannot provide it for themselves. Various proposals for meeting the need for small business financing, were suggested to the committee, as will appear more fully later. Some of these proposals, largely as a result of the hearings of this committee, are already taking definite form. The Metropolitan Life Insurance Co. has established a division of small business loans; the Chase National Bank of New York has set aside $10,000,000 for distribution among applicants needing only comparatively small sums. Other insurance companies and banks are considering the same type of action. A bill has been introduced in the Senate to expand the lending powers of the Reconstruction Finance Corporation, and another has been introduced to establish a private capital banking system under the supervision of the Federal Reserve System.

Witnesses before the committee have emphasized the need for tax reform in order to promote investment. It is recognized by the committee that the Federal Government must have huge revenues to discharge the obligations which it cannot avoid if the struggle for world peace is to be continued, national defense maintained, and the obligations of past wars discharged, to say nothing of the normal expenditures of government needed to promote the civilian economy. Since the capitalistic system can be strengthened only by expanding the area of what we call free competitive enterprise, the Congress should study tax levels and tax measures with a view to their revision so that to the largest extent possible the tax system may stimulate the formation and expansion of private business without sacrificing the revenue the government must have to perform the functions it cannot avoid.

Such a proposal, for example, would be an amendment which would encourage the formation of private development corporations. Under the present law regulated investment companies have certain advantages by reason of the capital-gains tax which would not be open to development corporations investing in equity securities. It has been suggested that if suitable provisions were made to enable research and development corporations to qualify under sections 361 and 362 of the revenue act as regulated investment companies and still permit stockholders in such companies to be treated as if they were direct owners of the portfolio securities of the concerns in which funds were placed, individuals might be encouraged to invest a portion of their savings in the common stocks of such companies. Again, since it is represented that the owner-managers of successful small companies are frequently induced to sell out to large units in order best to meet the estate tax, thus promoting concentration, the maintenance of independently owned units would be encouraged by tax reform which would mitigate the liquidation problems of family-owned businesses.

These and other suggestions, which will be discussed later in the report, are worthy of closest study by Congress with the view of granting such abatements of tax liability as would tend directly to stimulate the investment of private capital in expanding private business. This seems to be the great need of the time. It is true that little businesses, and local businesses, do not appear to have access to long-term capital such as is now essential in the development of new enterprises. Short-term loans, available from local banks, are not an answer to the problem, and Government loans through an agency like the RFC would not seem to be the complete answer because such loans must be administered at too great a distance from the communities in which the venture operates.

The answer to centralization is decentralization. This is just as true of business as it is of government for, unless centralization of business is checked, centralization of government cannot be checked. One answer to communism or socialism is the encouragement of decentralized capitalism and this can be brought about by a deliberate policy of government designed to foster the investment of private capital in privately owned, decentralized, competitive businesses.

The argument of the Communists is that capitalism cannot provide the opportunity for participation by all individuals in an expanding private economy. It should, therefore, be the first objective of capitalists and of the supporters of a free economy to broaden the scope of ownership and enlarge the sphere in which free competitive enterprise can create more opportunities for employment and for profit. The policy of a free government should be to save the system of private property by curing the abuses of capitalism. The policy of totalitarianism is to destroy the system of private property. Such destruction would be aided by any abuses of the capitalistic system that may be left unreformed.

The Subcommittee on Investment, in substance, asked the witnesses who appeared before it the following question: "What is the best method of promoting the investment of private capital in private business and industry, and what should the Government do to stimulate the use of such funds in free private, competitive enterprise?" The answers are summarized in the following materials.

Summary Findings

I

The subcommittee sought and obtained from leading life-insurance companies and the Life Insurance Association of America their cooperation in making available statistics showing the composition of life-insurance portfolios and life-insurance investment policies. Life-insurance assets at the end of June 1949 aggregated approximately 57.2 billion dollars and have been currently increasing at the rate of approximately $3,000,000,000 a year.

The New York companies account for an overwhelming proportion of the assets and make by far the largest percentage of the loans made by life-insurance companies to individuals and companies scattered throughout the country.

Yet despite the variation in size of loan, none of the 17 major life-insurance companies with assets of approximately $42,000,000,000 made any mortgage loans to business for amounts less than $25,000. Out of a total of $331,000,000 of mortgage loans to business in 1948 made by the major United States life-insurance companies, only $58,900,000, or less than 18 percent, were made to companies with assets of $200,000 or less.

II

The most popular form of business investment by the life-insurance companies in the past few years is the so-called direct loans or, as it is sometimes called, the private placement. In 1948 the 17 major United States life-insurance companies held a total of $7,041,459,000 of such loans. Of this amount, $4,275,925,000 had been lent to industrial and miscellaneous companies. The remainder was lent to railroads and public utilities.

Yet during 1948 only three such loans were made by the 17 major companies to industrial corporations with assets of less than $500,000. Out of the total of $1,879,504,000 of industrial direct loans made to 505 borrowers in that year, only $173,084,000, or barely 8 percent, was loaned to corporations whose individual assets were less than $10,000,000, though they comprised 187, or 37 percent of the total number of borrowers. Corporations whose individual assets were $20,000,000 or over accounted for 79.66 percent of all direct loans made by the 17 major companies during 1948. The number of borrowers whose individual assets were less than $1,000,000 who received direct loans from these 17 companies was 8.

III

The subcommittee was told, moreover, that loans to new enterprise are excluded from the realm of possibility on the part of these insurance companies unless "the new enterprise has a lot of physical value and a mortgage can be upon it." "As to unsecured loans," the companies, "are bound by certain restrictions of the law that an unsecured obligation of a corporation, the earning power must have been such as to cover the interest charge one and a half times for 5 years on the average and including the last year. Now there are a lot of loans that cannot conform." No new venture, no matter how meritorious, can even be considered (hearings, p. 170).

IV

Representatives of an insurance company with nearly $8,000,000,000 in assets testified to the subcommittee:

> We are not offered small loans, if you mean by small loans, loans of under $100,000. Very few come to us (hearings, p. 179).

Speaking of large company loans, a representative of the same company said:

> We are looking for loans, large and small, and you can imagine what a relief it is to get one of those. If we can get $50,000,000 out of one of those, it takes quite a lot of headaches off of these fellows [the financial officers of the company] (hearings, p. 181).

The publicity given through the daily press to such testimony on the part of these insurance officials led one of them to write the chairman of the subcommittee 4 days later:

> You will be interested to know we have had literally hundreds—and I do mean hundreds—of letters from all over the country making inquiry—about a program for dealing with small-business requirements (hearings, p. 495).

If it were not already obvious that there is an unsatisfied demand for small-business loans, the immediate and overwhelming public response to the testimony of these officials would be sufficient to demonstrate it.

V

Less than one-half of 1 percent of the total admitted assets of companies representing nearly 90 percent of the total assets of all legal reserve companies are invested in common stock equities of American industries. Even this, we may be sure, is invested only in stocks of established, large companies. Assets of this group of insurance companies increased $3,200,000,000 and, with normal turn-over, new investments acquired during 1948 amounted to $10,000,000,000. In face of these staggering sums, the companies taken together acquired only $25,000,000 of common stocks in American railroads, public utility, and industrial concerns. Though the experience of companies in those States which permit limited investments in common stock have apparently been quite successful, the place of common stocks in insurance investments is obviously quite unimportant whether by reason of law, tradition, or practice.

VI

The subcommittee was told that—

> the percentage of over-all wealth of the United States held in fiduciary hands is very high indeed. For example, in New England today 45 percent of the wealth is in fiduciary hands such as trustees, trust companies, investment companies, insurance companies, savings banks. colleges and other educational institutions, foundations, etc. * * * such sources of wealth could only be regarded as frozen as far as investments in other than standard high-grade investments are concerned (hearings, p. 447).

VII

Testimony presented to the subcommittee emphasized that new outside money for business uses is being obtained more and more by going into debt.

In 1946, over 68 percent of all new corporate financing was by the use of debt securities. In 1947, it was over 76 percent, and in 1948 over 84 percent. Most of these debt securities were purchased by insurance companies and other institutional buyers. In 1946, common stocks represented about 12 percent of new corporate financing, in 1947 about 10½ percent, and in 1948 only a little over 8 percent (hearings, p. 665).

VIII

Though common stock sales have been small in postwar years, the burden of over-all debt is not today serious. Substantial additions to equity have been made through the retention of earnings, postwar interest rates have been low, and long-term corporate debt has increased little since 1929. Interest charges of corporations, unincorporated enterprises, farmers, and landlords have consequently been earned with a greater margin of protection than ever before.

IX

Fundamental changes have taken place in the sources and flow of the people's savings. The words of a competent witness before the subcommittee point to the problem arising from these changes.

A vast portion of our national income, after taxes, has accumulated in the hands of little people. More wealth in the hands of little people is fine * * *. It is natural that these people should seek safety first with their first savings. However, it is unfortunate that circumstances have coaxed such vast sums into so-called safety first, with such little willingness of the owners to risk even 10 or 20 percent of their savings to own and finance American industry, the very industry that produced these savings. Such policies have caused a rapid flow of vast sums into our insurance companies and savings institutions. They in turn must place these funds in safety-first channels. Can they continue to find safety first for such vast and increasing funds? Surely if such trend continues, there will be no such thing as safety first, for the simple reason there will not be sufficient risk capital down below to provide the safety (hearings, p. 666).

Recommendations

From the evidence submitted to the subcommittee it seems clear that one of the important questions facing the American people today is to determine what steps can and should be taken to preserve an open door for investment in little and local business in terms of ownership as well as in terms of debt. That problem is paramount to the development of a steadily expanding economy.

On the basis of information before it, the subcommittee is impelled to make two over-all recommendations directed toward that end.

I

The subcommittee recommends prompt action on the part of Government to provide aids or supplemental channels for capital loans and equity capital to small enterprise. These measures might take any one of several forms but the subcommittee feels that the present facilities for making this type of funds available to small business are inadequate.

The alternatives suggested to the subcommittee included:

(*a*) Creation within the present banking system of specialized capital institutions empowered to make long-term loans or purchase the securities of small- and medium-size firms. Some type of tax incentive may prove to be efficient inducement.

(*b*) Government sponsorship of a system for spreading business risks through contributions to what might be called an insurance reserve fund covering business loans and/or business equities under appropriate safeguards.

(*c*) The cooperation of existing institutions reexamining their traditional policies in the light of contemporary needs and circumstances.

(*d*) Amendment of the Reconstruction Finance Act to permit more effective aid in dealing with the specific problems of small business.

(*e*) Establishment under governmental supervision of a system of cooperatives to supply small-business capital needs.

The subcommittee recommends that these alternatives, particularly the apparent need for specialized institutions, be given congressional study at the earliest possible opportunity.

II

The subcommittee recommends an early systematic review of present tax laws with special emphasis on their impact on small business and on the availability of equity capital generally. The present tax system was largely devised to meet the special fiscal needs of depression and wartime. Our objective now should be for a tax system geared to increased production, to development and stabilization of little and local business and the encouragement of equity financing.

Specific tax provisions which the subcommittee believes should be included in such a general review of tax matters are illustrated by the following. The subcommittee, basing its judgment upon the limited evidence before it, recommends:

(*a*) That the special tax advantages of small corporations be clarified and redesigned to increase benefits to the very small and to extend them to intermediate-size corporations.

(*b*) That added flexibility be permitted administratively, and if need be legislatively, in the rate at which businesses are allowed to write off physical assets for income-tax purposes.

(*c*) A thorough and complete study of the application and effect, real and feared, of section 102 of the Internal Revenue Code dealing with unreasonable accumulation of corporate profits.

(*d*) That provisions for the carrying forward of net losses be liberalized.

(*e*) That venture capital corporations be treated as investment companies for tax purposes.

(*f*) That steps be taken to mitigate the liquidation problems of family-owned businesses in the event of death of the principal family stockholder, by, for example, exempting from estate taxes the insurance proceeds of policies specifically taken out to pay such taxes.

While the question of so-called double taxation of dividends was frequently mentioned the subcommittee feels unprepared to make a recommendation on this issue without further study of the incidence and burden of taxation. The opportunities which tax-exempt secu-

rities afford for tax avoidance and shifting would be an important part of such a study. The subcommittee accordingly recommends a thoroughgoing study of the question of who actually pays the taxes under existing and prospective conditions.

Trends in Investment and Financing

Since the war a large portion of "personal" savings has gone into investment in tangible assets. During 1948 investment in assets of unincorporated business and farms increased 7.0 billion dollars while home purchases amounted to 6.6 billion dollars. Substantial amounts of business and mortgage debt were incurred, however, in financing these investments. Allowing for the increases in business and residential mortgage debt, the net additional amount invested by individuals in the ownership of residences was 2.5 billion dollars and in the inventories and facilities of unincorporated businesses and farms 5.6 billion dollars. During the same period 3.5 billion dollars of personal savings was added to the reserves which insurance companies hold for their policyholders and beneficiaries. The 2.5-billion-dollar increase in personal holdings of currency, bank deposits, United States Government bonds, State and municipal securities was precisely offset by a similar increase in consumer debt. In addition to the net personal savings thus accounted for, 1.8 billion dollars were turned over to corporations in exchange for their securities. While adding substantially to their personal ownership of tangible assets and their claims against insurance companies, the personal savers thus turned over only 13 percent of their savings to incorporated business through the purchase of new bonds and stock issues (table II).

Table II.—*Tangible and financial savings—Persons, unincorporated businesses, farms, nonprofit organizations, 1946 to 1948*

[Billions of dollars]

Item	1946	1947	1948	Total
Purchase of new homes	2.5	4.6	6.6	13.7
Increase in residential mortgage debt	3.2	4.1	4.1	11.4
Increase in equities in residences	−.7	.5	2.5	2.3
Investment in assets of unincorporated businesses and farms	4.3	1.8	7.0	13.1
Increase in business debt	2.6	4.2	1.4	8.2
Increase in equities in unincorporated businesses and farms	1.7	−2.4	5.6	4.9
Additions to private insurance and pension reserves	3.4	3.7	3.5	10.6
Increase in other liquid assets:				
Cash, deposits, U. S. Government bonds	11.6	6.5	1.4	19.5
State and municipal securities	−.3	.4	1.1	1.3
Corporate securities	.6	1.0	1.8	3.3
Increase in consumer debt—deduct	3.3	3.3	2.5	9.1
Personal saving applied to specified uses [1]	12.9	6.3	13.6	32.8

[1] Includes adjustment to personal saving concept.

Source: Securities and Exchange Commission and Department of Commerce.

Though the amounts which corporations obtained from individuals through the security markets were not large relative to personal savings, corporations in 1948 accounted for 25.9 billion dollars out of a total of $45,000,000,000 of gross private domestic investment. The distinguishing feature of the postwar period so far as corporate

business is concerned has been the reliance on retained earnings as a source of the capital required for postwar expansion. American corporations in the years 1946 through 1948 paid out 36 percent of their earnings as dividends compared with similar payments of 70 percent in 1929 and 76 percent in 1939. One-half of the funds invested by corporations in 1948 (13.2 billion out of 25.9 billion) were obtained out of retained profits. Other internal sources, including 5.5 billion dollars from depreciation funds, provided somewhat less than one-half the remainder. Bank loans, mortgages, the sale of stocks and bonds to individuals and banks made up the rest.

Thus when all forms of equity investment are considered the total amount invested since the war has by far exceeded any level previously known in American economic history. New products and new markets were developed from funds obtained (1) from research, advertising, and other expenditures wholly deductible from current receipts (thus in large part nylon, television, and many other new products); (2) from depreciation, depletion, and other capital consumption allowances (thus a substantial portion of new, improved, more efficient, capital-saving equipment); (3) from retained earnings; and (4) from sale of new capital stock issues.

The inducement to finance capital expansion by debt is partly the result of the high ratio of earnings yield to price for financing most common stocks. In that regard the period since 1947 has borne marked similarity to the years 1919, 1920, and other boom years in that stocks of long-established and successful American companies are selling at prices representing yields on current, as opposed to past or prospective, earnings of 6 to 13 percent. Indeed, the yield afforded by the earnings of all industrial common stocks when computed as a percent of average stock prices was 13.8 in 1948, 10.8 in 1947, as compared with 12.1 in 1920. Obviously the inducement to sell stock at such high yields is small as compared with borrowing funds at less than 3 percent from life insurance companies and other sources of long-term capital. By borrowing at 3 percent, earnings can be further pyramided on the stock already yielding 13 percent.

In spite of the relatively high volume of corporate debt financing since the war, the burden of business debt has never been lighter. The best single measure of burden of debt for the economy as a whole, as for individual debtors, is the proportion of current and reliably certain prospective income required to meet interest payments. For 1948 the dollar amount of net interest included in the national income was less than during the thirties and substantially less than in 1929 and 1930. Percentagewise, interest was only about one-fourth as important relative to national income as it was in 1929 and 1930. Interest charges of corporations, unincorporated enterprises, farmers, and landlords have been low enough to have been earned more than 14 times over. This compares with only three times in 1929. In large part the lightened interest burden is a reflection of generally lower interest charges.

The changes in public and private debt between 1929 and 1948 are, however, striking in several respects. Long-term corporate debt has increased but slightly from 47.3 billion to 49.6 billion dollars. Short-term corporate debt, it is true, has increased from 41.6 billion to 62.5 billion dollars. The farm debt of individuals has actually decreased from 12.2 billion to 10.5 billion while the nonfarm debt of individuals

has increased to 74 billion compared with 60.4 billion dollars in 1929. In striking contrast to these declines and moderate increases, publicly held Federal debt increased more than 1,300 percent from 16.5 billion to 216.5 billion dollars at the end of 1948. In 1929 publicly held Federal debt amounted to less than one-twelfth of all public and private debt; it now represents about one-half. Whereas net corporate debt at the end of 1948 amounted to 112.1 billion dollars, the net Federal debt stood at 216.5 billion or nearly twice the corporate long-term and short-term combined. While the burden of business debt has been lightened, war and depression have, as is only too well know, saddled the Government with larger debt problems.

While the burden of business debt remains light in comparison with that of the Federal Government, certain disturbing trends in business financing are noticeable. The current preference of corporations for debt financing and the declining reliance on sale of common stock in the market has already been noted. The preference of individual savers for investment in insurance companies and in fixed income obligations has already been noted.

Coupled with this natural desire for safety, there is, no doubt, some general lack of understanding on the part of the public of the advantages of common-stock ownership in established companies. One witness told the subcommittee:

> The attitude of the man holding savings determines whether it is going to be venture money or debt money. Ignorance and apathy are the two biggest deterrents to equity investments (hearings, p. 674).

One survey of public attitude toward various types of investment relied on by all witnesses is that made by the Federal Reserve Board of spending units with incomes of $3,000 and over. The survey reports that early in 1949 only about 8 percent of all such units owned some stock in a corporation open to investment by the general public. Of the spending units covered by the survey, 69 percent reported that they were against holding common stocks. The 69 percent opposed to the ownership of common stocks were divided about equally between those who regarded them as unsafe and those who indicated that they were not familiar with them.

The necessity for both business and Government to think in terms of a new class of investors is supported further by information on the distribution of personal income.

The proportion of personal income going to the very wealthy, traditionally the angels for new business, and the purchasers of common stock equities, has declined since 1929. Aggregate personal income, as estimated by the Department of Commerce, for 1946 was more than double that of 1929 (176.9 compared with 85.1 billions). Despite that fact the aggregate income reported for tax purposes by all who earned more than $50,000 decreased. It amounted to $6.0 billions in 1929, only 4.6 billions in 1946. When all persons are counted who reported net incomes over $100,000 (this does not include anybody getting less than $100,000) the total income reported in 1946 fell from 4.4 billion to less than one-half that amount or 2.1 billion. Finally, there were 513 returns reporting net taxable income of $1,000,000 or more in 1929. The aggregate income they reported amounted to $1,200,000,000 while in 1946 the aggregate income reported on 94 individual income tax returns in the $1,000,000 income class was less than one-tenth that amount.

The upper income classes for whom saving is relatively easier and risk investment a one-time tradition are, moreover, likely to turn to tax-exempt State and municipal securities as an investment outlet. Individuals held 8.9 billion or 43 percent of the 20.5 billion of State and local government securities outstanding June 30, 1949. From the advantages which tax-exempt securities offer by way of net yield to persons in high-income brackets, it is safe to suppose that a substantial part of the individually held tax-exempts were held by persons in the high-income brackets.

Statistics on distribution of income at the other end of the scale are unsatisfactory for the earlier years. It is significant that in 1946 when aggregate personal income was $177,000,000,000, those individual taxpayers with incomes under $10,000 who were required to file income-tax returns, that is after deductions (but before exemption), reported 115.1 billion gross income or more than 65 percent of all personal income. It is obvious that it is to this class that the economy in the future must look for a large part of all private investment as well as investment in business equities.

The present importance of life insurance companies as a channel through which this rising class of savers make funds available for long-term capital investment in industry prompted the subcommittee to inquire into the composition of life insurance portfolios and life insurance investment policies. The subcommittee's inquiry was facilitated by the information and analysis available through the industry's own statistical and investment research programs. The insurance research committee of the Life Insurance Association is also engaged in studies of savings and other aspects of investment, results of which should be extremely useful in future consideration of these problems.

Life-insurance assets at the end of June 1949 aggregated approximately 57.2 billion dollars and have been currently increasing at approximately $3,000,000,000 a year.

Those life-insurance companies which do business in New York State, and this includes nearly all of the large companies, make all of their industrial investments in the form of loans or bond purchases since they are prohibited by law from investment in common stocks. In New Jersey, Massachusetts, and some other Eastern States, the restrictions under which the companies operate are substantially similar if not identical with those of New York State (hearings, p. 172). On the other hand, smaller companies doing business in the South and West are permitted and in fact do invest limited amounts in common stocks. Two companies in the latter group indicated by their testimony before your subcommittee a very successful record for their common-stock investments.

Detailed investment portfolios were submitted by various companies corroborating the testimony which representatives gave the subcommittee. Mortgage loans on business and commercial property and loans to corporations generally, it was pointed out, require extensive investigation. Much information developed in making one such loan is not transferrable or of any great value in considering another loan. Residence and farm loans are consequently preferred as being less costly in this respect.

Since loans by insurance companies are limited to situations with a minimum of risk, loans of new enterprises are completely excluded

from the realm of possibilities. State laws which require a record of 5 years, earnings effectively prohibit loans to new enterprise except in those cases where the new enterprise has physical property upon which a mortgage may be taken.

The subcommittee was presented with evidence by the largest insurance company in the country that throughout the year 1948 only one business in the whole United States having a need for less than $100,000—the amount loaned was $29,000—obtained a business loan from one of the large insurance companies. This particular insurance company's new investments made during the year amounted, however, to well over $1,100,000,000. On the other hand, nearly one-third of the amount invested by this company during the year was accounted for by five large loans, averaging $63,000,000 each. At the end of 1948 this company had 707 business commitments aggregating $3,342,000,000 of which only 24 were for amounts under $100,000 each. These 24 loans accounted for less than one-half of 1 percent of the business loans this company had outstanding and not even two one-hundredths of 1 percent of the people's funds which this company controls. The preferred position which large business has in its access to such insurance company funds is all too obvious.

From the information supplied by witnesses who appeared before the subcommittee, it seems clear that the trend of investment practices in recent years has given rise to a serious unsolved problem. Long-term investment funds not invested in personal residences or personal business tend to flow to insurance companies or the established corporations with a safe record of earnings. Insurance companies and other trustees restricted by law, as well as by tradition, do not invest in common stocks or make capital loans to new or venture type enterprises. In practice they make very few small loans to business even though the funds which they control are sizable to say the least.

While commercial banking facilities take reasonable care of short-term business needs, there does not today appear to be adequate facilities providing long-term financial resources to small and intermediate business on a capital loan or risk basis. The resulting lack of long-term capital resources for small and intermediate business aggravates the inequality of opportunity between little and big business. This inequality tends toward a further concentration of economic power. As such it constitutes a serious weakness in the existing channels by which personal savings are made available for private investment.

Proposals for Financing Small and Intermediate Size Businesses

In the course of your subcommittee's study various proposals emerged for facilitating the flow of savings into capital for small and intermediate-size businesses. While some of the proposals have points in common, differences in approach, and in detail, justify the summarization of six different alternatives. Three of these were presented in the subcommittee hearings: (1) participation by insurance companies in loans made by local banks; (2) establishment of a Government-managed insurance fund covering small business loans; and (3) establishment of additional financial institutions regionally

within the Federal Reserve System. Other proposals considered by the subcommittee at the suggestion of various of its members include (4) an extension of the Reconstruction Finance Corporation loan and guaranty provisions as they involve the specific needs of small business; (5) a governmentally sponsored insurance fund covering not only loans but stock equities as well; and (6) establishment under governmental supervision of a system of cooperatives to supply small-business capital needs.

1. Representatives of insurance companies testified before your subcommittee that insurance companies would welcome the opportunity to participate in loans to small business on a basis of 90-10 with local banks. Some companies have recently been reported actively seeking more small-business loans.

Your subcommittee has taken the initiative in seeking means by which this cooperation may be further advanced. Representatives of insurance companies and the Small Business Advisory Committee of the Department of Commerce have been invited by the Subcommittee on Investment to participate in developing a general plan to put a portion of the funds of the great institutional investors within reach of small business. As soon as definitive results have been achieved, they will be reported with recommendations for action.

2. The Small Business Advisory Committee of the Department of Commerce proposes the establishment of a business loan insurance plan patterned after the Federal Housing Administration's method of insuring FHA title I loans. Under this plan commercial banks would be authorized to make loans up to a reasonable limit for each borrower and would be required to withhold a part of the interest charge which would go to a Government-managed insurance fund, out of which losses and all administrative expenses would be paid. Contributions to the fund would be credited separately to each lending bank and the balance held for use against losses in future loans. With satisfactory loss experience, the fund would become larger, the risk of the lender correspondingly reduced, and, it might be hoped, a more liberal lending policy safely adopted as the system progressed. The Small Business Advisory Committee points out that the plan would make use of no Government funds and should cost the Government nothing. It would place the responsibility for financing small business squarely upon the shoulders of the private banker. Any one of several presently established Government lending agencies might be authorized by Congress to supervise and control the program. The Advisory Committee feels that the Reconstruction Finance Corporation and/or the Federal Reserve System are probably best qualified for this assignment by their long record of lending to business and their already established country-wide organizations. The agency selected should be authorized to purchase these loans upon demand of the lending bank just as the RFC is now authorized to purchase real-estate loans through the instrumentality of one of its subsidiary corporations.

An important feature of the plan which the Advisory Committee recommends is that the Government agency selected to administer the plan should not have the power to review the loan before it is made. The local banker would have the sole right to make any loan he wishes so long as it met certain simple qualifications set forth in the law. The only review of the loan made by the Government agency, accord-

ing to the proposal, would be made when, and only when, a claim was made for a recovery of a loss by payment from the insurance fund. The review would be made to see that the loan had been properly made to conform with the regulations and the law.

A maturity of as much as 10 years would be provided in order to take care of long-term capital needs. An over-all limit on the amount of outstanding loans should also be set by Congress in the initial stages of the experiment. In order to cover costs and establish reserve for losses, an insurance fee of 1½ percent is believed by the Advisory Committee to be adequate, though they suggest that the determination of the rate requires careful study and a checking of experiences as the program is put into effect.

3. In exploring the needs for a suitable channel to fill the additional capital requirements of small business, Dr. A. D. H. Kaplan of Brookings Institution suggested to the subcommittee the establishment of a special capital institution or "bank." The proposed institution would call for regional banks established within the Federal Reserve System under policies laid down by Congress and administered by the Federal Reserve Board. Essential to the plan is the creation of an agency to which a commercial bank may readily refer a client whose needs go beyond current bank loans into the more specialized area of risk-bearing capital financing. Such banks would be permitted to purchase capital stock as well as the debt paper of an enterprise. The bank would furnish business advisory services as well as capital financing, working through the facilities of the local commercial banks in helping individual enterprises through their financial vicissitudes. Commercial banks in each Federal Reserve district would be permitted to subscribe a small percentage (up to 3 percent) of their capital and surplus in the regional bank. Under an extension of the plan, the capital bank would be permitted to place its debentures or rediscount its paper with the Federal Reserve bank.

Capital bank financing for small business would require a varied base—

Dr. Kaplan stated in further describing the proposal—

It could be supported by collateral, securities, accounts receivable, or certificates of indebtedness, secured or unsecured as the conditions warrant. Such a bank should be permitted to purchase capital stock as well as the debt paper of an enterprise. But it should have regard for the objectives of fostering independent ownership by the small enterpriser. To this end preferred stocks should be made callable by the issuing firm on a prearranged program. In taking the common stock of a borrower the bank as stockholder should be permitted to share in the earnings and in the increase of equity values; but there should also be provision for redemption of capital stock by the issuing firm within agreed time limits and adjustments of the transfer value of the stock, so that the management of the small enterprise may retain its full control of the venture. * * *

The proposal for a separate banking agency rests upon the conviction that the financing of capital operations of small enterprise involves a different approach from that which is normally taken in credit banking by a commercial bank of deposit. A capital bank that can serve small business must not be inhibited by orthodox banking traditions. * * *

A capital bank serving more than one community would have the advantage of diversification. Many a small-town or neighborhood bank is limited to retailers or to a limited line of industry for its credit market. The capital bank could encompass an area large enough to permit diversification of investments and thus have a better chance of offsetting losses with profit.

(4) Extension of the guaranty and direct loan provisions of the Reconstruction Finance Corporation Act to provide more effective financial assistance for small business may also be considered. Powers

of the Corporation in this field would be broadened to (*a*) permit longer maturities for business loans or guaranties involving small business and (*b*) by authorizing the Corporation to participate with local banks by agreeing to take over 90 percent of loans made for the benefit of small business enterprise. An important feature of this proposal seeks to reestablish the "character" loan as a major element in small business financing. The Corporation would be specifically authorized to give greater weight to management skills and earnings of small and new-business than to collateral security in the making of loans. Collateral available to the small-business man would, it may be assumed, ordinarily be adequate to cover the portion of the advance retained by the local private lending institution. The Reconstruction Finance Corporation, on the other hand, free from the collateral and restrictive requirements imposed on commercial banks would offer reasonable access to capital markets for efficient, successful, and independent small business.

(5) Another plan which came to the attention of the committee is also based on the general principle of Government insurance under the direction of a Small Business Finance Administration in the Department of Commerce as described in S. 1777, introduced in the Seventy-eighth Congress.

This plan proceeds on the theory that the present banking facilities do provide short-term loan facilities to the extent justified in individual cases, but that some legislation is required to provide adequate long-term loans to business, and also equity capital. The Administrator is authorized to insure long-term loans for any bank, trust company, or insurance company involving a principal obligation in an amount not in excess of 50 percent of the equity capital of the borrower with a maturity of not less than 5 nor more than 10 years, confined to manufacturing, processing, transportation, or mining companies. The insurance can be up to 90 percent of the total amount of the loan, but the bank or insurance company must assume the other 10 percent of the risk.

In the case of common and preferred stock, it is proposed to encourage the formation of investment companies registered under section 8 of the Investment Company Act of 1940, the purpose being to encourage small savers to make equity investments. By using the agency of an investment company, the risk will thus be spread between many different investments, and then reduced by the proposed Government insurance against loss. This is not to be a total insurance against loss, but only to the extent of 65 percent of the purchase price of preferred stock and 50 percent of the purchase price of common stock. Recognizing the interest of the Government in an expanding economy, the plan requires that both loans and stock issues in order to be eligible for insurance shall have been issued at least 50 percent for the purpose of making new capital available rather than for the purpose of refinancing existing capital or indebtedness.

The proposal suggests different insurance rates for loans, preferred stocks and common stocks varying in accordance with the character of the risk involved. While in the case of equities, insurance is authorized for corporations engaged in the purchase and selling of merchandise, the requirements are somewhat different from those in the case of manufacturing, processing, transportation, and mining. The plan suggests that "small business" be defined as any business enterprise having an equity capital less than $1,000,000.

(6) Still another approach to the problem of making capital available to small business calls for the establishment of cooperative institutions on the pattern of the Federal land-bank system or the banks for cooperatives which provide credit for farmer-cooperative associations. In each of these cases the initial capital was subscribed by the United States Government with provisions whereby the banks could be gradually transferred to the full ownership of their borrower-customers. Under the Federal land-bank system, for example, each borrower buys stock in a local association in an amount equal to 5 percent of the amount of his loan. The member's stock is pledged to the association as partial collateral for his loan. Member borrowers, aided by full-time employees as needed, manage affairs of the association and by their cooperative efforts aid in the servicing and collection of loans. In the event of delinquency or default of a loan this local assistance is of utmost importance in minimizing losses.

The system has (a) the virtue of local cooperative management and (b) by making borrowers collectively liable for each other's loans to the extent of their stock ownership render their obligations more attractive to distant lenders. The success of the Federal land-bank system in repaying all Government capital advanced and at the same time paying dividends to the cooperating owners suggests that the principle of cooperation as a device for supplying the capital needs of small business should be given serious consideration.

Your Subcommittee on Investment has not had the opportunity to investigate intensively any of these plans. The insurance plans raise questions about the insurability of business risks and the rate of premium necessary to establish a sound and solvent fund. The institutional plans leave unanswered the degree of control which such institutions must exercise in connection with equity and high-risk commitments. These problems and a multitude of details require a thoroughgoing study. The subcommittee commends the consideration of these and other possible alternatives by the appropriate standing committees of Congress.

Taxes and Private Investment

Much of the testimony submitted to the subcommittee was directed toward the general problem of tax levels. Recommendations for tax relief and reduction in Government expenditures uniformly admitted the necessity for defense preparations and other war-related expenditures. In all cases decreased taxes were advocated in order further to stimulate investment expenditures now though the level of the last 3 years represents the highest absolute and percentage level (relative to national income) ever attained in American history. None of the proposals submitted to your subcommittee dealt with the problem of what to do to stimulate investment when there are neither profits nor attractive prospects for profits. None dealt with the problem of stabilizing investment expenditures at a steady and sustainable rate of increase.

The frequency with which tax matters were mentioned as bearing upon the problem of investment, and particularly that of small business' health and growth, suggests to the subcommittee the desirability of an early systematic review of present tax laws by Congress. The present tax laws have grown up under special conditions which differ

greatly from what may be expected to prevail in the immediate future and particularly when peacetime conditions are reestablished. Many provisions of the law were added for fiscal reasons during depression or for fiscal and control objectives during wartime. It seems to the subcommittee that it is now desirable and appropriate that provisions of the law be reconsidered from the standpoint of their impact on business stability, the growth of monopoly, and the maintenance of full employment during more normal times.

While the subcommittee believes that much may be accomplished by a review of the incentive and deterring aspects of taxes, a word of caution seems appropriate. It is both easy and dangerous to expect that tax review or tax incentive alone will permanently solve any of the business or investment problems. Investment incentives incorporated into the tax law may stimulate business temporarily but may also lose their effect within a few years or degenerate into benefits for unintended groups.

Among the matters discussed before the subcommittee and illustrative of the type of specific tax provisions which the subcommittee believes should be included in a general review of tax matters are:

(*a*) The special problem of taxation of small corporations;

(*b*) The methods of determining the amount of depreciation of physical assets to be allowed in computing of taxable income;

(*c*) The influence of section 102 of the Federal Revenue Code on corporation policy in the retention or distribution of earnings;

(*d*) The offsetting of losses occasioned by fluctuating business income, commonly referred to as provisions for "carry-back" and "carry-forward";

(*e*) The treatment of venture capital corporations as regulated investment companies; and

(*f*) Mitigation of the estate-tax problem where the major asset of the estate is a closely held business enterprise.

(*a*) Tax preferences for small- and low-income corporations

Congress has already provided special tax advantages in the way of reduced rates to corporations with net incomes of not more than $50,000. The misunderstanding of what Congress has already done to favor such corporations is so widespread as to deserve special comment.

At present corporations with incomes of less than $50,000 are taxed at: 21 percent on the first $5,000 of income, 23 percent on the next $15,000, 25 percent on the next $5,000, and 53 percent on the next $25,000.

Although the marginal or bracket rate on the second $25,000 of income is substantially above the 38-percent rate applying to large corporations, the effective or average tax rates in this area rise gradually from 23 percent on an income of $25,000 to 38 percent on an income of $50,000.

Those who are not acquainted with the distinction between marginal and effective rates, as the staff of the Joint Committee on Internal Revenue Taxation points out, see the 53-percent bracket rate and believe that small corporations are being discriminated against as compared to larger corporations subject to the 38-percent rate. Since the first $25,000 is taxed at rates which average 23 percent, a higher marginal rate is necessary to bring the effective rates

smoothly up to the 38 percent applicable to corporations having income of $50,000 or over. The effective average rate of tax paid by corporations with incomes under $50,000 is in all cases less than the 38 percent levied upon larger corporations. The effective rates of tax applied to selected incomes under the present corporation net income tax as amended in 1945 is as follows:

Size of corporate net income:	*Effective rates*	Size of corporate net income—Continued	*Effective rates*
$5,000	21.0	$35,000	31.6
$10,000	22.0	$40,000	34.2
$15,000	22.3	$45,000	36.3
$20,000	22.5	$50,000	38.0
$25,000	23.0	$55,000	38.0
$30,000	28.0		

We feel that tax benefits for small companies are not only highly desirable but imperative and that the principle should be extended rather than abandoned or weakened. That present technically correct provisions of the Code appear too complex for general understanding suggests that a restatement or simplification of the so-called notch provision is in order. The flat exemption proposal offers one administratively feasible approach.

In any such review this subcommittee would recommend consideration of provisions extending the principle of progression to corporations having incomes somewhat larger than the present limit of $50,000. In view of the tremendous size of some of the larger domestic corporations and the necessity for encouraging not only small but intermediate size corporations, if the free enterprise system is to be maintained, it may be that the progression in corporate tax rates should be redesigned to increase benefits to very small corporations and to extend benefits to intermediate size corporations.

(b) Determining the amount of deductible depreciation

Representatives of small business strongly recommended to the subcommittee that steps be taken to liberalize and introduce more flexibility into the provisions and practices now employed in determining the amount of depreciation of physical assets allowable in computation of taxable income. Representatives of larger companies made similar recommendations.

Section 1 of section 23 of the Code now permits—

> a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
> (1) of property used in the trade or business, or
> (2) of property held for the production of income * * *.

Prior to 1934 taxpayers could generally determine the period over which physical assets might be written off for tax purposes. In 1933 a subcommittee of the Committee on Ways and Means noted that taxable net income of many corporations was then being wiped out entirely by depreciation deductions and that revenue requirements of the Government were, therefore, seriously suffering. In response to this problem, the Treasury adopted Treasury Decision 4422 and issued Bulletin F setting forth estimates of the useful life of various assets in various industries. The effect of these changes was to place the burden of proof for any departure from Bulletin F rates on the taxpayer. There is apparently a general feeling among businessmen today that the burden of proof in establishing estimated useful life

should be shifted again to rest upon the Government through the Bureau of Internal Revenue.

Depreciation deductions in 1948 amounted to about $5,000,000,000 for corporations alone, or roughly one-sixth of their net income before taxes. Depreciation eligible for income-tax deductions by individuals and unincorporated enterprises amounted to about 3.5 or 4 billion dollars for 1948. Corporate depreciable property is estimated at between 150 and 160 billion dollars as of the end of 1948, less accumulated depreciation reserves of approximately 55 billion dollars. The over-all average depreciation rate for corporations as a whole was about 3¼ percent in 1948. Any significant increase in the amount of deductions allowed would obviously cut into tax revenue at one point to be made up, of necessity, from some other source.

Among other possibilities, two alternatives were brought to the attention of your subcommittee. One of these alternatives was presented to the Eighty-first Congress by a member of this subcommittee in the form of H. R. 5696, title I, section 101. This section proposed a shortened period of amortization. A taxpayer who so desired might deduct amortization of his investment in facilities which add to or improve the efficiency of, productive capacity over any period that the taxpayer elects of not less than 5 years and not more than the normal depreciation period under the Internal Revenue Code. (In the case of assets having a life of 60 months or less, the period of amortization might be shortened to one-half of the depreciation period now allowable.) A certificate of approval would be required stating that the facilities involved conform to the objectives of helping to achieve maximum employment, production, and purchasing power. The section would be of benefit to all business but would be of primary benefit to small and new businesses in terms of helping them repay short-term loans and affording them operating capital when most needed.

A second alternative would permit heavier write-offs in the earlier years of the life of investment by encouraging or directing the Bureau of Internal Revenue to view favorably depreciation formula other than conventional straight-line methods. Under the straight-line method the write-off of an asset is spread evenly over the years of its estimated life. Under the declining balance method of computation, equal percentages of the undepreciated balance are written off each year, the effect of which is to provide for more rapid write-offs in the early years.

Still another suggestion was made to the subcommittee by a businessman who pointed out that use of a low-depreciation rate tends to delay the purchase of new equipment because the loss to be taken in scrapping a tool may constitute a substantial deterrent to its replacement by a more modern facility. The specific recommendation provided:

(*a*) A statutory option to amortize 25 percent of the cost of a new facility over the first 5 years, depreciating the remaining 75 percent (starting at the same time) on the basis outlined in (*b*) below.

(*b*) With respect to the remaining 75 percent, either (1) a return to the principle that the taxpayer may use the rate selected by him unless the Bureau can prove this to be erroneous or (2) a permissive allowance equal to 125 percent of the depreciation rate determined by the Bureau.

Finally, the fact should be remembered that depreciation charges, no matter how computed, can do no firm—whether large or small—much good unless it has net income. The real investment problem is how to induce additional business investment during the trough of a cycle when current operations show but a small gain, or even a loss, and the outlook is bleak. Accelerated depreciation may indeed encourage firms to plunge ahead with investment plans when sales and profits are actually or prospectively high. Economic statesmanship would seem better served by consideration of policies that would stimulate investment at other than boom periods.

(c) *Effect of section 102 on private investment*

Various witnesses mentioned section 102 of the Internal Revenue Code as an alleged deterrent or complication in investment matters particularly in the case of small or closely held companies in need of earnings retention.

In order to prevent unreasonable accumulation of corporate profits for the purpose of enabling stockholders to avoid imposition of surtaxes on individuals, section 102 provides an additional tax upon net income of corporations formed or utilized for the purpose of such tax avoidance. The added tax consists of 27½ percent on the first $100,000 of undistributed net income (as defined in the section) plus 38½ percent on any undistributed amount in excess of $100,000. The section, in its present form, has been in the Internal Revenue Code since the act of 1938 and, in principle, has been incorporated in the code since 1913. Since personal holding companies are dealt with elsewhere in the code, section 102 is of application only to corporations other than personal holding companies.

The fact that section 102 is a loop-hole plugging provision directed solely at attempts to avoid high individual surtax rates by withholding distribution of corporate earnings appears to be frequently overlooked. Directed as it is at tax avoidance, the section is not intended and no information submitted to the subcommittee indicates that it is being administered in a manner which would force the distribution of earnings contrary to the legitimate development of the business.

The broadly implied threat which businessmen and their advisers appear to read into the section suggests that some clarification of its applicability may be desirable. The desired clarification might be achieved by establishing through legislation or administration a presumption that retained earnings would not be deemed to have been accumulated for the purpose of avoiding surtax when and if actually invested in business-related plant and facilities. While the problem does not appear to involve large public companies with wide stock ownership, businesses with a small number of stockholders are entitled to standards by which to determine in advance whether, in retaining earnings and investing them, the penalties of section 102 are likely to be brought down upon the company.

The fact might be added that a Joint Economic Committee staff study is now in progress on the administration and significance to business of section 102.

(d) *Carry-forward and carry-back of net losses*

Under section 122 of the Internal Revenue Code a corporation experiencing a net operating loss in any year may apply this loss successively in reducing taxable income reported in the two preceding years.

In the case of such carry-back, a refund of tax may be called for. If the loss is greater than the net income of the two preceding years, the excess may be carried forward and deducted successively in the two succeeding years. The net income and current tax payable is thereby reduced.

The principles of loss carry-over have been recognized since the Revenue Act of 1918 except for the period 1933 to 1939 when the widespread possibility of carrying over depression losses necessitated suspension of the provisions for fiscal reasons. The provisions are founded upon a recognition that the accounting period of 12 months is often too short for the proper determination of income of new businesses and businesses whose profits vary from year to year. It is argued that for such businesses unless there is full provision for loss offsets, the Treasury shares fully in business gains but only partially or not at all in losses and that risk-taking is thereby made less attractive.

After study, both the Treasury Department and the House-Senate Joint Committee on Internal Revenue Taxation have favored an extension of the present 2-year loss carry-forward provision and a reduction of the loss carry-back period. While the carry-back procedure is useful in averaging business income, it does discriminate against new firms. The carry-forward provisions are not only administratively more feasible, eliminating the necessity of tax refunds, but are less discriminatory against new firms and new investments. The House revenue revision bill of 1948, which failed to pass both Houses of Congress, proposed an extension of the loss carry-forward provision to 5 years and a reduction of the carry-back provision from 2 years to 1 year. As an encouragement to venture investment and new business, the Investment Subcommittee views with favor the proposal to extend the loss carry-forward provision.

(*e*) *Special tax treatment of venture capital companies*

In the course if its hearings, your subcommittee was told of encouraging developments in various parts of the country in the establishment of new-type venture enterprises formed for the specific purpose of conducting and financing new processes or products or the advancement of existing industrial processes or products. In general the policy of such companies is to encourage the investigation, research, financing, and development of new enterprises. The companies do not expect to engage in the general business of purchasing securities with a view to distribution thereof or the underwriting of securities issued by other persons. Ordinarily such corporations take an equity position in the enterprise to be developed. In order to assure diversification, the percentage of its own capital and surplus to be invested in the securities of any one company or organization is usually limited. Projects for financing are carefully appraised in the belief that the aims and success of the research and development corporation can be accomplished only through the ultimate realization of satisfactory profits.

While venture capital companies are technically investment companies, the subcommittee was informed that they have difficulty qualifying under the revenue act as "regulated investment companies." The term "regulated investment company" is used in income-tax law to refer only to such companies as qualify for special tax treatment

under sections 361 and 362 of the revenue act. In general these limitations are that a corporation shall not be considered as a regulated investment company for any taxable year unless (1) at least 90 percent of its gross income is derived from dividends, interest, and capital gains on securities held less than 3 months and that less than 30 percent of its gross income is from such capital gains, and (2) at the close of each quarter of the taxable year at least 50 percent of the value of its total assets is represented by cash, cash items, Government securities, securities of other regulated investment companies and other securities limited in respect to any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer and not more than 25 percent of the value of its assets is invested in the securities of one or more issuers which the taxpayer controls in the same or related trades or businesses, and (3) distributes to its shareholders as taxable dividends, other than capital gains dividends, an amount not less than 90 percent of its net income for the taxable year without regard to net capital gains and complies otherwise with rules prescribed by the Commissioner of Internal Revenue.

If an investment company qualifies under the terms thus broadly summarized, it may be treated for tax purposes as a "conduit." This means that it and its stockholders are treated as if the stockholders were direct owners of the portfolio securities for purposes of dividend computation. The venture capital company, the subcommittee was told, may find difficulty in qualifying under the section because of the limitations in respect to holding not more than 10 percent of the outstanding voting securities of any one issuer. While the restrictions apply only to 50 percent of the portfolio, it is usually difficult for a venture capital company to qualify in respect to even 50 percent of its portfolio.

(f) The problem of estate taxes and small owner-operated businesses

One witness testified on the problems presented by the impact of succession and inheritance taxes on estates in which a small owner-operated business constitutes a major portion of the total estate assets. Apart from difficult problems of appraisal, the central issue is the achievement and maintenance of sufficient liquidity so that the tax may be paid upon death of the owner. If transfer is made from an owner to his wife and from her to other heirs in a short period of time, the problem may be acute. Sometimes the necessary liquidity is achieved through purchase and by merger into a large concern.

It was suggested to the subcommittee that the owner of such a business property be permitted (if insurable) to take out life insurance payable to the United States Treasury which would not be subject to tax at death but would be available to furnish liquidity necessary to take care of estate taxes. Such insurance would not be taxable to the extent that proceeds were used to pay estate taxes. The proposal is a variation of one sometimes made that the Federal Government offer estate tax payment bonds, an amount of which held by the decedent at the time of his death, would be excluded from gross estate for the purpose of computing Federal estate taxes. Under present law, insurance owned by an individual and premiums paid on it by him are taxable as a part of the estate.

The subcommittee is not certain how effective the simple solution of excluding insurance proceeds to the extent of the tax due would be in assisting the survival of small business, but believes that this and other suggestions should be given intensive examination by the appropriate standing committees of the Congress.

"DOUBLE TAXATION" OF DIVIDENDS

Many almost identical references were made in the hearings to the fact that corporations pay a "franchise" tax on corporate income, that interest payments are fully deductible, and that on dividends paid out stockholders pay a Federal income tax according to income level. The difference in treatment of interest and dividends has become more serious with the war-induced stepping up of both corporate and individual income tax rates.

Doubt has been expressed whether corporate income taxes in recent years have come wholly out of stockholders share or have come in part out of consumers. The majority report of the Joint Committee on the Economic Report in 1948, Senator Robert A. Taft, chairman, stated:

> In a seller's market it is possible to pass on to the consumer a considerable part of the corporation net income tax. Corporation taxes at best are only an indirect method of reaching the ultimate individuals who pay the tax, in part the stockholders and in part consumers (pp. 4, 5).

Furthermore, tax relief for stockholders stimulates investment only to the extent that scarcity of investment funds constitutes the neck of the bottle. It will only work to the extent that stockholders reinvest rather than spend, and only at such times as there actually are corporate earnings and dividends. It does not help to get more capital facilities constructed in times of depression when business is losing money or views the market outlook with pessimism. Yet that is precisely the time at which acceleration of investment is most needed.

Furthermore, dividend income constitutes only a small fraction of the total income of those who are now doing most of the savings—the brackets between $5,000 and $15,000. Such incomes coming to an overwhelming extent from wages, salaries, interest, rents, royalties and entrepreneurial withdrawals are, of course, taxed in many ways. Out of such incomes are paid not only income taxes but property taxes, many types of franchise taxes and especially excise taxes. Reductions in these are in most instances far more vital than a few additional dollars net on the small amount they receive as dividends. The fact that corporations pay a franchise tax for the highly valuable grant of powers which the State has given them and that their stockholders pay an income tax on distributed earnings is accordingly not extraordinary. If the grant of corporate powers is not worth the franchise tax, the latter can be avoided by businesses refusing to seek such special powers from the State, as indeed millions of business enterprises do.

The Treasury Department has indicated several expedients whereby such special situations as may be of serious importance might be mitigated or eliminated:

(1) Free the corporation from tax and adopt full taxation at graduated income-tax rates of capital gains realized by sale, gift, or bequest.

(2) Tax all corporate profits at rates applicable to individual stockholders in a manner similar to that now followed with respect to partnership income.
(3) Adjust for distributed profits at the corporate level—giving corporations a tax credit or deduction from taxable income for dividends paid, which would keep a tax on undistributed profits but would reduce or eliminate the corporate tax on distributed profits.
(4) Adjust at the individual level (*a*) by a withholding tax applied to all corporate profits, stockholders credited currently for the withholding on the portion of profits paid out in dividends, or (*b*) dividends received credit approach, exempting dividends from a substantial individual normal or first bracket tax rate or give stockholders an equivalent tax credit, or (*c*) partial exclusion of dividends received from individual taxable income and taxation of the remainder at regular individual rates.

In view of the variety of conflicting considerations your subcommittee feels that it has not had the opportunity to explore and examine the facts enough to warrant making any recommendations respecting the taxation of dividends. Particularly important to intelligent consideration of this problem is better understanding of the incidence and burden of taxation. The subcommittee accordingly recommends a thorough study of the question of who actually pays the taxes under existing and prospective conditions.

Venture-Capital Companies

One of the most encouraging facts developed in the hearings before your subcommittee is that free private enterprise is not only deeply concerned about the equity-capital problem, but experimenting with promising devices which may mitigate or even solve it. We refer to the fact that several venture-capital companies have been started in recent years, organizations such as the American Research & Development Co., Payson & Trask, Henry Sears & Co., Rockefeller Bros., Inc., and J. H. Whitney & Co. The statements of some of these companies included in the hearings well merit careful study.

Several special features of the operations of these organized venture-capital groups warrant brief mention. They specifically seek out new products or processes far enough beyond the very early laboratory stages to indicate commercial feasibility. They deal only with small firms, those needing less than a half million of new money, precisely the type of small business which in getting new funds must either put its assets in hock or endanger managerial control. These venture-capital companies avoid voting control, but look for top-quality management. They rarely buy out even a portion of old ownership. They provide not only new funds but new information, research, managerial counseling, and assistance.

Perhaps the outstanding experience of these companies, according to their testimony, is the great shortage not of funds but of soundly conceived projects. The International Bank for Reconstruction and Development emphasized that they have experienced this identical difficulty in their foreign lending operations.

On this point, J. H. Whitney & Co. stated that they had looked at approximately 2,100 propositions in the last 4 years. Thirty-five

percent were rejected at once because outside the firm's purpose, or clearly lacking in merit. Another 52 percent were rejected after initial review. A further 12 percent were rejected after full consideration. Only 17, or 1 percent resulted in investments, most in the range from one to five hundred thousand dollars, achieving 10 to 40 percent minority interest.

Of the 17 projects, 2 have been extremely successful, 5 moderately so, 2 will involve moderate loss, 4 may possibly involve total loss, 1 definitely is, and 3 are in early stages, incapable of appraisal.

These facts are illustrative of the difficulties which all organizations must face whether private or governmental, which seek to achieve constructive results in the venture capital field. They suggest emphatically a type of operation for which government is not only ill-adapted but almost adversely equipped to try to handle. As the location of plants demonstrated even during the last war, no public agency can allocate funds or select ventures with complete freedom from political influence. Government does not have the know-how required to make a venture enterprise succeed and lacks the fortitude to say "no" or to liquidate, especially at times when, or in areas where, such decisions might be fraught with administrative or political difficulties.

The conclusion of one of the witnesses before your subcommittee well bears repetition and emphasis:

> Despite the difficulties inherent in the investment of venture capital, if we may assume a reasonably congenial economic and political environment, we believe that the number of organized venture capital sources will continue to grow, and thus the American economy will prove again its ability to meet changing conditions and demands.

Concluding Comment

Your subcommittee had to choose one of two alternatives: either to do a highly superficial and extensive job, or to select one important yet limited phase for intensive examination. We chose to do the latter. We examined the supply of funds.

The total range of variables involved in the investment problem upon which information might have been sought is vast. As was stated in our preliminary volume of materials, they cover such vital questions as:

How long will this present unparalleled investment boom last? Will the total volume of business investment again collapse or will it stablize at levels adequate to maintain high level employment and sustained prosperity? If so, why? How?

Why is there such a great variability in private investment expenditures both for replacement and for expansion?

What facts or forecasts are used by businessmen in making their investment decisions?

When are investment plans and decisions made in relation to peaks of product demand: Before, after, or at the top of the boom in sales, production, and profits?

How long a time usually elapses between the time a decision to invest is made and the time when production from the facilities is available for meeting market demands?

What can be done by business and by government to minimize not only this variability in gross investment but the accompanying disturbance of economic stability generally?

If government is to act at all, at what point in the business cycle would its efforts most likely succeed in aiding private capital expenditures to stabilize at steady and adequate levels?

What are the dangers that such governmental efforts will be partly or wholly offset by discouragement of private investment plans and by the relaxation of incentive on the part of business managers to solve their own problems?

What portion of total investment is made by those entering into business for the first time? What encourages and what deters individuals to go into business? What is the minimum access to raw materials, skilled labor, markets, or funds required to make a start? In what industries? At what times? In how far does lack of freedom of entry in fact (as opposed to theory) constitute a factor limiting new enterprise? In what industries? Is access to know-how restricted? By whom? How?

What is the role of intermediary institutions in the making of direct investments or in generating added investment? In how far is the form of the investment contract a vital factor? Of what importance as a factor is the state of the market for old securities or that for new securities issued primarily for the purpose of shifting ownership in existing plant and equipment?

What are the methods and procedures whereby existing businesses decide to increase their own investment? Are they the same at all phases of the cycle? Where do plans for additional or new plant, equipment, and processes originate? Who screens them? How? Who makes the ultimate decision? How? What is the relative role played (*a*) by a persistent flow of orders in excess of ability to deliver, (*b*) by inventions, patents, and improvements in technique, (*c*) by increases or shifts in the population, (*d*) by discovery of new sources of supply, (*e*) by need or desire to get ahead of, or keep abreast of, competitors, (*f*) by changes in governmental tax, tariff, fiscal, or regulatory policies, (*g*) *by debt-equity ratios or liquidity or ready availability of funds*, (*h*) *by interest rates and costs of financing*, (*i*) by cost levels of labor, building materials, and equipment, (*j*) by prices and market prospects for the industry, (*k*) *by stock-market activity and the general business outlook*, and other factors?

While, to be sure, a certain amount of new information was incidentally brought to light on a number of these questions, only those italicized above were consistently placed under the spotlight of attention.

In doing this, your subcommittee in no way wishes to imply that the supply of funds is the only variable, or even the most important one, in the investment problem. As several witnesses pointed out, investment is not an end in itself, but only a means. No matter how much money is poured into a business, it will not survive unless it can attract steady patronage and find customers for its goods and services. The demand for plant and equipment is a derived demand. The growth of productive capital is adjusted not to the volume of money savings available for investment, but to the growth of consumption demand. As one of several witnesses pointed out:

> Over the long run, the problem of private investment is not one of shortage of funds, but rather a matter of assuring that profitable new investment opportunities will be present in sufficient quantity to provide a steady demand for such funds.

Your subcommittee found no general shortage of funds, even equity funds, except in the case of small businesses requiring between $50,000 and $500,000 of new money. Over-all relationships between capital in debt and equity forms now are not out of line with traditional or sound patterns. But should the current flow of savings increase its preference for debt forms and large business, serious rigidities and further economic concentration might result.

At no time has the total amount of per capita money income, per capita real income, private savings, and private capital investment been as high as in the last 5 years. Gross private domestic investment has risen from a low of less than $1,000,000,000 in 1932 to $45,000,000,000 in 1948, the recent spurt coming precisely at a time of very high postwar taxes. Inasmuch as investment is a powerful stimulus to business, it is altogether probable that postwar inflation would have been worse, had there been still higher levels of investment. Insofar as governmental tax and other policies provided healthy curbs to the postwar investment boom, they may have been beneficial.

At no time has the business birth rate been higher on the average than in the last 5 years and for no 5-year period, despite recent increases, have business failures on the average been fewer. In 1948 the number of business enterprises per thousand of population reached a new high. In the words of one of the witnesses, Dr. Clarence W. Fackler, representing the Investor's League, Inc.:

> Smaller and newer businesses have been able to raise equity capital with unusual facility because of the very favorable conditions under which they have operated since the war. Friends and relatives have been willing to invest money in many new small businesses to supplement Veterans' Administration guaranties because the risks seemed slight.

But postwar backlogs of need for new plant and equipment are beginning to be met. Business is becoming more competitive, the buyers' market reappearing. Venture capital is facing again such problems as restrictions on freedom of entry, patent practices, cartel agreements, monopolistic power tactics, obstacles to access to raw materials and know-how, the difficulties of entering an area already vigilantly watched over by oligopolies, and so on. Of peculiar interest is the fact that no witness ventured any opinion how decreases in excise taxes or tariffs might, if correctly timed, by affording stimulus to consumption, in accelerated measure stimulate investment expenditure. In economic literature this is called the acceleration principle. This, too, should be examined in detail.

Finally, if the flow of investment is to be spaced out over the lean years rather than merely increased in boom years, further inquiry and study should be directed to the factors determining the timing, not only of public monetary and fiscal policy, but of private investment. The distinction between postponable and nonpostponable investment, both public and private, raises questions of price, wages, and profit relationships and expectations necessary to bring forth decisions to proceed with either type. The subcommittee feels that subjects of this order together with the recommendations in the report of the joint committee last March calling for systematic information promptly available concerning investment plans are worthy of far more research by both private and public agencies than they have received to date.

(Signed) JOSEPH C. O'MAHONEY, *Chairman.*
PAUL H. DOUGLAS.
WRIGHT PATMAN.

SUPPLEMENTAL VIEWS ON PRIVATE INVESTMENT

With much of the majority report we are in full agreement, but we do not agree with the emphasis placed on some factors and the ignoring of others which seem to us of primary importance. In particular, it appears to us that undue emphasis has been placed on the role of life-insurance companies in the providing of investment capital and too little emphasis on the results of heavy taxation. In this supplementary statement, we intend to discuss merely the fundamental causes of the present situation and the general policies required to improve it.

The evidence before the committee appears to show that although there are large savings being accumulated by millions of Americans, there is a lack of money available for risk capital. This shortage applies to stocks both in large companies and in small companies. Very small companies which can be financed out of the savings of the man who operates the company or his family and his friends do not have much difficulty in securing a certain amount of money, but their sources also are soon dried up. Since the war the larger companies have obtained most of their risk capital out of retained profits. These profits are now decreasing and it is questionable whether they can continue in a buyers' market when the full force of competition is felt. Large companies have also been able and have sometimes preferred to finance through borrowing because of the low rates of interest and the more favorable tax situation which permits the deduction of interest paid. Obviously new companies, however, cannot be financed out of retained earnings, and the same is true of smaller companies operating in more competitive fields. In our opinion, the continuation of present conditions with a reduction of profits will seriously retard the expansion of plant and machinery so essential to the providing of more jobs, increased productivity and improved standards of living. In particular, it will check the development of new companies and small companies.

It may further lead to a demand for Government investments to make up the deficiencies of private expansion.

In addition to the shortage of equity capital, the small companies have difficulty in borrowing money on any long-term basis. The testimony is conflicting as to whether money is available on a short-time basis from the banks. We are inclined to think that it is available to the extent that the loans are sound, and we question the desirability of the Government stimulating short-term loans which are not sound. It does seem to us, however, that in the field of loans with maturities of from 5 to 10 years, there is a discrimination against small companies simply because no agency is equipped to make that kind of loan. Banks have always required a certain liquidity corresponding to the fact that their deposits are on a demand basis. Investment bankers and insurance companies are interested in long-

term loans of established companies, but are not much interested in such loans for small companies. There seems to be a need for some kind of institution which will provide such loans.

The testimony gives various reasons why private investors apparently do not invest in common stocks and other forms of equity capital. We believe that the principal causes are as follows:

1. High tax rates on middle and higher incomes. We believe that in the past most of the money provided for equity capital came from the middle and higher incomes. It has probably always been true that while savings were large on incomes under $10,000, savers in this group did not care to take a chance on losing their entire savings; in fact, probably they should not do so in their own interest. Such savings were invested in savings banks, insurance policies, or safe bonds. A man with more than $10,000 could afford to take a chance. If he had $50,000 or more he could select two or three different speculations with the good chance that one would more than balance the losses on others. Today a man with a net income of over $10,000 after deductions and exemptions pays at least 33 percent of the excess in taxes. In other words, the Government takes 33 percent of any profitable return and if he loses, he loses his own money. The man with $20,000 net income has to pay about 50 percent of any increase in income in taxes. Many of the small industries in towns throughout the United States were started by an energetic man with ideas backed by one or two wealthier men who saw him through to success. Many of the small companies thus begun developed into the great corporations of today. That process has almost come to an end because of taxation. At the same time, there is no machinery to channel the small savings of many small incomes into the same kind of financial support.

2. In addition to the high taxes on individual incomes, there is a discrimination against investors in common stocks because of double taxation. Corporations are first taxed 38 percent of their net income. Stockholders are further taxed on the dividends distributed. Investment in stock by income receivers in various brackets and the results obtained—assuming $10,000 invested, corporate earnings at rate of 10 percent of investment, and all earnings distributed as dividends—works out as follows:

	$10,000 income receiver	$50,000 income receiver	$200,000 income receiver
	After deductions and exemptions		
Stock investment	$10,000	$10,000	$10,000
Corporation profits 10 percent	$1,000	$1,000	$1,000
Corporation tax	$380	$380	$380
Profits distributed as dividends	$620	$620	$620
Tax at top income bracket	$205	$409	$508
Percent	33	66	82
Net after tax	$415	$211	$112
Net on investment (percent)	4.15	2.11	1.12

As compared to an investment in common stocks, an investment in bonds pays only one tax since the interest distributed is deductible by the corporation before calculating profits.

3. In the case of small corporations, the difficulty of securing investment capital from one or two persons familiar with the business and perhaps interested in the development of the community is increased by the tax difficulties which these companies have. We fully concur in the conclusions of the majority of the subcommittee relating to special tax provisions which should be included in a general review of tax matters. The more liberal rule in the writing off of physical assets should encourage investment in new machinery so necessary to increase productivity. The carrying forward of net losses and lower tax rates for corporations with less than $50,000 net income should be especially helpful to small business. The modification of section 102 and of the estate taxes on business owners should be helpful in making investment of small business more stable.

4. Part of the difficulty today is due to the unpopularity of common stocks. This is reflected in the survey reported in the majority report to the effect that 69 percent of spending units with incomes of $3,000 have reported that they were "against holding" common stocks. In the late twenties, probably 90 percent were in favor of holding common stocks. The unfortunate experience of the depression is still not forgotten and no doubt the tax laws which we referred tend to maintain the unpopularity. This same general feeling also makes it more difficult to obtain any relaxation of the State laws against investments by trust funds, savings banks, insurance companies, and the like.

What policies will tend to cure the causes of the present shortage of equity capital and long-term loans for small business?

It is useless to point out that the situation might be cured by a tremendous reduction in Government expenses and taxes. We are not likely to achieve such a reduction for some time to come. The total taxes today take more than 25 percent of the national income. Such a burden means inevitably a large percentage of income taxation on higher incomes, and there is not much hope that these percentages will be greatly changed. To some extent investors can take advantage of the capital gains tax rate, and we do not believe that this rate should be raised—certainly not on any legitimate investment in equities. In the long run, however, we will have to look to the savings of persons with lower income.

What happens to these savings?

To a large extent they go into institutions such as commercial banks, savings banks, and insurance companies. The majority report has devoted a great deal of attention to the fact that insurance companies do not make many loans to small businesses. The first question that arises is whether it is proper for them to do so. Those who have regulated insurance companies in the past have felt that they should invest only in the debt securities of well-established companies with an earning record. They opposed any investment in common stocks. We question furthermore whether a national institution of this kind is the best method of reaching the thousands of small-business men who may desire loans on their business. On the whole we would feel inclined to recommend that State laws be changed so that insurance companies may invest 10 percent of their assets in common stocks.

The same general principles applying to insurance companies also applies to savings banks. In this case, however, proper legal author-

ity might be given to encourage the development of loans to small business since the banks should be in a position to handle them on the local basis. We doubt if much progress could be made in this direction, however, without some form of Government guaranty on the longer term small business loan.

In the case of commercial banks it would seem undesirable to permit them to invest in equities. They might be encouraged to increase their long-term loans to small business. It seems unlikely again that banking habit will be changed without some form of Government guaranty. It would seem that the best reservoir of equity capital should be the direct investment of millions of small-income savers. Such investments could be directly encouraged by an elimination of the double taxation on common stocks. We believe that if dividends were partially exempt from income tax in light of the heavy tax on corporations, it would be a tremendous inducement to many persons to invest in such stocks. Various plans have been proposed, but we believe that much greater effect would come from a credit to the individual taxpayer such as he once enjoyed under the Federal income-tax law rather than a credit to the corporation for dividends declared.

We believe that a better public education by the investment bankers could substantially increase the popularity of common stocks.

We believe that some method should be developed by which the savings of private investors could be channeled into investment trusts or investment companies. A trust or company investing in many different enterprises would spread the risk so that no individual investor would suffer the entire loss of his capital through the failure of some one investment.

Finally, we believe we should study further possible plans for Government insurance governing both loans by banks, savings banks, and insurance companies, and the subject of equity investments by trusts or investment companies. Various plans along these general lines are outlined and suggested in the majority report. From every point of view it is desirable that there be a constant and steady increase in plant, machinery, and tools. The prosperity of the country depends on reasonably full employment, and we have nearly a million new young prople coming into the labor market every year. Likewise the prosperity of the country depends on the prosperity of the capital goods industry, and that can only be kept alive by a constant flow of investment capital properly balanced between equity investment and loans. As long as the savings are available, it should not be impossible to encourage their use in those channels most advantageous to the growth of a healthy economy.

(Signed) ROBERT A. TAFT.
CHRISTIAN A. HERTER.