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DISCUSSION AND COMMENTS ON THE MAJOR ISSUES FACING SMALL BUSINESS

INTRODUCTION

The Select Committee on Small Business is the only committee in the U.S. Senate which is exclusively concerned with the interests of small business. As such it is in a position to make a significant contribution to the development of the relationship between our government and the small business community. All legislation primarily relating to the Small Business Administration is referred to the committee. Equally as important, the committee is empowered "to study and investigate the problems of the small business and report its findings and make recommendations to the Senate."

The Senators who sit on this committee believe that they can properly discharge this responsibility only by listening carefully to the business community itself. That is why the Senate Small Business Committee was instrumental in creating the White House Conference on Small Business, and is anxious to receive the views of the delegates.

The Conference provides a new forum for direct input from the small business community to all branches of government and, through the media, to the American public. For a few days in January, national attention will be focused on the problems and concerns of small business. The Nation will hear the results of a lengthy process of self-examination which the Conference has created within the business community.

Over the past year and a half, at dozens of local, State, and regional assemblies, and at task force and delegate meetings, the problems of the small business sector have been confronted, cataloged and defined. Never before have the delegates themselves been involved to such an extent in setting the agenda for a White House Conference. This format speaks highly of President Carter, the skilled and efficient staff of the Conference, the Commission and its Chairman, and the volunteers who worked on the task force reports. The most important contribution to the quality of this Conference, however, is the extensive input from the concerned, articulate, and thoughtful people that make up the small business community in this country.

The Senate Small Business Committee hears almost daily from the members of the business community through hearings, trade and business conferences and conventions, correspondence and meetings in Washington and across the country. As part of its continued oversight efforts and in anticipation of the White House Conference on Small Business in January 1980, the committee held 27 days of hearings to listen to the opinions of business leaders about a broad range of small business topics—topics which correspond to a great degree with the agenda of the Conference.
This report is designed to transmit to the Conference delegates the background and results of these hearings. We have outlined some of the problems and past approaches to the issues, and we have indicated profitable directions for the future.

This report is not intended to be a complete record of small business issues or a plan for action. It is, instead, designed to provide the delegates with background on the committee's activities and to facilitate greater understanding and cooperation between the committee, the Conference delegates, and the small business community from which they come.

Making changes is not an easy task. Only a broad range of participation in the decisionmaking process will put the problem and suggested solutions in the best possible light. This document is the committee's contribution to this effort.

Historians will look back at what we do and apply to our decisions the "Law of Unintended Consequences." No matter how careful we are, there will be things we cannot or do not see now. For example, back in the early seventies, when government regulation began to escalate, it appeared to be simply a direct means for preventing excesses and abuses. Today, we are faced with the unintended consequences of those actions. We know that the cumulative bulk of all government regulations is itself a growing problem for small firms. In this case the unintended consequences of yesterday's actions are the problems we must solve today. The more wisdom we can bring to the process of finding a solution to this and other problems, the better our chances of mitigating the undesirable consequences which might follow.

We must not underestimate what is at stake. It is more than the exact measure of health in the small business sector. Small scale entrepreneurship is one of the most important vehicles for maintaining and transmitting the most basic values of our culture, values such as initiative, innovation, and individual responsibility.

A penetrating observer of human nature, Alexis de Tocqueville, wrote in the early 1800's that "Americans show a sort of heroism in their manner of trading." "I am of the opinion" he wrote, "that the true cause of their superiority must not be sought for in physical advantages, but that it is wholly attributable to moral and intellectual qualities." 1

There is a direct, reciprocal relation between these moral and intellectual qualities and their expression in independent business ventures. The existence of these attributes in the American people creates a vibrant pattern of enterprise that reaches into every crossroads town in the country. But if we take away this outlet for our creative energies, if we make it prohibitively difficult to go into business, we will actually be attacking and damaging the very qualities that make this country strong.

This result is not hypothetical. The committee, in an earlier publication, printed an article by sociologist C. Wright Mills. Dr. Mills contrasted cities in which most people were employed by small businesses, and cities where one or two big businesses dominated the town. In the

towns with many small firms, infant mortality was considerably lower and per capita health expenditure much higher. Housing was superior; home ownership was higher and there were one-third as many slums. Expenditures on education and libraries were far greater and church membership was higher in small business cities. There is no doubt that the presence of a healthy small business community contributes directly to the quality of our life in ways most people never realize.

That is why the Senate Small Business Committee is working to improve the climate for independent entrepreneurs. The goal must be to create a new economic climate, one in which small firms can be created, can grow and thrive, one in which a successful business can be passed down to the next generation with a deep feeling of accomplishment.

The committee believes the White House Conference on Small Business will help achieve this goal and looks forward to having its views.

Gaylord Nelson,
Chairman.
CHAPTER I

CAPITAL FORMATION

Capital is the lifeblood of business, and the ability to raise capital for existing and new businesses is fundamental to the health of the enterprises themselves, the American economy, and the free enterprise system.

In 1975, the ability of small business to raise equity capital was at a low ebb. One way of raising capital is through stocks issues but it was getting increasingly difficult for small companies to use this route. In 1975 only three small companies (with a net worth of less than $5 million), were able to raise capital by selling stock to the public, compared to 698 such companies which went public in 1969. There was no question that capital was truly drying up for the small business community and there was no single, simple remedy.

During the 1970's there was a radical change in investment patterns. Six million individual investors withdrew from the market leaving it increasingly dominated by institutional investors. In 1960, institutions owned by value about one-fourth of all common stocks; it is predicted that by 1985 they will own one-half of the market.

This presents particular difficulties for new and small firms, since individual investors are more inclined than others to take risks with their own money. Institutional investors, dealing with other people's money, are under legal constraints to make investments which they consider "conservative." Other factors leading them away from investments in smaller firms include the multi-billion dollar scale of their operations, and their lack of intimate knowledge of small, local firms.

In addition, there has been a steep decline in the number of independent securities brokers and dealers, which provide entry into the market and support services for new and small businesses. The number of brokers in the past decade has declined 37 percent from over 4,000 to 2,772 at the end of 1978. Only these smaller, independent brokers are close enough to local smaller firms to know them well enough to recommend the ones which are sound investments.

Many firms use retained earnings to provide the capital required for growth. Here, too, the capital sources were drying up. Tax laws, until 1975, cut deeply into a firm's ability to retain the capital needed for expansion.

Most small businesses have to rely on debt financing for their major source of capital. Inflation, the resultant decline in savings, and high interest rates have resulted in a credit squeeze on these small businesses.

The cumulative effect of these problems is to make it extremely difficult for small business to gain access to any source of capital.

BACKGROUND

An important evaluation of the capital formation problem was made by a Task Force on Venture and Equity Capital established by the
Small Business Administration in July 1976. Its membership included a highly knowledgeable and experienced cross-section of participants in venture capital financing organizations, executives of small and independent businesses, and brokers specializing in the financing of new ventures and educators. Chosen as chairman was William J. Casey, former Chairman of the Securities and Exchange Commission.

The panel submitted its findings in 1977. The so-called Casey report stated that in order to have a meaningful impact on the conditions of small business financing, progress must be made in several areas:

- Tax laws and regulations;
- Venture capital programs under the jurisdiction of the Small Business Administration;
- Requirements of the Employees Retirement Income Security Act of 1974 (ERISA);
- Securities laws and regulations.

The task force recommendations are significant because they indicate the range of changes required in legislation and in regulations to improve the future capital formation structure for small business.

The major recommendations were embodied in S. 1815, a bill introduced by Senators Nelson and Weicker in 1977. This legislation followed the outlines of the report, addressing its diverse areas, and, accordingly, several different Congressional committees had jurisdiction over the various subject areas.

Since S. 1815 was so broad in scope, various parts were reintroduced separately and referred to the various committees having authority to consider these matters. As a result, the ceiling on Regulation A stock issues was lifted twice by the 95th Congress, once from $500,000 to $1½ million and a second time to $2 million. The Securities and Exchange Commission has since expressed its willingness to "administer the $1½ million limit," and has informally stated to the committee that it prefers a "testing period" to evaluate its effects before the Commission would be willing to raise the ceiling to the full $2 million recently authorized by the Congress.

**CONGRESSIONAL ACTION**

In 1975, Irving Kristol wrote in the *Wall Street Journal* that the small entrepreneur was the "forgotten man" of American politics.

Four years later, small business is celebrating its status as a new political force and its gains are clearly seen in the area of capital formation.

Small business has gained $2 billion in yearly tax savings. Owners of farms and businesses now can pass on three times as much property free of federal inheritance tax to their families. Small firms are in the thick of a fight for additional billions in tax savings through further tax reforms.

This remarkable turnaround is due to a combination of several factors, including a major push led by members of the Senate Small Business Committee. The committee members argued persuasively that a generation of benign neglect should be reversed—that the American economy and society would gain immeasurable benefits if independent enterprise were given equitable tax treatment.

These efforts were successful and produced dramatic results.
In 1978, Congress enacted the most progressive business tax reforms in 70 years. The new schedule provides a tax saving of up to $14,750 for small companies and a total of $2 billion over the pre-1975 tax laws in tax relief for the 94 percent of U.S. corporations which earn less than $100,000 a year.

The result is a tremendous increase in the amount of capital available to small firms in the U.S.

Wilson S. Johnson, president of the National Federation of Independent Business, said in October 1978: "Adoption of the * * * plan for progressive corporate income taxes for small business is the most significant tax reform of the past 40 years."

An investment tax credit is one of the most valuable provisions in the law. Under this provision, the cost of equipment is cut through a tax credit. In 1976, Congress raised the investment tax credit from 7 percent to 10 percent. At the same time, an amendment doubled the amount of used machinery eligible for that credit from $50,000 to $100,000. For smaller businesses, which most often buy used machinery, the investment tax credit is nearly tripled, and the cost of growth is cut.

The tax credit was again broadened last year to provide a 10 percent credit for renovation of 20-year-old buildings and single-purpose farm structures.

Legislation offering additional tax relief to small businesses has been proposed in the Senate. Just before the 1978 law there was a three-step corporate tax rate. Under the new law there is a five-step rate and the fourth step is for businesses making between $75,000 and $100,000. The new proposal would redefine the lower rate to apply to businesses making up to $150,000. Any business in the fifth-step category has a tax rate of 46 percent.

The committee recommends that Congress continue to structure tax measures so that small businesses can retain more of their profits for reinvestment, and a stronger small business sector can be built.

In order to improve our Nation's manufacturing efficiency and productivity, incentives to increase capital formation must be provided. Depreciation writeoffs provide an important source of investment capital for small business.

For the past 4 years, the Senate Small Business Committee has worked to increase these allowances. Last year, the Senate passed a committee proposal which would have allowed businesses speedier writeoffs of up to $25,000 of annual equipment purchases over a three-year period, using simple procedures that would have eliminated over 100 pages of complex regulations. Unfortunately, the measure was dropped during a House-Senate conference on the bill.

In 1979, the committee is continuing to lead the fight. Last year's bill has been reintroduced, along with an even more sweeping measure which would allow businesses to write off investments in structures over 10 years, equipment in 5 years, and vehicles in 3 years. Another important provision in this bill would increase the investment credit from 6⅔ percent to 10 percent for 5-year equipment and from 3⅔ to 6 percent for 3-year vehicles. In addition, hundreds of pages of

1 See Appendix for S. 1435.
complicated regulations dealing with depreciation in the tax code would be eliminated. Also eliminated would be the hundreds of cases in the tax courts involving depreciation controversies.

The committee believes that depreciation reform is long overdue. Inflation and the growing complexities of all the depreciation schedules should make this a matter of the highest priority.

B. OBTAINING DEBT CAPITAL

A number of proposals have been made to increase the ability of the SBA to efficiently and appropriately administer loans for debt financing to small firms. Under one proposal the Small Business Administration would increase the maximum ceiling on SBA guaranteed small business loans from $500,000 to $1 million.2

For the committee's comments on these and other ways of improving SBA financial assistance to small firms, see the section in this report on the mission of the SBA. For further information on encouraging savings and other methods of capital formation, see the section of the report on Inflation.

C. VENTURE AND EQUITY CAPITAL

The committee believes that the dramatic increase in the cost of doing business means that steps must be taken to ensure sufficient venture and equity capital for new and growing businesses.

In 1978 and 1979 the Senate Small Business Committee continued its hearings on capital formation, which developed into the most comprehensive look at capital formation problems of new and small businesses within the last 20 years. Legislation which emerged from these hearings included:

- The capital gains rollover bill (S. 653) which would allow tax deferral when a small business owner sells his firm, if the proceeds are reinvested in another small business within 18 months; 3
- A tax credit for the purchaser of newly issued stock of firms with a net worth of $25,000,000 or less (S. 487 and S. 655); 4
- A bill to strengthen the financial structure of independent securities firms in order to be able to render capital raising assistance to smaller businesses (S. 1967); 5
- An exemption of publicly-held venture capital firms from the regulation of the Securities and Exchange Commission under the Investment Company Act of 1940 (S. 1940); 6
- A bill creating a new security called a Small Business Participating Debenture which would have the status of a debt security with a stated rate of interest (S. 1481); 7
- A reinstatement of tax favored options to broaden the base of ownership in new and small firms and to provide incentives for talented executives to join such ventures (S. 1967); 8

2 See S. 2049 in the Appendix for bill sponsors.
3 See S. 653 in the Appendix for bill sponsors.
4 See S. 487 and S. 655 in the Appendix for bill sponsors.
5 See S. 1967 in the Appendix for bill sponsors.
6 See S. 1940 in the Appendix for bill sponsors.
7 See S. 1481 in the Appendix for bill sponsors.
8 See S. 1967 in the Appendix for bill sponsors.
A series of tax, patent, procurement, regulatory and paperwork proposals to help emerging technically-based companies (S. 1860).9

D. CAPITAL GAINS TAX RATES

From 1969 until 1976, maximum tax rates on capital gains increased from 25 percent to a peak of 49.1 percent. Last year, a Small Business Committee hearing proved that this high tax had dried up desperately needed investment capital.

To remedy this problem, Congress adopted a compromise proposal, developed in large part by the committee, to roll back the maximum capital gains rate to 28 percent effective November 1, 1978.

As a result, by mid-1979, more than $500 million in new venture capital had been raised for small enterprises.

The National Association of Small Business Investment Companies wrote on May 30, 1979:

New, young and growing small businesses have hundreds of millions of additional dollars available to them * * * because of * * * leadership last year in reducing (taxes on) capital gains.

E. CONTINUITY OF OWNERSHIP

Small Business Committee hearings found that many family farms and smaller businesses were forced to sell out because of outdated federal estate tax laws which had not been revised since 1942.

To correct this major problem the committee drafted a comprehensive reform bill that Congress approved in 1976. Among its features are:

• Tripling of exemption from Federal tax from $60,000 to $175,625 to all heirs;
• Increasing relief for the surviving spouse by raising the special "marital deduction" to $250,000, or half the estate left to the survivor, if higher;
• Providing extended terms for paying tax on farms or businesses—15 years to pay the tax, with no payment of principal until the sixth year, and interest at 4 percent during the first 5 years for estates under $1 million;
• Favorable "use valuation" allowed if family farms or businesses are near growing cities and would otherwise be valued as development property for estate tax purposes;
• Increasing the lifetime gift tax exemption—the amount of lump-sum gifts which can be given during life was increased from $30,000 to $175,625.

Until last year, a wife who worked alongside her husband in a farm or business—but did not make a cash contribution—was required to pay estate taxes on the full value of the property when her husband died. An amendment changed that highly unfair "widow's tax" provision. The law now gives credit for a wife's labor at the rate of 2 percent per year (up to 50 percent) of the total farm or business value for estate tax purposes. Beginning Jan. 1, 1979, surviving spouses may claim this credit for all past years of labor.

Of particular interest to businesses was the provision in the estate tax reforms permitting a deferral of estate taxes for 5 years with

9 See S. 1860 in the Appendix for bill sponsors.
interest at 4 percent for estates under $1,000,000 with the privilege of paying the estate tax on an installment basis from the 6th to the 15th year.

The committee believes that estate tax laws should take into account the special needs of small businesses, and that recent improvements be kept current by making periodic adjustments for inflation along the lines of S.1825.10

CONCLUSION

At committee hearings in 1978, the American Electronics Association testified that companies formed in the 1970's could raise only half as much start-up capital as those founded in the 1960's. Witnesses blamed the 1969-76 capital gains policy as the primary cause of low venture investment.

Since those hearings 2 years ago there have been major accomplishments which assist small business capital formation. One of these was the significant reduction of capital gains taxes enacted on November 1, 1978. A second is the adoption by a Department of Labor regulation of the "overall portfolio theory" in July 1979. This action relaxes the Labor Department's interpretation of ERISA's "prudent man rule" so that pension fund managers can more easily place part of the investment portfolio in small business investments.

Together these items have resulted in the flow of more than one-half billion dollars in new venture capital to the small business community since the end of 1978.

As a result, the venture capital industry has been able to survive. According to testimony by the National Venture Capital Association before the committee, the infusion of new capital has added almost 50 percent to the amount of funds which are available to finance new and small businesses.11

This is a good beginning and 1980 should show continued improvement as a result of the measures discussed earlier in this chapter.

Meanwhile, much remains to be done, and new issues such as social security tax changes and a Value Added Tax (VAT) are being raised. The comments of the White House Conference Task Force on Capital Formation mirror this wide spectrum of concerns.

These are some of the difficult problems that must be solved if we are going to stop a growing concentration of economic power. The top 100 Fortune firms control the same share of manufacturing assets that the top 200 did 30 years ago. Put simply, this means that today the same amount of the Nation's assets are concentrated in half as many hands. The top 200 firms now control 61 percent of the nation's manufacturing and mining assets, which is the same percentage share owned by the top 1,000 enterprises at the start of World War II. As a direct result, small- and medium-sized businesses today control less than 27 percent of this country's corporate assets, a drop from nearly twice that amount in 1960.

The Senate Small Business Committee will continue to play an active role in developing and proposing solutions to the problems in capital formation. The suggestions that will come from the White House Conference on Small Business in January 1980 will be a significant contribution to this national debate.

10 See S. 1825 in the Appendix for bill description and sponsors.
CHAPTER II

ECONOMIC POLICY DECISIONS AND GOVERNMENT PROGRAMS

Decisions regarding the course of economic policy in our particular democratic system are not made by one central authority. They are made by the Congress, the executive branch, and by certain independent agencies—most notably the Federal Reserve Board. Fiscal policy and wage/price policy originate in the executive branch with the President; monetary policy comes from the Federal Reserve Board; and Congress is responsible for the tax system.

Just within the executive branch, the number of agencies which influence economic policy decisions includes the Treasury Department, the Department of Labor and the Department of Commerce. Within the White House itself there are even more policy advisors, including the Council of Economic Advisors, the Council on Wage and Price Stability, the Domestic Policy staff and the Office of Management and Budget.

The committee believes that small business must be given a greater voice in the economic decisionmaking process.

DEVELOPMENT OF GOVERNMENT STRUCTURE

The demand for government programs was a direct result of the unbridled economic growth historians call the industrial revolution. A new business world appeared, and it operated at first without the restraint of government: No one could foresee that this vast transformation would directly limit individual freedoms. But the problems became more acute and the demand grew for governmental action. By 1888, the corruption of the railway corporations led directly to Federal enactment of the Interstate Commerce Act, establishing the Interstate Commerce Commission as the first independent regulatory commission. Federal antitrust legislation followed to curb corporate power, including the Sherman Act in 1890 and the Clayton Act in 1914.

During the 1920's, corporate economic power continued to concentrate despite strong antitrust legislation. When the Depression focused attention on economic problems caused by big business, Congress authorized a temporary National Economic Committee, better known as the Monopoly Investigation. It's findings spurred the Senate to create a special committee to study the problem of small business and, in 1941 the House followed suit.

By the 1940's, government leaders recognized that special pains should be taken to protect the rights of small enterprises. When economic mobilization for World War II began, this concern was manifested in an important new design in the fight for small business rights. The Smaller War Plants Corporation was established to aid small businesses in obtaining a fair share of government contracts and to diversify sources of supply.
These developments laid the groundwork for much of the present government attention to small business. Congressional concern for the plight of small business was institutionalized in 1950 when the Committee on Small Business became a select committee of the Senate. The House of Representatives established its Small Business Committee in 1953.

The precedent established in the executive branch by the Smaller War Plants Corporation likewise progressed in stages. In 1951, the Small Defense Plants Administration followed the earlier model to assist in the Korean war effort. At the end of the war, this Administration was recast by the Small Business Act of 1953 into the Small Business Administration. Recognizing the different requirements and capabilities of the independent entrepreneur, this law created a single agency, reporting directly to the President, with a mission to concentrate exclusively on small business needs.

During the 1950's, government and business leaders agreed that special attention had to be given to the financing of smaller enterprises if they were to survive as a vital force on the national scene. In 1958, a new law, the Small Business Investment Act, set up a network of privately-owned and operated sources of funding to provide venture capital for new and small businesses.

During the past 2 decades, numerous amendments have been adopted to these two core statutes which have significantly enhanced the ability of the Small Business Administration, and the Federal Government, to improve the economic viability of small business. In 1976, Congress took the additional initiative of creating within SBA an Office of Advocacy, endowing it with a specific mission to promote the cause of small and independent enterprise within the executive agencies, and before the Congress.

During the past several years, Congress has stepped up its efforts to encourage agencies to recognize small business opportunities and problems, to accord "fair representation" for small business on advisory bodies, and to provide a fair share of contracts and other specialized assistance. Small business programs are continually being monitored and tested to better achieve these goals.

COMMITTEE ACTIONS

Committee hearings in October and November on "Small Business and the Economic Outlook" reviewed recent economic policy decisions and their impact on the small business community. Based on testimony presented to the committee, it is clear that small business must gain a more effective voice in the formulation of both fiscal and monetary policy.

One witness from Data Resources, Inc., an economic consulting and forecasting firm, said that a "full blown credit crunch is now in the process," and that it will place a substantial squeeze on small business. Another witness, Vondal S. Gravlee, President of the National Association of Home Builders, said that in his industry, composed almost solely of small businesses, the recent credit tightening actions of the Federal Reserve Board will reduce housing starts by 50 percent to 990,000 starts, and force the layoff of 1.5 million construction workers.
A. SMALL BUSINESS ADVISORY COMMITTEE

Small Business Advisory Committees serving the Internal Revenue Service and the Treasury Department, were created during the 1970's as a result of efforts by the Senate Small Business Committee. In 1977 these two groups merged into a single group called the Treasury Small Business Advisory Committee.

During 1978, the new committee organized itself into three subcommittees; tax policy; capital formation; and activities of the Internal Revenue Service.

The Advisory Committee and its subcommittees met with high Treasury officials on several occasions during the year. Serious efforts were made to identify, evaluate, and formulate views on tax policy and related matters which would be of benefit to the small business community.

The Advisory Committee provides an excellent medium for the small business community to talk face-to-face with Treasury officials who design policy and implement regulatory actions. In addition, it serves to educate the government about the particular concerns of the small business community.

The committee recommends that the Small Business Advisory Committee in the Treasury Department meet personally and regularly with the Secretary instead of meeting at the pleasure of the Deputy Secretary. The Treasury Department should create the position of Small Business Tax Analyst to study the effect of Federal taxes on small business and advise the Secretary on tax policy decisions affecting small business.

Other agencies, including the Federal Reserve Board and the Office of Management and Budget (OMB), should increase their coordination with SBA, and develop their own sources to increase small business participation in the economic decisionmaking process.

B. SMALL BUSINESS ECONOMIC DATA BASE

By and large, direct small business input into economic policymaking is limited to a few avenues: Advisory groups, the SBA, and public comment on proposed regulations published in the Federal Register. The committee believes that the effectiveness of small business participation, both direct and indirect, needs to be increased.

One reason why small business participation in economic policy decisionmaking has not been greater is the lack of data to prove the small business case. Currently, economic indicators are not broken down by business size (employee number), sales or asset level. Without this data, it is difficult to analyze the performance of the small business sector, or compare it to the performance of the entire economy. The solution to this problem lies in the creation of a small business economic data base.

The committee has provided clear direction to the Small Business Administration to accelerate the development of such a small business economic data base. The Congress has appropriated over a million dollars in each of the last 2 fiscal years to ensure its development.

The committee has indicated that information in the data base should include: Employment; number and type of business establish-
EVALUATION OF THE ADMINISTRATION'S 1978 SMALL BUSINESS TAX PROPOSALS AND OTHER ALTERNATIVES

TUESDAY, FEBRUARY 14, 1978

U.S. Senate,
Select Committee on Small Business,
Englewood, Colo.

The committee met, pursuant to notice, at 9:32 a.m. in the auditorium, Police-Fire Station, 3615 South Elati Street, Englewood, Colo., Hon. Floyd K. Haskell, acting chairman, presiding.
Present: Senator Haskell.
Also present: Herbert L. Spira, committee counsel; and Robert G. Liberatore, legislative director to Senator Haskell.

STATEMENT OF HON. FLOYD K. HASKELL, A U.S. SENATOR FROM THE STATE OF COLORADO

Senator Haskell. The hearing of the Senate Select Committee on Small Business will commence.

The purposes, as I think the people who have been notified realize, are to help us in the Senate decide what this year's tax policies will be in the small business area. We will first examine the administration's 1978 tax proposals as they affect small business; and then we will discuss alternatives, including a bill which I have introduced which defers capital gains on small business sales provided re-investment is made within the small business sector (S. 2428); and also to evaluate proposals to provide relief from payroll taxes.

An additional question is whether the job tax credit which was enacted over a year ago should or should not be extended. That legislation, which provides a $2,100 credit for each new employee hired in 1977 and 1978, expires December 31. I sponsored that bill and felt it would be helpful, and we want to take a close look at the results.

As we analyze the President's suggestion that the large corporate rate be reduced from 48 percent to 44 percent, and the rate at the bottom be reduced by 2 points, we note that of course it impacts and affects and gives relief to large corporations, or relatively large corporations. This formula does little for the 1½ million smaller corporations, and nothing at all for the more than 10 million partnerships or individual entrepreneurs.

Should the revenues to be forgone by that reduction in effect be given across the board to all business, whether it be corporate or otherwise, as a 10-percent credit on social security taxes.

(1)
My views on social security taxes are probably reasonably well known. I voted against the bill that came out of the Finance Committee last year; I voted against it on the floor, and I voted against it in conference. It is my feeling that social security is an income transfer tax with a tremendous impact and should be largely funded about one-third from general revenues.

Generally speaking, tax proposals by any administration, including the present administration, give small business the short end of the stick; and by and large, large business is favored.

The purpose of having this hearing here in this community is to provide a record which those of us in the Senate who are particularly interested in small business can use to push some of the proposals that will most benefit new and small enterprise, including those which I and others have suggested if those are found to have some merit.

So without further ado, I think we should start on our witness list, and I hope that the ladies and gentlemen who are testifying will observe the hearing list schedule as best they can as we do have a fair number of witnesses.

As the first witness, I will call Blaine D'Arcey from Central Investment Co. If he is here, Duane Pearsall is invited to come up with Blaine. These gentlemen—excuse me for using their first names—I have known for a long period of years.

The notice of the purposes of these hearings shall be inserted in the record immediately following my remarks.

[The information referred to follows:]

SMALL BUSINESS ASPECTS OF ADMINISTRATION'S TAX PROGRAM

Mr. Nelson. Mr. President, I wish to announce public hearings by the Senate Select Committee on Small Business on the small business aspects of the administration's 1978 tax program which was announced on January 21.

Hearings by the full committee, conducted by Senator Haskell of Colorado and Senator Hathaway of Maine, are scheduled to take place as follows:

February 14 in Denver, Colo.; and February 20 in Portland, Maine; to take the testimony of the small business community, tax experts, and other interested members of the public.

February 28 in Washington, D.C.; to hear from Government witnesses.

Witness lists for the Denver, Portland, and Washington hearings will be released as soon as they are completed.

SCOPE OF 1978 HEARINGS

The administration's tax message of January 21 recognized the small business community. It proposed corporate rate reductions of 2 percentage points for the two brackets below $50,000 of income—from 20 to 18 percent on the first $25,000 of taxable income and 22 to 20 percent on the next $25,000. Above $50,000 corporations would receive a 3-percent reduction in October 1978 and a further 1 percent cut in January of 1980.

Also mentioned were: simplification of the asset depreciation range system, with particular attention to small business concerns for complexity and recordkeeping; updating of Internal Revenue Code, section 1244, dealing with losses on stock of small corporations' stock that might become worthless; and incremental changes to "subchapter S" of the code, which allows corporations to be taxed as partnerships.

The February hearings will permit small business organizations to analyze the impact of these administration proposals upon smaller and medium-sized
independent firms, to set forth any alternatives which they may favor, and to express their views about the relative merits of such proposals. Anyone seeking further information may contact the committee offices at 424 Russell Senate Office Building, Washington D.C. 20510.

BACKGROUND

Because tax policies have a critical bearing on the abilities of small business to compete and survive, the Small Business Committee has been interested in the impact of the tax system on small business since it was established as an investigative body in 1950. During the past 3 years, this interest has been heightened because, during the 94th Congress (1975-76), six members also served as members of the tax-writing Finance Committee; and during the current 95th Congress (1977-78), there are four such dual memberships.

As a consequence, the committee held 12 days of hearings on small business tax matters in 1975, incident to congressional consideration of the stimulus bill of 1975 and the Tax Reform Act of 1976. This committee's investigation was continued in an additional day of public hearings in 1977, relating to the tax stimulus bill of that year, and particularly the employment tax credit.

As a result the following small business tax provisions were considered and enacted during this period:

1975
Temporary rate reductions for all corporations up to $50,000, the first rate relief since 1950 for earnings between $25,000 and $50,000;
A permanent 50-percent increase in permissible accumulated earnings;
Doubling in the amount of used machinery eligible for the investment credit ($50,000 to $100,000 in annual purchases).

1976
Extension of the 1975 small business rate reductions through 1977;
Reform of estate and gift taxes, for the first time since 1942;
Liberalization of Subchapter S of the Internal Revenue Code.

1977
Extension of small business rate reductions through 1978;
Employment tax credit ($2,100 credit for each new worker added in 1977 and 1978).

Following passage of the 1977 stimulus legislation, the committee continued to advocate tax simplification, relief and reform for the small business community. In October, we presented to President Carter and Vice President Mondale an extensive memorandum suggesting a series of small business tax proposals, drawn up in consultation with 27 small business organizations, and recommended that they be included in the administration's tax program. I ask unanimous consent that a summary of these proposals be printed in the Record.

There being no objection, the summary was ordered to be printed in the Record, as follows:

[The material follows:]

SENATE SMALL BUSINESS COMMITTEE TAX RECOMMENDATIONS FOR INCLUSION IN THE ADMINISTRATION'S 1977 TAX REFORM MESSAGE AS PRESENTED AT THE WHITE HOUSE, OCTOBER 26, 1977

1. Fair proportion of tax reductions to the small business community

It is possible to compute the portion of benefits that will be going to various income categories for each item and for the overall package.

For example, in 1975, the administration's proposal would have given 25 percent of the revenues of the economic stimulus package to small business. Congress, however, decided that this proportion should be raised to 33 percent.

"Small business" accounts for 97 percent of the number of U.S. enterprises, 55 percent of all private employment, 48 percent of the business output, 43 percent of the GNP, and over half of all inventions and innovations.

Accordingly, the Committee's proposal is that one-half of the overall business tax reductions, including rates, capital recovery "integration" or whatever other
measures are proposed, be allocated to “small business.” A tentative definition for this purpose might be taxable income of less than $100,000.

2. Corporate rates

The Committee believes there should be at least some reduction for the smallest corporations of less than $25,000 in earnings, since this would assist the great majority of companies whose owners are attempting to earn a livelihood for one or a few families. To encourage growth, innovation, and competition, the recommendations would extend to some tax reductions at the $50,000, $75,000, and $100,000 levels. The magnitude of these cuts should be dependent on the revenue available and in relation to balance of the entire proposal in accordance with the 50 percent share of total business benefits for the smaller firms.

3. Capital transactions

To preserve the incentive to invest and therefore sacrifice immediate satisfactions, this suggestion would be to retain capital gains for family (primary) residences, family farms and family and small businesses. A tentative definition of small business limited to this context might be enterprises with less than 500 employees, which is the lowest boundary of the SBA’s definition of manufacturers, and which is an administrable standard. This recommendation contemplates adequate safeguards to protect against abuse. For example, the requisite holding period could be lengthened to 5, or even 7, years.

The Committee also advocates increasing significantly the amount of actual losses which an investor can deduct against ordinary income if a small business in which he invested suffers losses or fails.

4. Capital cost recovery

Because most small businesses use straight-line depreciation, the Committee proposes an optional simple straight-line depreciation system, with a shorter useful life—perhaps three years—for investments in new or used equipment up to an appropriate level (perhaps $100,000 to $200,000). Where this system is elected, it would eliminate the complicated combination of bonus depreciation, ADR, and rapid depreciation and amortization methods, investment credit, salvage value, disputes about useful life, and recapture provisions for smaller businesses. It would relieve much of the pressure for “indexing” depreciation or substituting replacement-cost accounting in the future. It is contemplated that this benefit would be available to businesses of all sizes, but that it would be simple and understandable and therefore attractive to, and most used by, the great majority of small enterprises, for whom it would constitute a true reform in this important area.

5. Unincorporated businesses

The Committee recommends that there should be an affirmative program of encouragement and assistance for unincorporated firms, which constitute about 85% of all U.S. enterprises, including:

a. A reduction in individual income tax rates which is sensitive to the problems of the sole proprietors and partners in supporting their families. The Schedules C and F, filed by individual business persons, should be closely examined to see what might be done to help these enterprises;

b. An optional use of “cash accounting” for small businesses up to an appropriate level of inventories or gross receipts (perhaps $1-2 million). The current law requires any businessman having inventories (every merchant) to use the accrual method of accounting. According to a spokesman of the National Federation of Independent Business this could save such businesses accounting fees of up to $500 a year, and allow them to fill out their own tax returns. It is also the simplest method—used by most individual taxpayers—and would assist business in complying with the law. For these reasons, it is understood that the Internal Revenue Service does not object to such a proposal.

c. Full utilization by unincorporated businesses of the limited accelerated depreciation provisions, including full extension to used equipment.

Senator Haskell. Mr. D’Arcy has been in the business sector for many, many years and is the head of Central Investment Corp.

Duane Pearsall has his own corporation, was named Small Businessman of the Year in 1976, and is a member of the Small Business
Mr. Pearsall. That is correct.

Mr. Pearsall. Thank you, Senator Haskell, may I go first?

Senator Haskell. Certainly, by all means.

STATEMENT OF DUANE D. PEARSSALL, PRESIDENT, STATITROL DIVISION, EMERSON ELECTRIC CO.

Mr. Pearsall. Mr. D'Arcey makes a better anchor man than I. First, Senator Haskell, it is a privilege to be able to testify before this hearing, and I thank you for the invitation.

I want to amplify your initial comments without repeating the introduction to point out that Statitrol, our present company, represents a classic example of a company founded on an evolution of an idea for a technical product, home smoke detectors, which has resulted in an industry which is approaching now some $200 million. If it is acceptable, I will just highlight the written testimony?

Senator Haskell. Yes, Mr. Pearsall, your entire statement will be included in the record as well.

Mr. Pearsall. Statitrol also represents a classic example of the life cycle evolution of a technically oriented small business. Faced with competition from major corporations, we found ourselves with only one alternative, and that was to become merged with big business. I don't mean to be negative on that point, I am proud of the company that we are with. But the fact that I did not have an alternative is disturbing when it is looked at in the national scope.

We are also a classic example of this evolution of an idea, a technically innovative company, and I think this hearing is intended to identify any impediments that would prevent similar companies from succeeding in our economy.

As background to the testimony, I would like to identify two matters of record with the Senate Small Business Committee; one, the SBA Task Force on Venture and Equity Capital, which you have referred to, and the second is the all-encompassing Senate bill 1815 authored through the Senate Small Business Committee.

I would like to read this section just to lay a groundwork of background to a small business.

There is a cycle of financial events and opportunities to start a business which begins with the ability to save and the will to commit those savings. If public policy is to reflect the contribution these new and small businesses can make to the national welfare, our tax system must encourage the necessary savings and the commitment of these savings to new and small businesses.

After a new business is launched, the tax system should permit it to generate sufficient internal capital so that a growing equity and credit base will enable it to meet growth requirements. This can be done through tax considerations by first the deferral of tax payments; second, allowing small businesses greater flexibility to charge off assets needed to do business; and third, to recognize the effect of inflation on the specific tax levels as applied to income rates as established in the Internal Revenue Act of 1954. These tax considerations made for
the benefit of small business, will provide greater revenues for the Government in the future as small businesses use this increase in internal financing to provide additional jobs and create greater taxable wages and profits.

The first issue of the administration's tax package I believe, reflecting on the rates allowed affecting the small business level, ignores the effect of inflation. If $25,000 as established in 1954 were to be simply compounded at 7 percent, it would exceed $125,000 today. We have not reacted to inflation at the level of tax rate adjustment.

Second, the administration's proposal provides 150 to 200 percent greater tax relief for the larger corporations. The token reduction of 2 percent of income levels below $50,000 must be viewed only as an anemic form of patronage to small business.

The real question is not the rate, but the level. A far more equitable approach is detailed in the proposal included in title IV of Senate bill 1815. We originally referred to that as a graduated income tax but it provides a schedule that really reacts to the small business internal growth needs.

The investment tax credit: Since smaller businesses are always more labor intensive by comparison with large business, investment tax credits are relatively unimportant. As small business develops to an intermediate or large size, this becomes very significant.

I would like to add an overall comment to this tax credit, and that is, that we recognize in an electronics' consumer market today, a fantastic influx of those products from the Far East. If we are to compete with the low-labor-based countries' ability to produce consumer electronic products, the only way to do it is through more capital intensive business to automate production. That may not go far enough.

I have to say that our company finds that we cannot, even with the finances of a big company behind us, compete with Far East products. Our only alternative is to establish an assembly facility in either Taiwan, Hong Kong, Singapore, or some similar area.

We are following that route now, and that's an indictment against our investment tax rates as they apply today to capital equipment.

Under tax reform, these business functions bother me. As a former manufacturer's agent, the only time I had to call on customers and really get their attention was at lunch, and when the administration's proposal reduces a portion of that deductibility, it imposes a direct financial burden on many small businesses where that is a way of life, not a luxury as it is painted by the administration.

I have to mention capital gains, there has been a lot of rumor about further diluting the capital gains taxes which were already diluted by the 15-percent minimum tax which they call a preference tax item in the 1976 tax reform. Capital gains are the lifeblood of small business.

I think the 1976 Tax Reform Act, imposing this 15-percent minimum tax was a serious mistake and should be repealed. No knowledgeable entrepreneur or small business venture capital personality would invest in a small business if he did not have the hope of equity growth.
I want to also relate to the double tax on dividends. Again, this is rumored to be one of the elements discussed by the administration prior to their formal tax reform announcement. Although, this is not an issue now, we ought to recognize that small business is suffering by lack of capital investment. Over the past 20 years that has transferred total capital invested in the United States from the small business sector to the large business sector at a rate of 4 to 1. We must do something to reverse this trend.

I would like to insert here that I think that the bill that you have just introduced, S. 2428, will do a great deal to reverse that capital trend, and I hope that it receives unanimous support. I have found no one that has an objection to that bill. We refer to it as the "rollover" of capital gains.

This double tax on dividends will attract capital to only those big businesses which can afford to pay dividends. Small business does not pay dividends by the very nature of it, and therefore, would lose the benefit of that attraction. Should there be a removal of the double tax on dividends without compensating benefits to small business, there will be a further and more serious reduction of equity capital available to small business. I believe the double tax on dividends is wrong, but its removal should be done very, very carefully as it may seriously injure small business.

As a final note, and this was also pointed in the Casey report or the SBA Task Force report, that when the Treasury evaluates any proposal affecting revenues, they only calculate this on measurable current impact characteristics of that proposal. They do not make any attempt to assess the income to the Treasury on the basis of what I would call a "return on investment." When a tax reduction is made to small business, the Treasury should regard that as an investment for which returns will be made as those businesses become more successful and pay larger taxes. There is no consideration given today by the Treasury Department in these assessments for the future benefit of investing in small business, or, for that matter, any business.

I have made one other consideration here that escaped me for the moment. It is the comparison of the use of an investment tax credit to a reduction in corporate taxes on all business. It's my feeling that an investment tax credit could be twice what it is today. The current 10 percent permanent investment tax credit should be made permanent. I think that only 10 percent is an anemic approach to capital investment needs, that well could be 20 percent to encourage U.S. manufacturers to invest in capital equipment automation as a defense against foreign imports rather than, or in lieu of, a reduction in the overall corporate tax rate.

That concludes my statement. Thank you very much, Senator.

Senator Haskell. Thank you very much. I do have some questions, but if I could hear from Mr. D'Arcey, then I will ask them.

[The prepared statement of Mr. Pearsall follows:]
My name is Duane D. Pearsall. I am President of the Statitrol Division, Emerson Electric Co. My home is in Littleton, Colorado. Until its merger with Emerson Electric in March of last year, Statitrol was an independent manufacturer of commercial and residential smoke detectors. I have been a small businessman for the past 23 years, having started three businesses - two of which were successful.

Statitrol Corporation presents a classic example of the evolution of an idea for a technical product, a home smoke detector, which has resulted in an industry today that approaches two hundred million dollars. Statitrol also represents a classic example of the life cycle evolution of a technically oriented small business. Facing overwhelming competition from major corporations producing consumer products, Statitrol found itself with only one alternative to survive and that was to sell out to a major corporation.

With this background in small business and having been named as Small Business Person of the Year for 1976 by the Small Business Administration, I have a responsibility to speak out on legislation affecting the survival and growth of small businesses.
RECOMMENDED TAX CHANGES

Top Priority: Capital Gain Rollover for Small Business

Other Recommended Initiatives:

1. Adopt the Small Business participating debenture.
2. Reinstate qualified stock options.
3. Liberalize Subchapter S so as to make it more useful for venture capital investment.
4. Graduate the corporate income tax to $500,000.
5. Reduce the maximum personal income tax rate to 50%.
6. Adopt a simplified and more rapid depreciation system.
7. Revise estate tax laws to ease burdens in family-owned businesses.
8. Provide a tax credit for initial investments in small businesses.
think what we are talking about in the rollover provision is that you have an opportunity here to have an alternative to the inequity that currently exists in selling out to big business.

Senator CHAFFEE. I think that is true, although when you end up with the rollover, you are still in an illiquid position. You are still locked in, except if you get out, until you pay your tax.

Mr. LITTLE. Sure, but you are also making the presumption that you are going to reinvest all of the funds that you get from your buy-out into a new business. Let's say that you end up getting $1 million, just to take a nice, round figure. Well, you may not. One of the problems that I have with the rollover is I am not sure that the period to reinvest your funds is long enough, given the kinds of securities that you have to reinvest in.

So it may be that Mr. Pearsall gets $1 million. He can only find $500,000 to reinvest. He has still got to pay taxes on that $500,000. He has got some cash, he has got some liquidity there, but on that other $500,000 he reinvests, you are saving approximately $150,000 that can go into, again, a small business.

I foresee, with some of the people that we have dealt with here, that this isn't going to be just one small business to another. It is not going to be two businesses; it is going to be 3 and 4 and 5 and 10 and quite a number. Now, not everybody is like that.

Senator CHAFFEE. I understand that, and those are good points. I suppose you would like the longest period possible, 24 months as opposed to the 18.

Mr. PEARSALL. That is a point that concerns me. Eighteen months is really not enough to reinvest properly. It takes a long time.

Senator CHAFFEE. What do you say, Mr. Little?

Mr. LITTLE. I would opt for 5 years, myself.

Senator CHAFFEE. Five years?

Mr. LITTLE. Yes. What I would like to do, Senator, is the next time you are in the home district, let me come and sit down with you and I will go over this with you in detail.

Senator CHAFFEE. Let me see. I guess it was Mr. Derieux that addressed this in some detail. Fine.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 778.]
Senator CHAFEE. Obviously each of you do think it is tremendous, because it has had such high priority on the various list that have come in here. You have got to assume that if you are there, you are in, that this rollover provision will encourage lots of other people to come in and thus help you get out.

Is that it? I mean there is somebody to buy your stock, your minority share, or you are locked in position.

Mr. PEARSALL. I think your scenario misses the point that the small business is short of capital to begin with. They have got more ideas than they have capital to exercise.

What I am considering is that this would be a means of enlarging the productivity of the small business sector by numbers and size of those businesses, instead of going at it with anti-merger legislation at the top end.

Senator CHAFEE. Mr. Little, do you have anything to add?

Mr. LITTLE. I think again you come back to the fact that—well, I haven’t been in Mr. Pearsall’s position, but let me put myself in his position for a moment. And this, of course, goes for us as investors, as well.

We have a situation where you make an investment in a business, and what are our ways out, either way? We can either sell that business for cash or we can sell that business by taking stock back from a large company. If we sell for cash, we get an immediate 30 percent bite out of that dollar that we receive. Now, that is immediately 30 percent that we cannot turn around and invest somewhere else.

Obviously, you are much more likely to sell out to a large corporation in a stock for stock deal. That is a tax deferral also. So what we are really saying here is give us something that is equally as good a tax deferral if we want to sell the business for cash.

With a smaller business, one of the things that you do by having the large corporation be in the position of trading you stock for stock is that if that is your only way to get a tax deferral, you then eliminate another smaller business who comes along and says, well, obviously you don’t want to take my stock, because my stock is just as illiquid as your stock. So we have to have a cash transaction.

Well, if you take the cash transaction, then you are immediately going to have to pay some taxes on it. So what you want to have here is the ability to get some cash and then turn around and reinvest that cash in another small business.

Or every once in a while, we in our business meet these people who are not just involved in one small business but are involved in four or five small businesses. They take that cash out and invest it in one, two, three, four places. It just stretches the dollars that you invest 30 percent further, and it also puts you in a position where there is a great deal more choice as to where you might sell your business.

And you also take a great deal of the balance or the tipping the scales away from selling out to the larger business. Have I missed anything there?

Mr. PEARSALL. That is it exactly. I think there is a gross inequity today. I sold out on a stock exchange basis, and it was a good thing to do. It was very timely. But I didn’t have an alternative. And I
impact the small business community most severely and it will be compounded by a recession, and the customers of those small businesses are vulnerable to recession. We have a social crisis facing us.

Those are my two main concerns. In the interest of time, the two bills that impress me most are the rollover provision, which started with the Casey report in 1977, and which has not survived the congressional process as yet, but it is the one bill, to me, that will tend to infuse capital back into the small business community that has eroded over the past 25 years; and the second one is the small business—

Senator CHAFEE. You know, I don’t quite understand why you and Mr. Little and some of the other witnesses have attached so much to that rollover provision. The rollover provision permits a person who has invested in a small business to get out of the small business and reinvest in another small business.

Now, explain the great significance of that as far as preserving the small business, you or Mr. Little, and one of our other witnesses spent a lot of time on that. But I guess we have got the expertise here. Go ahead.

Mr. PEARSALL. I will give you a quick example. I have been on the other side of the picture trying to get investments in our business to survive. Now I am on the opposite side of the picture and I am investing in small business as a cause.

My wife disagrees with me.

Senator CHAFEE. Wives frequently do.

Mr. PEARSALL. Yes, they do. She cannot understand why I would invest in a small business, because when you do, your investment is so illiquid, you are in that business for a long time, and you are a part owner whether you wanted to be or not, as opposed to the liquidity of a major blue chip company where you have a predictable return, predictable relative to small business.

So the illiquidity of small business has forced capital away from small business and into Government securities and blue chip investments. What we need to do is to stop this erosion of capital out of the small business sector and in some manner, in a broad fashion, suck it back into the small business sector.

Senator CHAFEE. I appreciate that, but how do you get liquidity out of the fact that you can rollover. Is somebody going to come along and buy your investment, buy you out? Let's say you are a minority stockholder and shareholder in a small business.

Now, we acknowledge there is no liquidity to it. How does this act help that?

Mr. PEARSALL. It is the deferral of the tax bite that is the big carrot to get investors into it. In my case, I cannot survive and meet inflation rates by investing with interest income. If I had some carrot that would give me a long-term deferral where I could pull it out with an equity gain at some future time with just capital gains burdens on it, that is a great incentive.

To quote a financial adviser in Denver the other day, a very sophisticated one, he said, "if the rollover proposition got into position, I would advise half of my clients to invest in smaller businesses that qualified under this act. I think it is a tremendous incentive."
gross revenues in 1956. In 20 years, that total capital relationship had eroded. In 1975 it was only 77 percent of that invested in small business.

To me, that is a dramatic statistic that I have not seen in print anywhere and I have not had it verified, but it came out of the research group serving that Casey Report committee.

I apologize for not being here earlier. I had a testimony at the House Small Business Committee this morning, and unfortunately, they are not as diligent as you. They didn’t start until 10 o’clock. Let me quote from Milt Stewart’s report to a Denver conference in 1979. Perhaps this has already been entered, but I will abbreviate it.

This is quoting 1974 figures, considering total taxes to include Federal, State, local, social security, unemployment, insurance and income. “It is reported that manufacturing firms of $50,000 to $100,000 in gross receipts, comparing total taxes as a percentage of net worth, was 30 percent.”

Figures then are regressive. As the business gets larger, the tax burden relative to net worth gets smaller, until when you reach over $1 billion, the tax burden is as low as 11.5 percent. To me that is an appalling statistic.

One thing that Milt Stewart has said is that “it is time to recognize we can’t continue doing ‘small’ things for small business,” and hope to preserve the basic foundation of our economy, which I think is small business.

My other main concern is interest rates. I have had a small business, an innovative business, which grew and was successful, and we sold to a major corporation. Having sold, I became the president of a division and participated in big business corporate planning.

I can tell you that they have been planning for a recession, as any reasonably run big business has been planning for the past couple of years. They are not going to feel it in their financial statement if it lasts less than a year.

However, I have yet to see a small business of under 50 employees that isn’t already stretched out in today’s economy when business is good, that are going to survive. I am estimating that, barring an emergency measure or a miracle, we are going to see over a half-million small businesses quit business within the next 6 months.

Senator CHAFEE. Good Lord, that is a depressing prediction. Within 6 months?

Mr. PEARSALL. Within 6 months. That is only 5 percent of those 10 to 13 million small businesses.

To verify that, I spoke to a group last week that were business representatives, each of whom had about 10 small business clients. Totally there must have been 300 small businesses represented, later confirmed the number nearer 1,000. I made that statement to them and asked them, in their opinion, from the percentage of people that they represented, would that statement hold water. They said it was underestimated.

That is a conjecture. Nobody’s crystal ball is really good in this area. But I am deeply concerned that the interest rate problem and the Federal Reserve restriction on bank loans today is going to
community, you can see very readily that the majority of it is concentrated in the retail sector. Since this is true, the impact of inventory is great in that area.

In inflationary times, present accounting rules which are allowed by IRS have a tremendous impact on those small firms.

We would like to make the point that just as the present depreciation code is tremendously inequitable to small firms because of its complexity, so also is the present rules governing accounting procedures.

We would like to suggest that the committee consider moving to cash accounting for small retailers, say under $2 million or $1 million a year in gross sales, giving them similar treatment to that given the small farmers under $1 million in gross sales today.

We believe that this would be a tremendous simplification that would help small retailers and small wholesalers across this country.

I think that about concludes the points that I would like to make, Mr. Chairman. Thank you very much and I will try to answer any questions that you might have.

Senator CHAFEE. Well, thank you. I think you have brought to us something original here that we have not given thought to before and indeed, have not had raised with us, this cash method of accounting for the smaller firms.

As you pointed out, quite rightly, that most of the small businesses that we see are capital intensive. They are not the merchandisers. They are the manufacturers. And thus the whole thrust, as you have heard this morning, has been on capital cost recovery which many of your members do not have a problem with because they are not that capital intensive.

Mr. Motley. 10 percent of NFIB's membership is manufacturers, which means roughly about 60,000 of them, and it is a tremendous problem and we did help to draft the present 10-5-3 proposal. We support it very strongly.

But we believe if we are looking for things to help the entire small business community, you must be aware that it is a tremendously diverse group out there and no one proposal will help everybody.

Senator CHAFEE. All right. Why do we not go ahead, thank you very much, Mr. Motley. Let's go ahead with Mr. Pearsall.

STATEMENT OF DUANE PEARSSALL, PRESIDENT, SMALL BUSINESS DEVELOPMENT CORP., GOLDEN, COLO.

Mr. Pearsall. I have no constituency to represent. I am a small businessman from Denver, Colo. I will only make a couple of comments that really are of deep concern to me and submit the balance of the report for the record.

I want to call the committee's attention to the 1977 Casey Report. That was a Venture and Equity Capital Task Force of SBA. A statistic came out of that study which did not get into print, and which to me summarizes what our problem is today in the small business community.

That problem is that total invested capital in small business, now speaking of those under $50 million in gross revenues, equalled 3.1 times the total capital invested in businesses over $1 billion in
EVALUATION OF THE ADMINISTRATION'S 1978 SMALL BUSINESS TAX PROPOSALS AND OTHER ALTERNATIVES

HEARINGS BEFORE THE SELECT COMMITTEE ON SMALL BUSINESS UNITED STATES SENATE NINETY-FIFTH CONGRESS SECOND SESSION ON EVALUATION OF THE ADMINISTRATION'S 1978 SMALL BUSINESS TAX PROPOSALS AND OTHER ALTERNATIVES

ENGLEWOOD, COLO.—FEBRUARY 14, 1978
PORTLAND, MAINE—FEBRUARY 20, 1978
WASHINGTON, D.C.—FEBRUARY 28, 1978

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Smith, Van P., president of the Ontario Corp., Muncie, Ind., and chairman of the Taxation Committee of the National Chamber of Commerce Council of Small Business, accompanied by Dr. Jack Carlson, vice president and chief economist of the National Chamber; and Robert R. Statham, the Chamber's Taxation and Finance manager.

Steele, John, president, Rocky Mountain Farmers Union, Denver, Colo.

Stewart, Anna-Ruth, Stewart Shell Station, Portland, Maine.

Stults, Walter B., executive vice president of the National Association of Small Business Investment Companies and representing the Council of Small and Independent Business Associations.


Weaver, Hon. A. Vernon, Administrator, U.S. Small Business Administration.

EXHIBITS


Letter dated March 6, 1978, to Senate Small Business Committee, from Edwin A. Heisler, attorney, re: administration of Section 1244 by the Internal Revenue Service.


HEARING DATES

February 14, 1978: Morning session.

February 20, 1978: Morning session.

February 28, 1978: Morning session.
NOMINATION OF MILTON STEWART TO BE CHIEF COUNSEL FOR ADVOCACY OF THE SMALL BUSINESS ADMINISTRATION

HEARINGS
BEFORE THE
SELECT COMMITTEE ON SMALL BUSINESS
OF THE
UNITED STATES SENATE
NINETY-FIFTH CONGRESS
SECOND SESSION
ON
NOMINATION OF MILTON STEWART TO BE CHIEF COUNSEL FOR ADVOCACY OF THE SMALL BUSINESS ADMINISTRATION

APRIL 14 AND 25, 1978

Printed for the use of the Select Committee on Small Business
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SELECT COMMITTEE ON SMALL BUSINESS

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(II)
Mr. Lewis, Mr. Chairman, to sum up, you cannot find a better man. We support him and urge his confirmation.

Thank you, Mr. Chairman.

Chairman Nelson. Thank you, Mr. Lewis.

Our next witness is Mr. Duane Pearsall, president, Statitrol Corp. of Littleton, Colo.

Mr. Pearsall. Thank you, Mr. Chairman. We are a division of Emerson Electric Co. but prior to its acquisition a year ago Statitrol was a small business.

In 1976, I was awarded the Small Business Pearson Award of the Year by the Small Business Administration.

I have become visible since that time and have participated in every small business function that I know is available to me in Washington. In every circumstance, Milt Stewart's name comes up. He is an example and a stimulus to each small business person's efforts for supporting the needs of small business and preventing what I consider unintended effects of legislation which has had a negative effect on small business over the last few years.

I have made 40 to 50 speaking engagements in the past 2 years, chambers of commerce, etc. I would like to say in that connection, the Denver Chamber of Commerce had a retreat last week when the question of legislative issues of small business came up, that is, legislation supported by the Denver chamber. A director from big business said there was no point in our company participating in that effort since we have representation in Washington through the Business Round Table, the National Association of Manufacturer, the U.S. Chamber of Commerce and our own lobbyists.

By comparison, small business has very little and you have heard from most of those associations this morning. I want to take this opportunity to thank you, Senator Nelson, for your personal efforts in behalf of small business.

I have carefully reviewed the business history of Milt Stewart involving his participation in a small business investment company (SBIC) and the problems involved with the Securities and Exchange Commission.

In my view, the judgments made by Mr. Stewart throughout this sequence of events were sound. Under similar circumstances, I would only hope my judgment would have been as good.

I have a concern if I were to entertain a public office myself similar to Mr. Stewart. I am concerned about the disincentives of serving the Government through exposure of honest business judgments that might be cast in a bad light as they were by Senator Weicker this morning.

I do not think that was intentional, but that is a disincentive for legitimate, capable business people to take an active role in Government.

What I consider the most important aspect of Mr. Stewart's nomination is his knowledge of the inner workings of Government and his courage and commitment to fight for the survival of small business.

I, therefore, urge that the committee approve the nomination of Milton Stewart as Chief Counsel for Advocacy of the SBA. I would
consider my trip to Washington this morning very worthwhile if the committee approves that nomination.

Thank you for the privilege of appearing today.

I will submit the rest of my statement for the record, Mr. Chairman.

Chairman Nelson. Without objection, it will appear in full in the record at this point.

[The prepared statement of Mr. Pearsall follows:]
My name is Duane D. Pearsall. I am President of the Statitrol Division, Emerson Electric Co., Lakewood, Colorado. Until its merger with Emerson Electric in March of last year, Statitrol was an independent manufacturer of home smoke alarms and commercial smoke detectors. We were a small business firm prior to that acquisition and I am speaking today from the standpoint of a small business person of 23 years. I have started three businesses, two of which were successful.

My acquaintance with Mr. Stewart began in early 1976 shortly after I received the award as Small Business Person of the Year. Since early 1976, I have become involved in Federal legislation affecting small business. I had the privilege of serving on the SBA Task Force on Venture and Equity Capital. This required monthly visits to Washington. I have participated in every small business function available to me, including membership in the National Federation of Independent Business for the past 20 years, the National Small Business Association and as a charter member of the Executive Committee of the Small Business Council of the U.S. Chamber of Commerce. Milt Stewart is highly respected by all these organizations.

During the past two years, I have made 40 to 50 speaking engagements to special organizations, service clubs and chambers of commerce. Currently, as a member of the Executive Committee of the Denver Chamber of Commerce, I have helped in the development of its Small Business Council.

Before making this appearance, I have checked with every small business organization referenced in this statement and found them to be unanimous in their support of Mr. Stewart's nomination.

In my opinion, no where in this country is there a man better qualified for this position.

I have carefully reviewed the business history of Milt Stewart, involving his participation in a small business investment company (SBIC) and the problems involved with the Securities and Exchange Commission. In my view, the judgments made by Mr. Stewart throughout this sequence of events were sound. Under similar circumstances, I would only hope my judgment would have been as good.
Far overshadowing this circumstance, however, is Mr. Stewart's knowledge of the inner workings of our Government. His reputation and experience, combined with his compatible relationship with the SBA Administrator, Mr. Vernon Weaver, should allow Mr. Stewart to accomplish the purposes of the office.

My real concern is the growing disincentives attached to Government service. I, for one, would not want the responsibilities of this position regardless of the rewards. Milt Stewart, however, understands the needs of small business and has both the courage and the commitment to fight for their survival.

I, therefore, urge the Committee to approve the nomination of Milton D. Stewart as Chief Counsel for Advocacy for the Small Business Administration.

Thank you for the privilege of supporting this nomination.