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SMALL BUSINESS - PROBLEM OR OPPORTUNITY
Duane D. Pearsall

Thank you, Mr. McKinney. Mr. Chairman, distinguished guests, and distinguished members of the financial services community.

On behalf of small business, we sincerely appreciate the opportunity to express our needs and our future needs in financial support if we are to fulfill our responsibilities and help build the economic strength of America. I cannot stand here and tell you that I represent a consensus of all small business in the United States - all 10 million of them, nor can I stand here and tell you that your small business accounts represent the greatest future profit source and growth potential for the full-service bank system in America.

If there was such a thing as consensus of small business, particularly in political action, we would have taken credit for electing President Reagan and we would be able to elect any future president. The voter potential is there; the consensus is not. It is aptly characterized as "America's Sleeping Giant".

Because there has not been a consensus, nor a significant voice in Washington to articulate any such consensus, small business has been the beneficiary of what has been termed "trickledown benefits of
legislation" directed at business without regard for the needs of smaller businesses.

For a moment, may I review some of the inequities that have been created through lack of attention and for lack of small business voice in Congress.

First, when I speak of small business, I generally refer to the SBA definition which, without going into detail, represents manufacturing firms with 500 employees or less. In other types of industries, the numbers vary, but none exceeds the manufacturing size level.

 Discrimination in tax policy is most evident in the basic tax rate. Until the Tax Reform Act of 1978, and not since 1934, has there been a recognition that small business deserves a graduated income tax in the same manner as an individual. The current rate, beginning at 17% on the first $25,000 in five increments, reaches the maximum corporate rate of $100,000. If Congress responds to the recommendations of the Transition Team, surtax exemption schedule will be raised to $500,000 before reaching the maximum corporate rate.

There are other tax inequities that take the form of tax credits. According to the Chief Counsel for Advocacy of SBA, there are 50 or 60 forms of tax credits available for business. The smaller the business, however, the fewer the tax credits available and the higher the proportionate basic tax rate. If one looks at taxes paid by businesses of all sizes relative to basic net worth, a clearly regressive pattern is displayed. According to the same source, businesses with gross revenues of a half million dollars have a relative tax rate
of 30% where businesses with gross revenues in excess of one billion dollars pay with a relative rate of 11%.

Much is said about our regulatory environment. Indeed, it is a burden on all business. However, in a study completed in early 1979, referred to as the Policy Review Committee on Technology and Industrial Innovation, a sub-committee studying this issue could not find a regulation that did not disproportionately impact smaller businesses. The differences were not minor nor insignificant, indeed, the differences in impact were magnitudes of 30 or 40 times. Another effect discovered in that same study was that regulations in many cases forced concentration of industry. For example, in the four years following the enactment of the Environmental Protection Agency rules, one-half of the cast metal founderies in the United States were forced out of business. Of course, these were the smaller independent cast metal founderies who were the basic suppliers to larger industry. The net effect was that, in many cases, larger industries were forced to integrate vertically to maintain their supply source. Further concentration was forced because of overly restricted SEC regulations inhibiting small business from access to public markets for growth capital.

Small business also lost one of its only incentives available to attract competent executive-level employees when Congress removed the availability of a qualified stock option plan. The current sentiment of Congress and the recommendations of the Transition Team suggest a restoration of stock options as a high priority item in the next Congress.
Further inequities exist in the inability of small business to establish a significant pension program with the same tax benefits as accrue to big business. IRS and keough plans are helpful but fall far short of being an equitable alternative.

Perhaps the greatest disaster facing small business this year accounting for a dramatic increase in bankruptcies is inflation and the high cost of capital. By its nature, small business suffers a high debt to equity relationship. Compound this characteristic with the exhorbitantly high interest rates of the past year, and we have outlined the most effective formula devised to eliminate small business from the economy. There is a growing perception among small businesspersons that the prime rate is not legitimate, that it is managed, and that there's no business rationale that says it should ever exceed four points above the inflation rate. There is a general belief that international companies contract with the major banking institutions for borrowing rates below prime. There is a suspicion that national companies, with a closer relationship to the bank officers, in anticipation of escalating rates, negotiate their credit lines at the most expeditious time. They are convinced that the ultimate victim of this prime rate roller coaster is clearly the small business sector.

Gyrating interest rates create a growing distrust of the financial services community.
The foregoing has been a fundamentally negative picture of where small business is today. These deplorable characteristics clearly underscore why small business, which contributed 46% of the Gross National Product in 1972, is contributing less each year and is anticipated to contribute only 43% in 1981. I said earlier that small business is characterized as a "sleeping giant". He is now beginning to awaken. Small business is beginning to organize first at the grassroots levels and may soon become a major factor at the national level. Congress is now aware of the potential for small business in terms of employment, competition, innovation and productivity. Indeed, there is a new era pending for small business, particularly in capital formation. However, it will only be of benefit to those businesses that survive the present credit and interest rate disaster.

The greatest potential area for economic growth in our country, I believe, lies in the small business sector. The greatest impediment to that growth is access to capital. At least two major roadblocks exist. First, regulations such as ERISA effectively foreclose from small business access to the largest capital pools in the world - pension and profit-sharing trusts. Certainly, any such funds to be invested in small business would be considered "imprudent".

A second major impediment is the lack of delivery mechanisms that compensate for "economies of scale". That is, the larger the institution, the less interest in smaller loans.

I do not understand banking nor all the incentives that might divert funds to flow into smaller businesses. I am concerned that there is a
growing trend towards concentration of banks which will exacerbate the already serious problem of focusing attention on loans to small business. Rather than government programs such as the Small Business Administration, which generally relate to subsidized borrowing, there may be new or innovative internal bank programs which address a form of subsidized lending.

In the past year, the Small Business Administration has moved to establish a "Certified Bank" program which certifies a bank to totally process and control an SBA guaranteed loan. Except for some expressed concerns from the minority small business area, the program is going over well. The major benefit is to get the SBA out of the lending business.

The full-service banks have historically been the fundamental source of funds for small business. As these institutions grow however, the natural result is that they relate to larger customers and small business may have to look to other sources. On the horizon, those sources may take the form of non-financial institutions such as the commercial Credit Division of Control Data Corporation or Merrill Lynch.

Personally, I could envision no happier circumstance than to see full-service banks recognize small commercial loans as a long-term growth potential, to establish small business departments with profit center characteristics to employ loan officers with small business experience, to establish management assistance centers, and to have the courage to recognize the longer term rewards from such a program. The entrepreneurial
spirit and the creative genius of America is out there. The missing ingredients are capital, treated as "patient money", and financial counseling.

Small business, whether measured in terms of job creation, competition, innovation, or productivity, has been and can continue to be, America's greatest economic resource.