

increase of business borrowing. The effect of the drop in low-risk interest rates would be gradually diffused through the credit structure, as banks and other financial institutions adapted their portfolios to the changed pattern of interest yields. Because the primary impact of an increased supply of funds is on the low-interest, low-risk sector of the capital market, and only the spill-over occasioned by secondary repercussions makes funds available to risky investments producing higher yields, we assume an average rate of 5 per cent to apply to this part of our tax cut.

The investment behavior of small corporations is considerably more sensitive than that of large corporations to changes in tax rates.<sup>35</sup> Companies with high growth potential are affected most adversely by corporate taxes, which prevent internal accumulation of the capital they need. External sources of long-term capital are available to small companies only at high cost in terms of both money and loss of control.<sup>36</sup> The corporation income tax also diminishes the attraction of risky investments, since a small firm is less likely to be able to take advantage of the loss-offset provisions to reduce the tax liability on profitable operations. But the significance of these arguments should not be overstated. Not all small business would grow rapidly in the absence of taxes; the need for new capital of many companies is small and can be satisfied. A recent survey of the Department of Commerce<sup>37</sup> found that of all the firms in their sample, 56 per cent had no desire for outside financing, 24 per cent obtained all the funds they desired, 13 per cent obtained some, and only 7 per cent failed to obtain any. New firms were somewhat less successful in raising capital and, most significantly, it was the demand for long-term and, particularly, for equity funds which failed to be met. On the basis of this evidence, we assume that 50 per cent of the increase in retained earnings is invested within the small firm; to this we assign a rate of 18 per

<sup>35</sup> Lintner, "Effects of Corporate Taxation on Real Investment," *op. cit.*, p. 533.

<sup>36</sup> For an analysis of the case of the growing firm, see J. K. Butters and J. Lintner, *Effect of Federal Taxes on Growing Enterprises* (Boston: Graduate School of Business Administration, Harvard University, 1945).

<sup>37</sup> Loughlin F. McHugh and Jack N. Ciaccio, "External Financing of Small and Medium-Size Business," *Survey of Current Business*, *op. cit.*, October 1955, pp. 15-22.