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An INTRODUCTION *to*
F I N A N C E

By

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AN INTRODUCTION TO FINANCE

I ECONOMICS AND SOCIAL ASPECTS OF FINANCE

IN THAT broad sense which implies the adjustment of means to ends, and of ends to means, when both means and ends are thought of in terms of money, financial problems, financing and finance are in effect co-extensive with economic life as a whole in any modern community. For economic operations in such a community present themselves primarily in the shape of an expenditure of money for the attainment of certain ends, and the problem of how the money costs are to be met is inescapable. Everyone's income helps to "finance" his expenditure; how everyone's income is to be adjusted to his expenditure, or his expenditure to his

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income, is a "financial" problem ; and the shifts and expedients which are necessary for the attainment of equilibrium—if, indeed, equilibrium is ever attained—are "financial" operations no less vital or interesting to the individual concerned than the flotation of an international loan is to the Rothschilds and the Barings who manage the operation, and to the Finance Ministers of impecunious States on whose behalf the operation is conducted. Nevertheless, for purposes of discussion here, "Finance" must be interpreted in a somewhat more definite manner. In one sense, all pecuniary transactions can be thought of as "financial" transactions ; but there are some pecuniary transactions which are thought of as being "financial" in the technical sense, while others are not.

It might at first sight appear that the distinction which has to be drawn between the wider and the narrower uses of the term turns on a question of fact ; namely,

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on the question whether the resources involved are furnished by someone other than the recipient who intends to apply them to some purpose. Thus, if John Citizen buys a house out of his own savings, the operation is not, technically, a financial one ; whereas, if he borrows the money in the first instance from a Building Society and repays the latter by instalments, the operation of buying a house *also* becomes a financial operation, because it involves the intervention of a professional lender. But economic science has long used the term “ Public Finance ” to describe, not only those aspects of governmental expenditure which involve the raising of loans through the intermediary of technical organisations, but also those operations, such as the raising of taxes and the administration of State property yielding a profit, which involve no loan operations at all. Moreover, when additions and extensions are made to the plant and

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equipment of a joint stock company and the necessary funds are provided by means of withholding from the shareholders part of the profits earned by the enterprise, the exponents of the new subject of "Corporation Finance" would undoubtedly say that the operation has been "financed," just as the operation would have been called a financial operation if the company had raised new capital in the shape of debentures or shares in the London money market through the co-operation of a professional intermediary specialising in this class of business.

The examples above show, too, that the distinction between financial and non-financial operations does not always turn on the distinction between "capital" transactions and "revenue" or "income" transactions ; for "public finance" is concerned in the main with the devices by which the current day-to-day expenditure is provided, and the operations of the

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banking system with the provision of those temporary advances which anticipate the sale of the products of industry to the consumer.

But, though the distinctions drawn above are not sufficient accurately to delimit the frontier, they are guides to current conceptions. The truth is that the frontier between financial and other transactions is vague and very difficult to draw. Broadly, financial transactions are concerned with the raising of sums of money for the purpose of meeting the costs of economic activities where these activities either do not bring in an immediate return or where they—as in the case of much of the work of governments—do not bring in a return at all, and their cost has to be met by a general levy on the resources of others, or, finally, with the raising of sums of money in order to meet costs anticipatory of activities which are intended to bring in a direct pecuniary return at a

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later date. Very broadly, financial acts distinguish themselves from acts of purchase and sale by their subordinate, ancillary and provisional character. But it is useless to heap words on words in the effort to attach an invariable content to words which, in the mouth even of the technician, have a different meaning in different contexts ; for to do so is to run the danger of excluding important aspects of the situation. Illustration may serve to make the situation clearer.

By far the larger part of modern production takes place in anticipation of demand. Production takes the form of a continuous stream of goods, some of which are, at any moment, in a completed condition, others are just emerging from a semi-finished or partly finished condition, while at the same moment others are just beginning to be shaped out of the raw materials which they embody. At any moment the finished goods which happen to be in existence

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constitute the "stock" of that particular commodity, but the constituents of the stock change from moment to moment as goods are sold and are replaced by others which have just completed the production process. If consumption and production were completely adjusted there would be no "stock," since the newly finished goods would be at once taken off the market. But in fact consumption is, in the majority of cases, more discontinuous than production ; the technique of production makes it desirable to make the flow as even as possible. Stocks are accumulated in anticipation of demand. These stocks, as well as the whole of the goods currently in process, represent a series of costs ; wages, expenditure on fuel, raw materials, transportation and the like. These costs are ultimately to be met out of the sale proceeds ; until they are they have to be met in some other way. In so far as they are met by loans in anticipation of sales,

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whether these loans are made by bankers or whether they are made by those who furnish the raw materials, etc., being prepared to await payment until the goods are sold, a "short-term" financial operation is involved; production is being "financed" by the banker, or by means of short-term commercial credit. The economic activities involve cost, and the outlay does not bring in an immediate return; the mechanism by which the time-interval is bridged between outlay and return is part of the financial mechanism.

Again, production involves, not only current expenses in connection with the supply of labour and raw materials, etc., needed to bring goods to market, but it requires the creation of permanent units through which production is organised. These permanent units which undertake production constitute the "business enterprises" of the community, however much they differ in detail and in legal form from

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one to the other. They require, not only current assistance in bridging the gulf between production and consumption at any moment, but a permanent volume of pecuniary resources ; the capital of the enterprise. The capital is invested in innumerable ways ; in the provision of plant and equipment of all kinds. The costs involved are anticipatory costs, in the sense that they are intended to subserve the production of goods and services which alone bring in the revenue which will make the concern profitable. The problem of raising this capital is a financial one and forms part of the general question of Industrial Finance.

Lastly, as regards the economic operations of Government. In some respects the economic operations of Government resemble those of business enterprise. When a Government borrows in order to extend the telephone system, or when a municipality raises funds for erecting an electricity works, the sums so raised are

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anticipatory costs, just as they would be if the services, the provision of which they are intended to further, had been provided by private enterprise, and the essence of the problem is not altered by the public character of the authority involved, though the legal position may be much altered thereby. There are even analogies between private business and Government in that respect in which the difference at first sight appears so marked—the sphere in which Government undertakes to provide certain services and meets the cost of those services not by a charge varying with the amount of the service consumed, but by a charge on the general body of citizens, *i.e.* the sphere of “taxation.” For the finances of a club are also conducted on a not dissimilar basis—the general costs of running the club are met out of subscriptions paid by the members ; though the amount of the amenities consumed by different members may vary very greatly there is little

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attempt to differentiate the tax-levy or subscription involved.

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The impact of finance upon the modern world is of immense significance. In what follows attention will be drawn to some salient characteristics from the economic point of view. The social aspects deserve, and will receive, special consideration.

First, the *magnitude* of the operations involved. Leaving on one side altogether the supply of long-period capital, each year the financial organisation has to finance the sowing and harvesting of the crops and the raw material supplies of the world. Of the total production of foodstuffs and raw materials, a part no doubt is consumed on the farms and other production sites by the producers themselves ; but by far the larger part now enters into commerce, and to finance the grower during the intervals between sowing and final payment by the

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consumer is an operation the immensity of which is by no means always fully appreciated. For variations in the price and volume of a single crop may make very great differences to the strain imposed on the financial system. Thus, the world's wheat harvests in 1925-6 and 1930-1 differed by some 10% (3,344 million bushels in 1925-6 ; 3,675 million bushels in 1930-1). The average annual price in the first year (cents per bushel) was $139\frac{1}{2}$; in the year 1930-1 it was $73\frac{3}{4}$. On the assumption that in each year 60% of the production entered into commercial trade and required financing at some stage or other, the amounts involved fluctuated from £558 millions in 1925-6 to £326 millions in 1930-1. Wheat represents only a single (though certainly very important) raw material ; in addition to the financing of the raw material supplies of the world, the financial organisation has to provide for the current needs of manufacture and

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commerce. Without labouring the point any further, it is clear that a task of immense magnitude is involved.

Again, though figures relating to long-period capital issues are full of pitfalls and have, therefore, to be used with great caution, it would appear that in 1929—a year, it is true, of quite exceptional stock exchange activity in the United States and elsewhere—the volume of capital issues (excluding loans to Governments as far as possible from the computation) in the United States, Great Britain, Germany and France alone amounted to over £2,400 millions. Of this amount five-sixths was offered in the United States, but the whole world participated in the provision of the funds ; and the figures will at least serve to show the scale of operations involved. (It must be remembered, however, that the effect of joint stock enterprise is in part only to *make visible* the flow of capital to business ; if the whole of

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business were to-day in private hands, as it practically was a century ago, the volume of capital demanded might be the same but the statistical data would be much less available.)

Secondly, these magnitudes involve complementary and, in the main, equal magnitudes in the shape of a flow of savings. It is not enough for the financial system to cause funds to flow from industry to industry or from place to place in the appropriate amounts ; it must stimulate the growth, and organise the collection, of savings, and must safeguard their investment to the extent necessary to guarantee the continuance of the flow. This, as will presently appear, is a matter of great complexity ; not only or, indeed, mainly because of the problems of *organisation* which are involved, but because of the social strains set up when a superstructure of financial obligation is built upon the foundations of a standard of value which is not

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stable in purchasing power. But at this stage of the argument it is sufficient if the reader bears in mind that the task of finance is a double one ; it is not only a question of applying funds to certain uses, but of seeing to it that funds are there to be used.

Thirdly, in the modern world, the scale of Government finance has assumed dimensions alien to the inherited traditions, not only of the financial world itself, but of the business classes and the academic students of economics and politics. Partly as a result of the Great War, partly as a result of the changing conceptions of the functions of Government (and these conceptions have changed, not only because of the general prevalence of democratic governments or dictatorships having to make a popular appeal, but because science in general, and administrative science in particular, is constantly opening up new avenues for exploitation), the scale of Government has expanded, and with

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that growth of scale the national Budgets have swollen also. This fact not only lends added significance to the technical problems which emerge—alternative systems of taxation and the like—considered as technical problems, but greatly adds to the significance of Government finance as an element of the economic life of the community, however the positive functions of Government may be regarded.

Fourthly, finance is one of the most potent, and almost the least impeded, of the agencies integrating the modern world into a single economic system. Tariffs interrupt the flow of goods, immigration and emigration laws prevent the free movement of persons from place to place. Though the flow of capital is not absolutely free, for nationalism dislikes the idea of domination by "foreign capitalists," yet, in comparison to the impediments in the way of the movements of goods and persons, capital movements are on a

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sufficiently broad scale to enable us to speak without hyperbole of a world rate of interest and of a world capital market. Without such a free flow of capital it would have been impossible to develop the natural resources of the Americas, of Australasia and of the Far East to the extent that has actually taken place within the last century and a half.

The social effects, to which we now turn, are no less striking. A century ago it was still possible for the most prominent English private banker of his day, Vincent Stuckey, to explain to a Parliamentary Committee that the rural Englishman preferred the notes issued by a private banker "with twenty thousand a year in Land" to the notes of the Bank of England. Until quite recently land and buildings and jewels constituted the *essence* of the idea of property : to-day the essence of property consists in the possession of "securities." Finance has altered the face of the world

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by making wealth *mobile*, in the sense that property rights attach directly, not so much to physical things as to documents of title to such things, or to rights to draw income, whether fixed or fluctuating, through institutions owning such property or from Governments and other public bodies which have borrowed for many purposes, productive and unproductive, on giving an undertaking to pay interest for the loan. Because property so largely takes the form of owning such titles to income, the constituents of a given fortune may change extraordinarily quickly : an “ estate ” of a million pounds may mean very different things on two successive days, simply because a different set of investments is held ; and the “ management of property ” in these days means much more frequently than it did even twenty years ago the art of knowing when to sell and when to buy securities of different kinds. The fact, so frequently deplored, that

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the modern capitalist is "irresponsible," "divorced from places and things," is simply due to the growth of a species of property the essential character of which is its *mobility*.

Two very striking results follow. Property is more vulnerable than it ever was before to attack, because so large a part of it consists merely in rights to income. And these attacks can come in an obvious and a subtle guise. The obvious weapon of attack is taxation : the less obvious weapon is a change in the purchasing power of money. An income tax of five shillings in the pound reduces the net yield to the investor to fifteen shillings, and is regarded as a high rate of tax. But, if the price level doubles, the real yield of the investment is halved. Experience during the period of inflation following the War proved that a price level is capable of doubling, not only in the course of a year, but in the course of a day. The vulnerability of fixed income rights to attack from fluctuations

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in the purchasing power of money is thus of immense significance in the modern world in which, owing to the progressive transfer of certain types of undertakings to Government or quasi-Government operation, this kind of security is steadily increasing in importance. Property is more vulnerable to-day, further, because ownership is so much more clearly divorced from responsibility, and because the owners of such property seem so clearly immune from the obligation to reside at a fixed place for the performance of work which is the lot of the majority. Mobile property has created a class seemingly free from the most obvious restrictions resting upon the worker : it is not surprising, therefore, that the increasing publicity devoted to the doings and activities of an apparently irresponsible social class should result in an increasing resentment at the differences of fortune thus indicated.

Lastly, the spread of international

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investment raises social issues of a special, though still of a very serious kind, for it involves the contact of nationalities and of races. When this contact assumes the form of the capitalist employing local labour, of which he knows nothing at all except that such labour is willing to work for him or in his enterprise, it assumes at times an unlovely and unamiable form. It is not only that the introduction of modern capitalistic methods of production may destroy the indigenous standard of inherited skill and way of life ; it opens the door to exploitation of a crude kind, for the local labour may be helpless to protect itself and the capitalist owner may be unable, owing to ignorance and distance, to impose conditions of labour and standards of life. Without doubt, the introduction of capital into these new areas helps to increase their productivity, but the process of capital infiltration is not accomplished without serious elements of loss.

II

THE ORGANISATION OF THE MODERN FINANCIAL MECHANISM

SINCE finance is essentially the process of linking up the supply of funds with the demand for them, financial mechanism is in all countries intended to subserve the same primary purpose, however much the details of the structure may differ from place to place. A distinction must, therefore, be drawn between the different financial markets, each of which exists to link up a particular kind of supply with a particular kind of demand for capital, and the nature of the agencies involved. In all countries there is a marked tendency for the distribution of functions among the various financial agencies to be determined in large part by historical causes, the

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importance of the historical factor itself varying, of course, with the various financial centres. Old financial centres, such as London or Amsterdam, will possess a financial structure more deeply marked by historical survivals than newer markets such as New York or Berlin. The main line of division concerns the degree to which there is division of labour or integration of function among financial agencies, *i.e.* the extent to which in each sub-market there are separate firms or institutions or, alternatively, the extent to which the same group of firms will perform different functions whilst maintaining identity of legal form. Thus the old private banking firms of such centres as London, Paris, Amsterdam and New York not only concern themselves with the issue of new securities, but are also concerned with the financing of foreign trade and with dealings in bullion and foreign exchange. That is, the "merchant banking" firms not only act as

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“ acceptance houses ” but also as “ issuing houses,” side by side with firms which specialise more closely in one or other of these directions.

Every modern financial structure comprises five different divisions :—

(1) A market in which funds which are only available for short periods of time can be handled. This market is known as the Short Loan Market. The funds which flow to this market come to it from other institutions, mainly from the Commercial Banks and the large private banking institutions. The borrowers in this market are the dealers in bills and the dealers in securities, or, to put the matter in technical language, Call Money is borrowed by the Bill Market and the Stock Exchange.

(2) A market in which funds available and required for moderately long periods of time are lent and borrowed. This market in all countries is the field of activity of the Commercial Banks. They absorb

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the current spare funds of the community, which constitute their deposits, and re-lend the bulk of them to the business community in the shape of commercial loans and overdrafts.

(3) A market which exists to facilitate, firstly, the creation of investment securities and, secondly, the transfer of long-period securities. Thus a twin organisation is necessary, of Promoters and Issuing Houses, on the one hand, and of an organised Securities Market, on the other. This latter market is the Stock Exchange, together with its membership of brokers (and, in London, of jobbers).

(4) Each financial structure comprises a series of specialised institutions, made necessary by the desirability of safeguarding savings in a special way or satisfying a particular kind of demand. These specialised institutions are of many kinds : Savings Banks, Agricultural Banks for short and long term loans, Building

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Societies, Insurance Companies and Investment Trusts, to name only those which are familiar to readers on both sides of the Atlantic.

(5) Lastly, there is one specialised division of the financial structure which carries out functions of a most important kind. This is the Central Bank ; the primary function of this institution is to act as the Central Supervisory Agency of the financial system as a whole. How it carries out its functions will be discussed at a later stage.

Organised money markets differ from one another, as already pointed out, by the manner in which the agencies operating in these various markets are related to one another. Thus, in London, the Bill Market is more important as a source of demand for Call Money than the Stock Exchange : the reverse is the case in New York. In London the function of promoting and issuing new securities is in the

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hands of the old merchant banking firms ; in Berlin this function is carried out in the main by the Commercial Banks, in New York by private banking firms *and* the special subsidiaries created for this purpose by the Commercial Banks. The Savings Banks are a more important element in the German banking structure than in the British. The dealers in bills in London are specialised, in New York they are not. Building societies have recently acquired great importance in England ; agricultural banking in the U.S.A. But the structure as a whole covers the *same range of activities*, and this is the important matter. The survey of financial operations which follows is built up on the basis of the various sub-markets already described.

III

THE SHORT TERM MONEY MARKET

FUNDS borrowed and lent in this money market range from the day-to-day call loans to loans lent from one period of settlement on the Stock Exchange (in London) to the next. The essence of the "call" loan is that it is lent subject to very easy terms of withdrawal. But why should anyone be willing to borrow or lend on such terms? It seems at first sight impossible that it can pay anyone to borrow for 24 hours, running the risk of having to repay the money, or for anyone to lend for the same period of time.

The explanation lies in the facts that *any* rate of interest for *any* length of time is better than no rate of interest at all, and that, from the standpoint of the lender,

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a loan which is repayable at very short notice is a great convenience, since it earns something and yet is liquid. (One day's interest on £365,000 at $2\frac{1}{2}\%$ per annum is £25, about one month's salary of a fairly well-paid London bank clerk, so that one year's salary can be paid by investing this amount for a fortnight.) Hence the great financial institutions like to keep a certain proportion of their funds permanently in such loans ; they are a "second line of defence," ranking next to actual cash held in vault or at some other bank as liquid funds. And it is also convenient to borrowers to have loans easily repayable, since, if money can be obtained more cheaply elsewhere, the first loan can speedily be repaid by borrowing at a lower rate elsewhere. The *price* which is paid for a very liquid investment is, from the standpoint of the lender, a very low rate of return ; from the standpoint of the borrower, the low rate he pays is

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compensation for the risk of having the money suddenly withdrawn.

The *supply* of such funds comes from two main sources. The normal supply comes from the great Commercial Banks which, as already pointed out, regularly invest a certain proportion of their deposit money in this way. But there are special sources of supply as well ; funds awaiting permanent investment in the hands of financial institutions, *i.e.* proceeds of loans and sums available in anticipation of dividend requirements and the like. The net effect is that the supply of "short money" as a whole is more regular than individual portions of it.

The users of "short money" are, primarily, in London, the dealers in bills ; in New York the Stock Exchange brokerage houses. Not all the funds used by bill dealers and stockbrokers is subject to short terms of recall, but much of it is. Whether employed in the purchase of bills or in the

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purchase of securities (by being lent to the customers of Stock Exchange houses who desire to buy securities they cannot immediately pay for) the money so lent flows back into the great stream of circulation, by which industry and trade are nourished. For the bills of exchange bought by means of this borrowed money represent, to a large extent, the current movement of produce and goods in the International Trade of the world, and the securities which have been bought by speculators with borrowed money have had to be sold by someone else, so that the purchasing power at the command of the seller has increased. In addition, call money borrowed by bill dealers, under post-War conditions, is largely used by them in buying Treasury Bills, a bill of exchange issued by Government to finance its current expenditure, so that, again, through the channel of the Treasury, the money borrowed flows back into the general stream.

There are problems, however, attaching to the existence of the Short Loan Fund. The fundamental principle of every money market is that money paid for must be money used. Now, this means in practice that whilst *specific* loans are liquid, the total of the Short Loan Fund is not. If a broker borrows £100,000 from Bank A, he does not lock it up, but buys bills with it. Suppose that the Bank calls in the money, what can he do? He can either re-sell the bills he has bought, which may prove unprofitable, or re-borrow. But the possibility of re-borrowing is conditioned by the Short Loan Fund *as a whole* remaining unchanged; if all the lending institutions withdraw simultaneously it becomes impossible. Under these conditions, to re-sell what has been bought with the borrowed money *must* become unprofitable, for everyone will be trying to sell at the same time.

One of the functions of the Central Bank

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is to prevent the Money Market from becoming "jammed" in this way. For the Central Bank, both in London and New York, stands prepared to buy bills of exchange at a stated price, or to advance at a stated price ; alternatively, to create conditions in the Short Loan Market which will *restore* the normal process of its operation, which it can do by the device of buying securities in the open market, thus adding to the supply of funds in that market. The power of the Central Bank to act in these ways is, as we shall see later, the key to the understanding of the very peculiar position which it occupies. But the upshot of the present section is this : while the Money Market functions normally, short money really is a liquid form of investment, but only because it is assumed, by both borrowers and lenders, that money borrowed and lent can be re-borrowed and repaid through loans by someone else.

IV

THE INTERNATIONAL SHORT LOAN FUND

THERE is one form of lending for short periods of time which, since the War, has assumed enormous proportions and presents peculiar features of its own. This is lending by institutions in one Money Market to institutions in another. The total of the sums so lent and borrowed constitutes the International Short Loan Fund. Before the War London was the great lender in this way ; to-day London is both a lender and a borrower, while it shares its former predominance with New York and with Paris. Though the amounts involved are unknown, it is probable that a sum of something like £1,000,000,000 is involved in the aggregate.

(1) A large part of the international trade of the world is “ financed ” through

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London. Bills are drawn on the importers of goods in Hamburg or Shanghai, but these bills are validated, *i.e.* accepted, on behalf of the real importers by London banking houses, who rely on receiving funds for meeting the bills as they fall due from the importers. Pending the date of payment, the bills are discounted in London, *i.e.* ready cash is given for future payments, so that the banks are able to advance to the *exporters* in anticipation of repayment by importers. So long as the remittances are not yet received, London is lending abroad the present value of the bills, and, in so far as the amount of bills is increasing, the volume of London's foreign lending is increased.

(2) When the rate of interest is higher, say, in London than in New York, it pays American firms to invest in London. *i.e.* to lend money to London bankers. What really happens is that in London dollars are sold to those having debts to settle in

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America, and the pounds paid for these dollars represent the proceeds of the loan. As a general rule, no gold is actually transferred ; from the banking point of view the transaction is then purely a book-keeping one, which has the effect of enabling Great Britain to meet (temporarily) one set of American debts by creating another. •

(3) Thus it may very well be the case that London is lending on the one hand and borrowing on the other. The situation in New York may (on other grounds, however) be the same. A foreign Government may be borrowing in New York by means of a long-dated loan. The proceeds of the loan (dollar proceeds) may be sold by this Government to the local Central Bank for cash, say, marks. The Central Bank in question may want to hold dollars permanently as part of its reserve, in which case New York will be a creditor on Long Term Account and a debtor on Short Term Account.

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(4) When a currency is disorganised, banks and business firms, as well as private individuals, try to escape from the consequences of further declines in the value of the currency by holding foreign bank balances. Thus, during the period of currency disorganisation in France, many millions of pounds of English money were acquired by French interests. France, in so far as these sums are held permanently in this country, is really making Great Britain a loan to this extent : in so far as French balances are permanently kept in New York, France is making a loan to the United States.

Thus the International Short Loan Fund, when analysed, is an extraordinarily complex thing. Instead of great financial centres being borrowers only, or lenders only, they are both, and their net position may be that of borrowing at one time and lending at another.

What are the dangers which accompany

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so considerable an extension of the system of international short-term lending as the last decade has witnessed? They are two in number. .

First, the danger of a sudden withdrawal of these funds, which may put the Central Bank into a position of very great difficulty. For the normal weapons of defence may be unable to prevent these sums from being withdrawn, and a heavy loss of gold may be the consequence. If, for example, French balances are withdrawn from London, the technical method by which this is done is by sales of sterling in the Paris foreign exchange market; this reduces the franc value of the pound and, if this reduction is great enough to make the costs of shipping gold from London worth while incurring, gold *will* be shipped. Hence a market with heavy foreign balances due by it is in an essentially unstable situation. This is why the influx of foreign balances into the London market is so

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often spoken of as the influx of "bad money." The money is "bad" simply because its withdrawal may, later on, involve heavy gold shipments. This, again, explains the statement, so frequently heard in these days, that the more gold a bank has lost, the less the danger of its losing any more, for, by losing gold, the foreign balances have been depleted.

Secondly, what is lent "short" must be invested "short"; that is, international funds borrowed for short periods cannot be invested for a period of time longer than that. The danger is that funds so lent will be invested primarily in bills of exchange. An increase in the demand for bills raises their price, *i.e.* lowers the market rate of discount, which makes the bills dearer to buy. Now, if the Central Bank, for reasons of its own, desires to see the market rate of interest maintained at a certain level, its policy in this respect is endangered if an inflow of funds from abroad is pressing the

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rate in a downward direction. For, if the rate falls low enough, bills will be attracted to that centre for sale, *i.e.* the high current price (low rate of discount) leads to fresh bills being created for the purpose of being discounted, and if borrowers are foreigners an *outflow* of funds may be initiated, ultimately leading to gold movements. Thus, any beneficial effects produced by the previous inflow may be neutralised.

The growth of the International Short Loan Fund has thus created new problems, calling for some revision of the traditional attitude on the subject of the benefits to be derived from acting as an international centre. That attitude was based upon the popular conception of London as a predominantly lending centre, and had not taken into account the difficulties arising when a centre is at times more of a debtor than it is a creditor.

V
THE COMMERCIAL
BANKING FIELD

IT IS through the Commercial Banks that industry, trade and commerce, the professions and the general public usually come into contact with the machinery of finance, and this in two ways ; as lenders to the banks, and as borrowers from them. Although it is habitual, in discussions of these subjects, to lay stress upon the functions of banks as *lenders*, their functions as borrowers are equally important. Many people and even many industrial and commercial firms have never found it necessary to borrow from their banks, but they find it absolutely necessary to maintain a banking account. The fact is that the modern world, at any rate the modern English-speaking world, habitually uses the banking

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system, not only for the purpose of borrowing, and of depositing spare funds, but for the purpose of making its payments. Transfer by means of cheques is so convenient that the majority of transactions, certainly by value, most probably also by number, are made by means of cheques. In Great Britain the existence of a stamp duty upon every cheque drawn no doubt acts to some extent as a deterrent against the drawing of cheques in settlement of accounts which can be met without inconvenience by the use of small bank-notes ; but in the United States no such deterrent exists and the use of cheques for even the smallest payments is then habitual to those possessing a banking account. And the possession of a banking account (formerly in England, at least, the sign of a certain superior social status) has been made easier on account of the intense competition for customers by the banks themselves. The first group of questions

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which arises, therefore, concerns the relationship between banker and customer.

(a) *The Deposit Side of Banking*

In Great Britain a distinction is drawn in the literature of banking between Current Accounts on the one hand, and Deposit Accounts on the other ; a distinction which corresponds to the American division between Demand Deposits and Time Deposits. The importance of the distinction in Great Britain is supposed to lie in the fact that only Current Accounts are available to be drawn against on demand by cheque, while carrying no interest ; sums standing to the credit of Deposit Accounts are repayable only at notice, but carry interest. In practice, however, these rigid distinctions do not quite obtain and, in any case, practice in the North of England differs much in these respects from practice in the South of England. In the

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North, interest is paid upon the minimum amount kept on the credit side of the account. In these circumstances, there is not much advantage to the customer in keeping two accounts although, as a matter of fact, it is known that, in consequence of the trade depression, a considerable increase in the volume of Deposit Accounts has been taking place in the last eighteen months, taking the whole banking system into account.

In the U.S.A. the position is very different, owing to differences in the legal regulations relating to Reserve Ratios. In Great Britain there is no statutory obligation upon the Commercial Banks to keep any cash reserve at all, much less a statutory amount. In the U.S.A. the Federal Reserve Code imposes on all the Member Banks the obligation to maintain at the twelve Federal Reserve Banks a reserve against demand deposits of 7, 10 or 13 %, according to the physical location of the

Member Bank. Against time deposits a uniform cash reserve of 3 % only has to be kept. This distinction has had the effect, perhaps entirely unexpected, of greatly stimulating the growth of time deposits. For a bank may be better off, financially speaking, by paying interest upon a Time Deposit, if at the same time it can cut its reserve requirements down from 13 to 3 %. In effect, the growth of Time Deposits under these conditions is tantamount to a net reduction in the reserve requirements imposed on the Member Banks of the System.

The relationship between banker and customer is much wider than is implied in the mere keeping of an account by the one for the other. In America, in particular, banking competition has resulted in the banks being prepared to carry out a wide range of services on behalf of customers, some of which can hardly be regarded as falling within the sphere of banking at all.

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But in Great Britain the custody of documents and securities, the performance of Executor and Trustee functions (through subsidiary corporations in some instances), etc., have very much widened the range of contact.

(b) The Lending Side of the Banker's Activities

A distinction must be drawn between the following three elements : (1) the time element, *i.e.* the length of time for which the loan is made ; (2) the charge made for the loan ; and (3) the nature of the security required. So far as Great Britain is concerned, advances by bankers fall into two great categories—loans and overdrafts. A loan is made when a fixed sum is advanced for a fixed period of time, say three or six months. The borrower pays interest upon the amount for the period of time in question. An overdraft is the right to borrow up to a given amount in excess of the

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customer's own credit balance and, therefore, the amount "overdrawn" depends on the extent to which the facilities granted are actually made use of during the period of time for which the facilities are granted. Hence the overdraft is a much more elastic form of borrowing. Though in Great Britain the distribution of loan and overdraft facilities is in part a matter of local custom and tradition (loans in the South, overdrafts in the North), it seems to be the case that overdraft facilities are growing at the expense of loans.

The charge made is governed, in the case of Great Britain, by a conventional relation based upon the movement of Bank Rate, *i.e.* the official minimum rate fixed by the Bank of England for the discount by it of bills of exchange. Charges range from $\frac{1}{2}$ to $1\frac{1}{2}\%$ over bank rate, with a fixed minimum of 4, $4\frac{1}{2}\%$ or 5% . That is, when bank rate falls below $3\frac{1}{2}\%$, loan charges to customers no longer fall with

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it. Under existing arrangements, also, the interest paid upon deposits (or upon minimum balances on current account) varies in Great Britain with the bank rate, being fixed at 2% under bank rate for deposits subject to 7 days' notice of withdrawal, with a maximum of 5% interest. It is clear that the banks must maintain a margin between what they charge and what they can afford to pay to depositors, for out of the difference the banks must meet their charges for staff, buildings, etc. It is true that on a large part of their total deposits banks with branches in the South of England pay nothing, for current accounts in the South carry no interest. On the other hand, while earning more than bank rate on their loans and advances, banks earn nothing at all on their actual cash reserves, and a good deal less than bank rate upon such part of their funds as they invest in the Short Loan Market, or in the very finest classes of bills

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of exchange which they can buy in the Bill Market. Their earnings on securities, also, since these are mainly Government securities, tend not to be more than 4 to 5%, and on Treasury Bills, of course, considerably less. The earnings of the banks depend, not only upon the manner in which their funds are invested, but upon the properties in which they are so invested. In this respect, the British banks tend to follow a fixed routine and, although their proportions are subject to a certain amount of change (for loans and advances to customers fall off in periods of bad trade and rise somewhat in periods of prosperity), the amount of elasticity is not very considerable. Bad trade, by lowering the rate to be earned in the Call Loan Market, reducing both the amount and the yield of loans and advances, raising the price and therefore the yield of long-dated securities, must affect bank earnings adversely, especially as the cost

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of staff and buildings, etc., remains more or less the same, whether trade improves or declines.

In the United States, the place of the overdraft is a much more modest one than it is in Great Britain : the normal form of a commercial advance takes the shape of a loan secured by promissory note or other collateral security—Stock Exchange securities, produce warrants and the like. But this raises the third point, namely, the nature of the security required. Loans and overdrafts can be divided into two groups, secured and unsecured. Where the loan or overdraft is “unsecured,” it means in effect that the banker’s belief in his customer’s ability to repay rests upon his personal knowledge of his customer and upon his knowledge of how the loan is to be used. But when a loan is “secured,” there is some piece of property or some legal right which the banker can utilise to compensate for the non-repayment of

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his advance. The most obvious illustration of the first kind of security is furnished by goods or produce in course of shipment pledged to the banker pending realisation of the proceeds ; the most obvious illustration of the second kind of security is a guarantee by third parties to the banker that, if the borrower does not repay the loan when called upon, the guarantors will do so in his place. Since the varieties of tangible and intangible property are very great, it follows that the security held against loans consists of many different kinds.

(c) Problems of Commercial Banking Organisation

The first duty of the banker is to secure the safety of the deposits entrusted to him ; the second, to invest the funds at his command in such a way as to secure, as far as he can, an even flow of profits. Security

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and profitability alike depend on spreading the risk and it is the desire to spread risks which explains why bankers keep, or try to keep, their funds invested in certain conventional proportions along certain lines. What these lines are is partly a matter of law and legal conditions, partly a matter of the investment opportunities open to the banker under circumstances of time and place, largely a matter of experience. The old adage that to be a banker one must know the difference between a mortgage and a bill of exchange throws light upon one fundamental aspect of the matter ; liquidity. Since the banker has liabilities a large part of which are payable at a moment's notice, some part of his assets, *i.e.* his cash reserve and some fraction of his loans, must be equally available at a moment's notice. In Great Britain the Commercial Banks are entirely free from any sort of legal interference : in the U.S.A. the position is very different

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in this respect. Not only are particular classes of banks prohibited from making loans of a certain kind, or holding securities of certain descriptions, the law goes further and limits the amount which can be lent to any one customer. But what is attempted to be done by the force of law in the United States, the force of custom and experience tends to do in Great Britain.

In the final analysis, what has been said above of the liquidity of the funds invested in the Short Loan Market is true of the investment of funds generally. Bankers' loans are used by the borrowers for specific purposes. If all the depositors were to try to draw out their funds simultaneously, every bank, however sound it might be, would be bound to close its doors, since it would be impossible to sell securities and call in loans sufficiently quickly and on a sufficient scale. A run on a single bank can be met by assistance from other

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banks, a run on all the banks together can only be met by assistance from the Central Bank, and it can only help by the device of printing more notes. For the absolutely liquid assets (that is, the Cash Reserve) even of the Central Bank are not large enough to meet more than a small proportion of the total liabilities which the banks together owe the public. The safety of each bank is in part dependent on the size of its liquid resources ; the ultimate safety of the banking system as a whole lies in the fact that not all the depositors will normally ask for their money simultaneously and, should they do so in consequence of panic, in the fact that the Central Bank will come to the assistance of the Commercial banks by a free use of the printing press. But large reserves and sound investments by themselves will not save the system as a whole in moments of general pressure.

If the banking structure of Great Britain

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is compared with that of the United States, a striking difference in the form of organisation appears. The entire commercial banking business of Great Britain is done by a group of 16 Joint Stock Banks, that of Scotland by 8 banks, some of which are owned by the larger of the English banks, which also control most of the remaining provincial banks of Lancashire. Five banks in fact do the main bulk of the banking business. The contrast with America is startling, if it is borne in mind that there were 7,707 National Banks and 1,633 Trust Companies recorded by the Comptroller of the Currency on 13th December, 1928, not to speak of the thousands of banks organised under State Laws. English banking is primarily organised on the basis of a few large institutions covering the country with a network of branches ; American banking upon the principle of " unit banking." Though, in certain States of the American Union, branch banking

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is permitted and is rapidly making headway in such States, and though the device of "chain banking," *i.e.* single banks associated through a holding company, represents a compromise between the British and American systems, yet what has been for a generation a *fait accompli* in Great Britain (and, indeed, in most parts of the world) is still a matter of acute controversy in the United States.

The purpose of branch banking is to assist in the geographical distribution of risk and to draw deposits from as wide an area as possible. So long as industry continues to be largely localised, geographical distribution of risk demands a widespread organisation, and districts rich in deposits can be drawn upon to supply the deficiency of borrowing ones *within the limits of a single organisation*. From the technical banking standpoint there is a further advantage derived from a growth of scale which must not be overlooked. The

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cheques paid in over its counters will be cheques on its own customers to a greater extent the wider the organisation. But to pay such cheques no cash is required ; all that is needed is two book-entries. Growth of scale implies *economy in reserves*, a smaller proportionate amount of cash has to be kept relatively to total business, because fewer cheques will be presented through other banks, and more through the branches of the same bank. Thus considerable advantages accrue ; increased safety, economy and profitability.

How far are these advantages *only* to be obtained by means of branch banking ? American critics would say that it was possible to obtain the same results in other ways. It is possible to obtain " out of town " customers, *i.e.* to get customers in places where the bank does not operate, and the larger American banks do, in fact, try to obtain such customers. Further, it is always possible for even a small bank to

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spread risks by making use of the facilities of the Central Money Markets. It can buy bills in the Bill Market, hold gilt-edged securities which can be readily sold on the Stock Exchange, and lend money at call or short notice. American banking organisation *facilitates* such methods of distributing risks by the fact that the large banks in cities like Chicago and New York act as "correspondents" for hundreds, in some cases thousands, of small banks scattered all over the vast area of the United States. Lastly, the apologist for "unit banking" would argue that, even if such banks have some disadvantages to contend with, they also have some unique advantages. They are less bureaucratically organised and inspired and, because they are more restricted in scope, they are more likely to be interested in the success of local enterprises and more prepared to see such enterprises "through" a period of depression or bad trade. The bigger the bank

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and the wider the network of branches, the more indifferent such banks must become to the fate of particular districts, industries and firms.

This line of argument proves perhaps too much rather than too little. All over the world, even in the U.S.A., the organisation of banking is tending towards the British, or, rather, the European system of branch banking. The charge of bureaucratic handling of business can be launched against unit banking as easily as against branch banking, when the unit banks attain a certain size—in fact, some of the New York banks are now among the largest in the world. Lastly, the association of a bank with a particular locality may lead very easily to such an intimate dependence of the bank on the prosperity of that locality that it becomes a danger to the bank itself : a danger which is exemplified in the wave of bank failures in the agricultural regions of the United States

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whenever agriculture is passing through a phase of falling prices. It is the duty of the banker to take a wider view of the situation than the business man. When he meets only the business men of his own locality, he is liable to take their view too easily and to overlook the dangers of local over-expansion. One may regret that banking is becoming less associated with the hopes and fears of particular localities, but the trend towards large-scale operation is so characteristic of business generally that small local banks have no longer the resources to finance such large concerns easily. Because the borrowers are becoming larger in size, the banks must become larger too ; otherwise the customer may be too large to lend to safely, for bankers know that a single big account is more dangerous than ten separate accounts aggregating an equal amount.

VI GOVERNMENTS AND THE MONEY MARKET

THE STATE in the modern world administers for the general benefit of the citizens of the country an enormous revenue. Since revenue and expenditure by Government are about one-fifth of the national income (£800 millions against, say, £4,000 millions) it is clear that the management of this immense amount of money requires very great care in order to prevent the smooth working of the money market from being adversely affected.

It is possible so to organise the system of Governmental finance as to separate it altogether from normal money market channels. Where this is done, the so-called "Independent Treasury System" comes

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into being. During a large part of the nineteenth century the financial procedure of the Government of the United States was based upon this system. The attempt was made to segregate in the American Treasury the revenues of the country in cash (gold, silver and notes) and to keep them there until they flowed out again to finance Government expenditure. It is easy to see that, when revenue and expenditure are heavy, intolerable difficulties are thereby created. If the period when tax collections are heaviest coincides with the maximum demand for accommodation for agriculture or industry, the banks are put into a most embarrassing situation, for their funds are drained away from them at the very moment when they need them most. If the bulk of the expenditure falls at a time of business slackness, the banks are faced with a plethora of funds. Thus the Independent Treasury System tends to accentuate the degree of variation

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of money market rates, and for that very reason has had to be abandoned. But even association of Government with a Commercial Bank does not quite meet the situation. What is wanted is association with an institution which will be in a position to even out the ebb and flow of money due to the financial operations of Government. Such an institution is the Central Bank. The management of the Government's current account and of its short-term and long-term borrowing operations are entrusted to it, because it, and it alone, is in touch with every part of the Money Market.

From the present point of view, the task of managing the finances of Government is essentially that of preventing a temporary excess of revenue over expenditure from depriving the Money Market of funds, and of preventing an excess of preventing an excess of expenditure over revenue from flooding the market with

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funds. The first result in rising money market rates, the second in falling rates. The instruments of adjustment are the Bank's own lending operations and the manipulation of the size of the "Floating Debt." Since the War the British Government has always been in debt to the Money Market, the evidence of indebtedness being the Treasury Bill. Periods of pressure lead to an increase in the Floating Debt. *i.e.* Treasury Bills plus the amount lent directly by the Bank of England (these advances are known as Ways and Means Advances), periods of ease lead to a reduction in the Floating Debt. Now, when there is an excess of revenue over expenditure (as there usually is in the first three months of the *calendar* year, which correspond to the last three months of the *financial* year, when the bulk of the Income Tax proceeds are flowing in), the way to prevent a shortage in the Money Market is to pay off Floating Debt, because this

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adds to the resources of the market. And the way to prevent an excess of expenditure resulting in usual ease is to increase the Floating Debt. The Bank's own loans can be used as a balancing factor, to add to the supply of cash in periods of stringency, to reduce cash (by *not* lending) in periods of ease. If revenue is flowing in faster than Floating Debt (Treasury Bills) is being paid off, the Bank can lend more freely : in periods when an increase in the Floating Debt is not taking funds off the market fast enough, the Bank, by reducing its own loans, can stiffen up rates and prevent an abnormal reduction in the price of loans in the Money Market.

The system so far described is the British system. In the United States, though the Treasury Bill has recently been introduced, the same function is carried out by the purchase and sale of Certificates of Indebtedness. At the quarterly dates when income tax receipts, on the one

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hand, and interest payments, on the other, create a situation of difficulty in the market, the Federal Reserve Banks, by the purchase of special One Day Certificates of Indebtedness, by not buying more bills to replace maturing ones and by other devices, attempt to even out the ebb and flow of money.

VII

THE LONG-PERIOD CAPITAL MARKET

1. *The Machinery of Issue*

IN THE modern world, savings can be devoted to the acquisition either of tangible property, such as land, houses, furniture, pictures or jewellery, or of property rights, such as mortgages, bank deposits or "stocks and shares." It is with the last class that we are concerned here. The classes of capital-rights which are offered to investors and which are handled in the long-period capital market take the following main forms :

(a) The obligations of Governments and Public Bodies of all kinds. Traditionally, Governments have chiefly borrowed for two main purposes—for waging war and

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for covering the deficit on the Budget even in times of peace. But such unproductive forms of borrowing, though responsible for the greater part of existing National Debts, are not the only purposes for which Governments can borrow, and they do not represent the reasons why subordinate Public Bodies borrow. The fact is that the control and operation of certain essential public services, the supply of railway and other forms of transportation, the provision of light, sewage, docks, water, etc., are more and more passing into public hands. Hence, Government debts may be raised, and to an increasing extent are raised, for productive purposes. The interest payments necessitated thereby are not a charge against the taxpayer, as they are in the case of unproductive Debt, but are met out of the revenues earned by the undertakings acquired, created or extended by the use of the funds so borrowed. There is, in other words, no essential

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difference, in the economic sense, between a Government borrowing for reproductive purposes and the borrowings effected by a "Public Utility" enterprise organised in Joint Stock Company form.

(b) Obligations of all kinds issued by non-Governmental bodies. These, again, fall into three main groups :—

(i) Secured obligations. The most important class of such securities consists of mortgage debentures or mortgage bonds. By means of such bonds or debentures, the borrowing undertaking secures to the investor the due performance of the obligations it has assumed by assigning to him part or all of the assets, tangible and intangible, present and future, owned by the undertaking. In the event of default, therefore, the investor can protect his rights by seizing the assets held as a pledge.

(ii) Unsecured obligations with Preferential Treatment. Two main classes of

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investments fall within this category. First come what are legally evidences, not of ownership *in* the undertaking, but of *loans* to it unsecured by specific pledge of property, such as Income Debentures or Income Notes, where the investor is merely promised priority of interest payments, though this priority may be safeguarded in various ways. Next come evidences of part-ownership in the concern, given priority of interest payment over other classes of *owners*. This gives one the great class of Preference Shares. Such preference shares may merely carry the right to payment of interest in preference to all other classes, but with no guarantee that such interest will in fact be paid. Or the preference share may be made *cumulative*, in which case interest unpaid in any one year is carried forward to the next ; or the preference share may be made both cumulative and *participatory*, in which case, if earnings or dividends distributed

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to other classes of owners exceed a certain amount, the preference shareholder participates to a further extent in the prosperity of the concern, over and above the fixed interest to which he is entitled.

(iii) Lastly come various classes of share capital which rank after the classes mentioned (if the undertaking has issued more than one class of obligation or capital) in the distribution of income. In general, this class of rights may be called Residual or Ordinary Capital, and the shares Ordinary Share Capital. Such capital is itself divisible into Preferred Ordinary and Deferred Ordinary Capital. Where in an enterprise both these classes of shares are issued, the Preferred Ordinary will rank, as regards dividend payments, before the Deferred Ordinary Capital, which represents the true residual element of ownership in the concern.

The presence, or possible presence, of

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rights of so many different kinds within the same enterprise profoundly affects the practical working of the joint stock company. But, whether many or few, all such securities have in the first instance to be issued to the public, and an elaborate mechanism exists for the purpose. Issue covers three main elements : Promotion, Underwriting and the technical Act of Issue. Promotion, *i.e.* the processes necessary to the formation and legal creation of the concern, of course, only arises where the public is asked to take up capital or debt in a *new* enterprise, but issue and underwriting operations cover, not only capital operations on behalf of a new concern, but all cases where existing concerns offer new capital to the public or where existing public authorities desire to borrow afresh.

Promotion and issue may be united in the hands of the same institution, and the same institution may also agree to

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underwrite part or the whole of the issue. On the other hand, these various activities may be divided. And, in many cases, the activity of issuing must be divided into two parts, one purely mechanical and subordinate, the other substantial and essential. The essential part of the work of issue consists in preparing the statements and particulars by which the facts are brought to the notice of the public, in discussing with the promoters of the enterprise itself or the borrowing Government the terms on which the issue to the public is to be made, the time and conditions under which it is to be made, and the like relevant circumstances. The subordinate part of the task of issue concerns the mechanical aspect of actually receiving and accounting for the subscription. This mechanical work may be done by the " Issue House " itself ; it may be left to a Joint Stock Bank, though, under British practice, a Joint Stock Bank agreeing to

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take subscription over the counter and allowing its name to appear on the "prospectus" (*i.e.* the statements relating to the issue) does not thereby assume any responsibility as to the goodness of the issue towards subscribers.

Issue may take two main forms. The issuer may offer *on behalf* of the enterprise or Government, receiving a commission or a payment arranged on some definite basis for the work or trouble and expenses involved. Or the issuer may have undertaken to buy up the entire issue at a fixed price and offers it to the public at another (and necessarily higher) price. This constitutes technically the form of issue known in Great Britain as the "Offer for Sale"; in America, it constitutes the act of "Underwriting." The advantage of this form is that the enterprise is relieved of all further trouble; its issue has been taken "firm" by what is presumed to be a reliable house or group of financial houses,

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and they must now run the risk of being unable to dispose of the security.

This risk is necessarily always present though to a smaller or greater extent, according to the intrinsic soundness of what is being issued and the state of opinion as regards the outlook for securities in general. Accordingly, in Great Britain the issue house safeguards itself by securing *contingent* subscribers to the issue, and this constitutes underwriting in the British sense. In return for a commission (the "underwriting commission") individuals and firms will promise to take up any portions of the issue not sold to the public. Hence—at a price—a market for an issue can be found, even if the investing public is not in a mood to bite freely at new securities.

It is clear that the machinery of issue is complex. Who are the issuers? In London there is a group of firms, traditionally known as the "Issue Houses," firms like

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Barings and Lazards and Schröders, who, however, in the main confine themselves to international loans and have little to do with British industrial issues. A second group of issuing houses is composed of certain large Stock Exchange firms, dealing partly with Colonial issues, partly with British industrials. Lastly, during the Stock Exchange boom of 1928, a certain number of new issuing agencies appeared, some of them not of a very high-class character. British Government loans are handled by the Bank of England ; and a few very large corporations are also strong enough to issue directly on their own behalf through their banks. The underwriting of new issues is arranged for by the issuing house. Each will have its own list of persons and firms who will habitually underwrite for it (other finance houses, brokers, investments trusts), the principle being that the underwriter must take the bad with the good and take issues

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as they happen to come along. But there is a certain competitive fringe ; at times when the securities markets are active there will be a certain competitive scrambling for underwriting privileges. A high underwriting commission points to a weak issue and a weak market situation. Moreover, the underwriter does not always live up to his obligations. In recent months the liquidation of certain companies created during the preceding boom has disclosed some very bad cases of high underwriting commissions paid to individuals unable to take up the shares on a failure of the public to subscribe.

The American machinery of issue resembles the British in that the issuing houses include large brokerage houses and private bankers like the Morgans, but differs in so far from the British situation that in recent years the great New York Commerical Banks have created subsidiary "Security Corporations," which handle

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issues which the Banks themselves are not in a position to do. To such dependent corporations there are no exact British analogies. Moreover, the *marketing* of securities in the two countries presents considerable differences. A large part of the securities issued in the United States are not intended to be quoted on any Stock Exchange, which tends rather to be the rule in Great Britain. Further, a system of retail selling of bonds and shares through direct solicitation of the investor is possible in the United States, where the "bond houses" have built up a great and costly organisation for the house-to-house sale of securities. Such a development has been severely hampered in Great Britain by the legal prohibition of "share hawking" in the latest Companies Act.

2. *The Stock Exchange*

When a great number of individuals hold investments which are legally easily

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transferable and when, on the other hand, the number of such securities is very large and their aggregate value larger still, the necessity for some organised market in which such securities can be bought and sold freely becomes clear. Without such a market it would be difficult to dispose of the securities easily and this would hamper the process by which large-scale modern industry can obtain the funds it needs—since the possession of securities which are not easily transferable increases the risk to the investor and makes him less inclined to hold property of this particular kind.

The Stock Exchange has been the object of such fierce denunciation by critics of the modern capitalistic system that it is essential to understand the true functions which it performs. A distinction is often drawn between the utility of the Stock Exchange as an agency whereby securities are transferred between investors, a function which is regarded as “legitimate,”

and the use of the Stock Exchange as an "instrument of speculation," which is looked upon as a "perversion" of its true function. But, in fact, speculation also involves acts of purchases and sale, indistinguishable in form from pure investment transactions in the first instance. And the motives which lead investors to change their investments and those which lead to speculative purchases and sales are also not clearly distinguishable. But, apart from these obvious difficulties in the way of discriminating against speculation, it has still to be proved that speculation can be dispensed with, given the further circumstances that the future is unknown and that *anticipation* of the future course of events is inevitable. In the realm of economic life, uncertainty as to the future takes the form of uncertainty as to the course *prices* will take, including, of course, the prices of securities. The economic function of speculation, then, in

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so far as it is concerned with the prices of Stock Exchange securities, is a two-fold one : it consists in adjusting the relative values of securities to one another at any given moment of time, and in adjusting the present level of security prices to what, in the opinion of competent judges, will be their *future* price level. The first adjustment is made by selling "over-valued" securities and buying "undervalued" securities, with the result that the price of the first kind of securities will fall and that of the second will rise. The second adjustment is made either by selling securities or particular kinds or groups of securities when it is anticipated that the underlying forces at work will in any case produce a decline in the long run, or by buying them when it is anticipated that the underlying forces at work will produce a rise. But there is no guarantee, except such as are afforded by the circumstance that opinion is not necessarily

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wholly one-sided, to prevent the movements in question from being overdone. If and to the extent that they are, the fluctuations in security prices are greater than might have been experienced if no speculation had taken place at all. But if the market thinks the rise or the fall has been overdone, counter-speculation sets in which promotes a fall or a rise.

It is one of the main functions of the modern financial press and of the experts of brokerage and financial houses to assemble and study the data upon which judgments can be formed as to the relative merits of securities. The main influences which affect the general level of security prices are also known. Periods of rising prices, increasing production and employment, in a word, periods of good trade, are also periods in which non-fixed interest paying securities—the residual claimants to the profits of industry—rise in price because the dividends paid on such shares

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increase in amount. Periods of falling prices and bad trade mean falling prices for industrial shares and rising prices for fixed interest paying securities, in so far as their prices are not affected by the fear that times are so bad that the debtor will default. Superimposed upon these general movements are movements caused by the special circumstances, good or bad, affecting particular industries or areas, and superimposed upon these again are movements caused by the special circumstances of particular undertakings or governments.

To the extent that the investor and the speculator must be familiar with these general circumstances affecting the movement of security prices, and to the extent that these movements are predictable, one can legitimately speak of the scientific aspect of investment and speculation. But speculation and investment remain an art and not a science because no one can foretell the *magnitude* of the movements

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involved before they actually take place. The reason must be clear. A fall in the long period rate of interest, for instance, makes a paper security paying a fixed or certain rate of return more valuable, but no one can say by how much more valuable it has "really" become. In 1928-9, when the United States was experiencing the greatest Stock Exchange boom in its history, it was argued, and quite legitimately argued, that the great growth of savings and productivity justified the valuation of securities at a price which substantially reduced the yield on the market value. Whereas formerly securities sold at a price equal to "ten years' purchase" of the annual earnings, they ought now to sell at a much higher price. But how much higher? In the end securities sold at prices equal in some cases to fifty or one hundred years' purchase, *i.e.* at prices which yielded only one or two per cent. on the market value! Until the

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break came in the autumn of 1929 these prices did not seem absurd, because there was no scientific standard by which to measure what they *ought* to be worth and there was only a general presumption that prices were going "too high" and would sooner or later decline. When a sufficient number of people finally believed this, they *did* decline. But no one could tell in advance *when* this would happen.

Actual market movements may therefore become quite irrational in magnitude, whatever the original justification for a rise and a fall may have been. And a further circumstance is likely to add to the magnitude of the movement in the *wrong* direction. Firstly, the professional speculator may try to exploit the irrationality of the situation by taking part in it. Securities may be selling above what he regards as their true value, but so long as the public is inclined to think that the rise will go on, it is safe to speculate on the side of the

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public. This drives the prices of securities up still more. And further, the irrational attitude of the public prevents the rapid application of the corrective—sales of the security made in the hope of prices falling sufficiently to enable the shares so sold to be bought in at a profit. An excited upward-moving market is one in which “bear” sales are highly dangerous, and, consequently, are not made. Until an advanced stage of the boom all the elements which should help to temper and moderate it are absent. A market in which no one will sell but only buy—*i.e.* a “bull-market”—is top-heavy and in the end leads to an equally top-heavy “bear” market in which no one will buy but everyone is willing to sell.

Thus speculation is necessary, but its manifestations—even where there is no attempt at deliberate manipulations of opinion by false rumours, “pool” operations and other devices intended to excite

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purchases or sales—are not always of the kind required in order that the economic functions which it is supposed to subserve shall be adequately carried out. And, in so far as the case against speculation is carried from the economic to the moral plane, the criticisms levelled against it are largely justified. It cannot be denied that the hope of getting rich quickly by speculation generates a tone of life which is inimical to the development of those habits of mind and of conduct which are necessary if men and women are to be content with the rewards which steady work and application to the routine of economic life offer them.

3. *Aspects of Company Finance*

Many of the problems of company finance (or corporation finance, to use the American equivalent) arise out of the very special characteristics of the joint stock company or corporation. As usually

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put in economic literature, the special characteristic of the joint stock company is that it permits an individual to spread his risks in many directions, by a relatively small investment in each special direction, but yet allows by a combination of sums, each relatively small, a great accumulation for each special purpose to be achieved. But this is only *one* of the special advantages of the joint stock company form. In addition, this form permits of great elasticity not only as regards the *amount* which the individual contributes, but also as regards the manner in which it is contributed. As the analysis of the various kinds of securities dealt in on the Stock Exchange showed, the individual may contribute capital in a form which carries prior rights or in a form which carries residual rights. We may put this in a somewhat different way by saying that the individual investor contributes both capital and risk-bearing, but the actual

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contribution may contain varying proportions of either : the only condition being that the more risk carried, the higher the ultimate return must promise to be.

Nevertheless, the joint stock company, just because of the differing natures of the contributions made by different investors, *i.e.* because of the presence of different classes of rights, also carries with it, besides its great advantages, certain disadvantages. When different rights are crystallised in the same structure, possibilities of divergence of interest exist, as well as possibilities of co-operation. So far as the joint stock company is concerned, these divergencies express themselves in differences of interest as regards both the form and the amount of the *capitalisation* of the concern. This requires explanation.

Legally, the *capital* of a joint stock company consists only of the amount subscribed by the shareholders. The actual

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amount paid up may be less than the amount which is authorised as the total capital, but whether the paid up capital differs from the authorised capital or not, there is a definite connection legally between shareholding and capital. But from the economic point of view, the capital with which the concern works is a much wider conception than this. Money advanced to the company by creditors (debenture holders) is part of the capital with which it works : so is the amount retained out of past profits—the Reserve Fund or Surplus. In actual practice, at any moment a concern will owe certain amounts to trade-creditors and may be borrowing from its bankers : these amounts in effect constitute the floating debt of the enterprise. One requires a word which will include the legal capital and the other permanent funds with which the enterprise really works. Such a word is the American phrase “capitalisation.” We have now

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to see how the existence of different interests in the concern may affect the form of the capitalisation and its amount.

There are three considerations to be borne in mind in discussing this question : considerations of safety, control and profitability. The theory upon which the government of the joint stock company is built up is that of democratic liberalism : the Directors of a Company are assimilated to the position of Members of a legislature elected by their constituents. In fact, widespread voting rights in a company easily interfere with the efficiency of its working. It is therefore possible to compromise : to give certain classes of rights priority, both as regards safety and security, provided that in return these classes of rights are prepared to sacrifice part of the control of the enterprise. Each party desires some *quid pro quo* for what it sacrifices, and each party can sacrifice something for what it desires.

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Hence the debenture or bondholder, and to a large extent the preference shareholder, have no voting rights (though of course it is possible legally for them to possess them) except in circumstances where the safety of the capital, or the security of the income, is at stake. Assent may be required for re-organisation proposals : for proposals to increase the volume of rights ranking prior to, or equally with his own, and so forth. Those ultimately in control are willing to part with some rights in order to obtain that which is in some respects fundamental : a concentration of authority within the enterprise.

One of the reasons making for a large volume of secured and prior rights will now have become clear. The form of capitalisation is influenced by the desire not to divide control too much. But there is another reason which works in the same direction so far as the form of capitalisation

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is concerned. Apart from the desire not to share control, there is the desire to add more to the earning capacity of the enterprise than is represented by the fixed interest or dividend which needs to be paid for the use of the funds obtained. If, on its capitalisation as a whole, an enterprise is earning 10% net, whilst it need pay only 6% interest on its debentures and, say, 7% dividend on its preference capital, the margin available for payment of larger dividends on the ordinary or residual capital goes up. The dividends to be expected upon ordinary shares depend, therefore, not only upon the earning capacity of the enterprise as a unit, but also upon the proportion of prior to residual capital. From the standpoint of the holder of residual capital, it pays to increase the proportion of prior-ranking capital, provided it does not mean sharing control, and provided also—an important element in practice—that the

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earnings as a whole are reasonably stable. For if they are not, a large amount of fixed-interest-bearing debt and capital may make dividends upon the residual capital more unstable than the earnings as a whole.

The manner in which the amount of the capitalisation is affected by the existence of different rights can be seen from two illustrations. Firstly, on the creation of an enterprise a large variety of interests may co-operate and of these interests some at least may desire to see the capitalisation expand. A promoter who obtains liens on a number of enterprises which he then unifies into one legal entity and resells to the public, makes a profit out of the difference between the buying and selling price which grows as that difference grows. If the financial interests concerned with the issue of the new securities are paid in shares, again that is an influence making for an enlarged capital. Or again, a new concern is founded to exploit a new patent

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or discovery. The inventor or patentee offers to take shares instead of cash. Pressure making for increased capitalisation is again present, especially as it is exceedingly difficult to estimate what the earnings of an enterprise of this kind will really turn out to be. No doubt it is one of the functions of the financial press to warn the public against over-capitalised enterprises. But in periods of speculative mania and optimism, such warnings are notoriously disregarded.

4. Some Relations between Finance and Economic Welfare

Some of the relations of Financial Operations to Economic Welfare are very imperfectly understood, not only by the general public, but also by the business community.

Firstly, an individual can safeguard himself against loss by selling a security to

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someone else, but if the enterprise issuing the security does not prosper, the economic loss sustained through a misdirection of human effort nevertheless persists. From the standpoint of economic welfare, the enterprise has wasted resources which might have been better applied by another person in the same or some other direction. The real loss to society from the failure of the recent "crop" of artificial silk concerns to yield a profit is the wastage of the human labour and equipment which have built plant, etc., which will never be operated.

Secondly, in so far as equipment and human labour continue to produce as fruitfully as before, society as a whole suffers no loss even if the market values of the securities representing the nominal value of the productive enterprises of the community undergo a decline, and society as a whole gains nothing if these securities *rise* in value. The real wealth of the

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United States was no greater as a result of the phenomenal rise in stock market values in 1928-9, and is no less because of the subsequent decline : for the real wealth of a country consists of the stream of goods and services which can be consumed, and not of the nominal value of the securities issued by the enterprises producing these goods and services. Particular individuals have been ruined by buying securities at too high a price, but losses such as these have in fact been compensated by the gains of those who sold the securities at those prices : and no actual loss of any kind was incurred by those who retained possession of their securities throughout the period of rising prices and the period of subsequent fall. The effects of the boom, if any, upon the real wealth of the United States have been exerted in indirect ways : by over-stimulating construction in certain branches of industry : by encouraging, first, wasteful consumption

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and (since the depression) over-anxious economy. But apart from influences such as these no ultimate effect on material welfare was produced. As soon as this truth is realised, the depression itself will begin to pass away.

Thirdly, because speculation is concerned with the *transfer* of securities, it does not "withdraw funds from productive use." The impression prevails that if funds were not used for speculation, the amount accruing for commercial or industrial purposes would increase *pro tanto*. But this is an error. Where *new* securities are bought with borrowed money, the proceeds pass directly from the financial to the industrial circulation: the capital of a new steel works, for instance, when bought by speculators for the rise, is furnished by those speculators or those from whom they borrow, irrespective of the motive leading to the purchase. Where existing securities are bought with borrowed money, the

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sellers of the old securities are in a position to take up new capital issues or to employ their funds for any purpose they wish. If the sellers again invest in old securities the funds are simply transferred to a new set of sellers and so on. The amount withdrawn from immediate productive use is simply the sum changing hands at a particular moment, and this is much less than the total amount borrowed for speculation over a given period of time. Thus if speculators have borrowed £100 millions in six months and on the last day of the period £10 millions is the amount due to sellers, *that* £10 millions is for the moment, but only for the moment, "withdrawn." The other £90 millions is still owing by speculators to lenders, but the sellers of the £90 millions of securities bought by the use of these funds have really received the money. As the volume of speculation grows, the "float," *i.e.* the sums due at any moment, also increases, but the extent

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to which sums have been withdrawn from other uses, even temporarily, cannot be measured by the mere figure of outstanding loans to speculators ; the proceeds of these loans, when transferred to sellers in exchange for securities, have mainly gone back into the general circulation of funds.

VIII

THE PROBLEMS OF PUBLIC FINANCE

THE PROBLEMS of public finance are complicated by the fact that the social and economic welfare of a community is affected not only by the amount which the State absorbs in taxation and by the manner in which that amount is collected, but by the way and the objects upon which that revenue is expended. Thus, in addition to difficult questions relating to the best manner in which to raise a given revenue and problems relating to the desirable aggregate amount of taxation, there is also the problem of the purpose to which that revenue, when collected, can best be devoted. Taxation, in other words, affects welfare both by being collected from certain individuals and by being

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spent for the benefit of individuals. A system of taxation yielding certain sums of money may be better or worse than another system yielding an equal amount : one scheme of expenditure may be adjudged to have better or worse effects than another. But in order that final judgment may be passed, it is necessary to take both revenue and expenditure into account. It is *prima facie* clear that a system of public finance which levies taxes on the poorer sections of the community, and expends the funds so raised on ends largely benefiting the richer sections of the community, is helping to redistribute the national income in a less desirable way than a scheme of finance which taxes the richer sections of the community and uses the proceeds in a way which largely benefits the poorer sections of the community : for money, or *money's worth*, added to the incomes of the poor adds more to real material welfare than a similar sum (in money or kind) added to

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the income of the well-to-do. But there are obvious limits to the process of redistribution, which come from the possibly deterrent effects of high taxation. These deterrent effects may be so serious as to outweigh any directly beneficial effects otherwise obtained. Enough has been said to show how very complicated the problems of public finance are, when the effects both of taxation and of expenditure are taken into account.

Impressions derived from the practice of Governments in the past have led to an almost complete misunderstanding of the part which Government expenditure plays in modern economic life. There still lingers the view that Government expenditure is "unproductive," a view which is crystallised in the old statement that economy in Government expenditure enables money "to fructify in the pockets of the taxpayer," the obvious implication being that if money is *not* allowed to fructify in this

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way, a net loss, equal to the amount spent by Government, results. But this is a complete error. The difference between private expenditure and Government expenditure is not a difference between something and nothing, but between the production of one kind of thing and the production of another kind of thing. And it is by no means true that if Government abstained from spending anything at all, then the national income would remain the same in amount, however different the things upon which it is spent. For if there were no expenditure upon public health services, education, police, roads, the provision of information, etc., it is quite clear that the amount of production in the community would fall off. Taxpayers might have to pay a smaller amount in taxes, but the fund out of which taxes are paid would be so much less that the community would be very much less well-off than it is now. It is true that there are

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certain forms of Government expenditure which are unproductive in the economic sense. Expenditure upon armaments adds nothing in time of peace to the material well-being of the community, and in time of war, of course, is utilised for the destruction of the sources of well-being. Part of the expenditure of modern Governments, again, is "transfer expenditure," *i.e.* payments to old-age pensioners or payment of interest upon the National Debt. Such expenditure adds nothing directly to the productive resources of the nation, and therefore nothing to the National Income, except in terms of money. But the indirect effect of such "transfer expenditure" may be very great. For the bulk of expenditure upon Debt Services accrues to the richer classes of society, and the bulk of expenditure upon Pensions and Unemployment Payments (in Great Britain) accrues to the poorer sections of the community. The distribution of well-being is affected

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by such payments in a most marked way ; and in a modern State, in which the view is entertained that a greater effective degree of equality is itself a good thing, the Budget ceases to be a *mere* question of raising the minimum expenditure in the most convenient way. The Budget becomes an instrument of Social Adjustment whether, as in Great Britain, between the rich and the poor, or, as in other cases, between the urban population and the rural population, or, as in the case of Protective Duties, between Producers and Consumers. The Budget, in other words, has ceased to conform to the type of which it was true that any expenditure included in it was of a purely and strictly unproductive kind. It has become part of the machinery of Social Reform on the one hand, and on the other, its growth is merely an indication of the increased part which Government is called upon to play in economic life generally. The question

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whether a particular service can be better performed by the State than by some other agency is, to some extent, a question capable of expert determination. But services which in some countries are left to private enterprise, such as the provision of life insurance and railway transport, are in other cases carried out by the State, and so the discussion of what it is "natural" for the State to do and not to do is very likely to be biassed by the traditional or customary division obtaining in a particular country. How much the State should do in the way of Social Reform is again an issue upon which no finality can be reached. For the answer depends not only upon the precise objects of social reform expenditure and their results, but also upon the reactions of taxation upon production, and these differ not only with the nature of the taxation imposed, but with the willingness of the taxpayer to pay taxes, which varies very much

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from time to time and from place to place.

The expenditure of a modern State is not, however, financed entirely by taxation. The aggregate revenue can be divided into (1) proceeds from State property; (2) proceeds from loans; (3) proceeds from the performance of specific services; (4) proceeds from charges for acts in which an element of service is contained; (5) proceeds from taxation; (6) proceeds from penalties. Some of these sources of revenue are not closely distinguishable in practice; thus, if the Post Office charges enough for the services it performs to gain a net revenue over and above the direct cost of the service, it is in effect levying a tax: the process of imposing a fee for stamping documents which validate proceedings important in the economic or social life of the community also partakes of the nature of taxation, whilst on the other hand, in return for taxes paid, the taxpayer does

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receive some benefit, although that benefit is not measurable exactly. The purpose of taxation is, in fact, to meet the general charges of Government, and arises out of the circumstance that, in the absence of State property yielding a sufficient income or State enterprises yielding a sufficient profit, the only way of meeting the cost of Government is by some levy on the citizens which does not pretend to vary with the benefit received, but with some standard, more or less accurate as the case may be, of "ability to pay." Revenue from State property, owing to the alienation of rights in the past, is not usually of great importance in the modern world: but proceeds from State enterprises (which, of course, involve the possession of fixed property by the State) is becoming more and more important as public utility enterprises are taken over by public authorities of one kind or another. In both these cases, of course, the revenue gained is, in

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part or in whole, offset by expenditure on maintenance and operating, so that only the margin between revenue and expenditure is available for meeting the general charges on the Budget. The possibility of meeting the general costs of Government by means of loans is clearly limited ; in time of war expenses rise as well as loan-proceeds, and in time of peace a Government which attempts to meet general expenditure out of loans will find it impossible to raise loans except at constantly rising rates of interest. The place of loans in public finance is broadly limited to (1) war (and even here the purists would prefer heavier taxation to larger loans) ; (2) borrowing for short periods in anticipation of normal revenue proceeds ; (3) productive purposes (more important in the case of subsidiary Governments than in the case of the Central Government) ; (4) temporary exigencies destroying the budgetary equilibrium for the time being,

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other than war, such as the failure of the crops in a country dependent upon agriculture. (There is one form of borrowing which in distracted periods, War and Revolution, possesses great elasticity, the ultimate effects of which are, however, ruinous. That is borrowing by means of "inflation," *i.e.* an indefinite increase in the volume of paper money. In the end, however, inflation as an instrument of finance breaks down because the money issued becomes valueless, or almost so valueless that it no longer pays to increase the quantity any further.)

The upshot of the previous discussion is that the State must necessarily rely upon the yield of taxation for the bulk of the revenue which it needs to meet its expenditure. This raises, in the first instance, the question of whether it is possible to state in general terms how much taxation can be levied from a given community, or, in other words, whether it is possible to

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state what the community's "taxable capacity" amounts to.

This is a task which has been frequently essayed in recent years, with no very satisfactory results, and expert opinion is gradually coming round to the point of view that it is impossible to define, even approximately, what the limits to taxable capacity are. The limit is reached when the "bad effects" of taxation outweigh any good produced by the expenditure of the proceeds of that taxation. Now it is clear, in the first place, that opinion may differ as to what "bad effects" should be taken into account : and however these may be defined, two systems of taxation, yielding an equal revenue, may produce different kinds and quantities of bad effects. Not only so, but the badness of the effects, if any, varies not only with the volume and kind of taxation imposed, but with the opinions entertained by the taxpayers as to the "equity" of the taxation. And

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"equity" in these matters being largely, if not entirely, a matter of settled expectation, of what people are used to and therefore regard as "fair," it follows that given a change in this respect, a large measure of taxation may have approached the limit of capacity to a smaller degree than a smaller measure of taxation would have done, given no change in this respect. Finally, as already hinted at previously, the effects of the taxation on material welfare cannot be finally weighed until the effects of the expenditure financed by the taxation have also been taken into account. Without going as far as some writers who describe the whole concept of "taxable capacity" as a myth, it is at any rate clear that it is an elusive and unsatisfactory concept, with no great bearing upon the practical issues at stake.

The "bad effects" of taxation relate to the repercussions of taxation upon the taxpayer. Though it is habitual to speak of

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taxation as being imposed upon persons (as in the case of income taxes) or upon things or commodities (such as excise or customs duties), in the end, of course, all taxes are paid by persons or institutions. The effect of taxation is to discourage the production of the thing taxed, through alterations in the willingness of individuals who "really" pay the tax to produce those things, or to consume them. The important question then is, by how much will the production of the thing taxed fall off?

In modern communities such as Great Britain a large part of the revenue is derived from the taxation of income, through income tax and super-tax, and of savings, through the imposition of estate, inheritance and legacy duties. Moreover these taxes have a growing importance, since they present very great technical advantages over other forms of taxation. They lend themselves easily to

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exemption, differentiation and progression, and therefore fit in with the modern tendency to adjust taxation to differing degrees of ability to pay, and they finally possess the great virtue that they leave the taxpayer free to pay them by varying his expenditure on other things without interfering, except to the extent that his means are reduced in the aggregate, with the various possible directions of expenditure. A discussion of how far, if at all, income tax and death-duties affect the production of the things taxed, is of great practical importance. In other words, is the production of income and of savings adversely affected, and if so, to what extent?

The deterrent effect of a combination of high income tax rates and of high death duty rates is in current controversy rated very seriously. The knowledge that a large fraction of what is earned will be taken away in income tax, it is argued, destroys people's incentive to earn, the fact that

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earnings are less, and the net amount remaining after tax has been paid, reduces the *ability* to save, whilst the further fact that these savings will in turn be taxed reduces the *willingness* to save. Economic life is thus doubly affected : by a reduction in the spirit of enterprise, and by a reduction in the available volume of capital.

So far as willingness to earn is concerned, there is something to be said for the view that, in so far as the taxpayer desires to maintain a certain standard of life, higher income taxes, so far from deterring him from working, make him work harder. And, similarly, in so far as an individual desires to accumulate a given sum for the benefit of his descendants, a higher rate of death duty encourages him to save more, so as to leave the same net amount. If his income, out of which the savings are made, falls off, he will rather cut off expenditure upon current consumption than

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reduce the amount he saves. To the extent that considerations of the kind just outlined influence individuals subject to tax, the deterrent effect of such taxation is less than appears at first sight. But, it must be borne in mind (a) that where the income is itself uncertain, the willingness to take risks is diminished, for the gain is in any case uncertain, and the deterrent effect of the tax has a more than proportionate influence ; (b) a large part of the saving of the community is done by a small section of the taxpayers, owing to the inequality of incomes, and represents " automatic " saving, *i.e.* the excess of income over a high but largely predetermined standard of living. Taking these considerations into account, it is probable that the present scale of taxation is having a deterrent effect, but one which is probably less than is usually supposed.

The problem of deterrence is a different one from the problem of incidence, *i.e.*

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as to who ultimately pays the tax. In the case of income and super-tax and taxes of inheritance, expert opinion is almost unanimously in favour of the view that such taxes *cannot* be shifted and that the incidence is on the payer of the tax, though the effects of such taxation may be very wide. In the case of taxes on commodities, the question of deterrence and of incidence is more complicated. A tax on beer has deterrent effects on its production and consumption, but the incidence of the tax may be very complicated. The duty is levied in the first instance on the brewer, and he tries to "pass it on" to the consumer either by raising the price or lowering the quality or by employing both methods together. In so far as the *aggregate amount* spent upon beer is the same as before, the whole of the tax is borne by the consumer, but less beer is consumed. If the *same amount* of beer is consumed as before, the whole of the tax is paid by the

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consumer, except in so far as, his total resources remaining the same, the prices of other things consumed by him fall because his demand for them is less urgent than his demand for beer, in which case part of the tax is shifted on to the producers of these things. But if, in the effort to keep up sales, brewers do not pass on the whole of the duty, *i.e.* do not raise the price of beer in proportion to the tax, they pay the duty. This makes brewing less profitable and tends to discourage as much production of beer in the long run as could otherwise have taken place. Taxes upon commodities are borne by producers and consumers in the proportion to which each party is in a position to turn in other directions, *i.e.* to produce other things or consume other things. The less easy it is for a producer to shift his production, and the easier the consumer finds it to alter his consumption, the more likely is it that the former will pay part of

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the tax, or, in extreme cases, the whole of it. The more wedded the consumer to certain types of consumption, the more likely it is that he will pay the tax. The result is that consumers tend to pay the whole of the tax on necessities, except where the supply of such necessities is highly competitive and some of the producers can be differentially treated. A tax upon wheat, accompanied by "Empire Free Trade," would not in all probability lead to a rise in wheat prices proportionate to the tax, except in periods when the Empire harvests were deficient. As the above illustration already shows, such considerations are important, particularly in dealing with the effects of tariffs. The question of whether the "foreigner" can be made to "pay" the tax depends upon the particular situation of each commodity : the more the market in question approached the single market for a commodity, *i.e.* the more dependent

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sellers are upon it, the more likely it is that part of the tax will be borne by producers ; the more sellers approach the position of having a monopoly of the commodity and the less dependent they are upon the particular market imposing the tax, the more likely is it that the local consumers will pay the whole or the greater part of the tax.

Taxes upon commodities suffer in general from one defect from which taxes upon income are exempt. They tend to fall with much greater proportional effect upon the lower ranges of income than they do upon the higher ranges of income, because a larger proportion of a small income is spent upon commodities than is normally the case with a large income, especially if the taxed commodities are necessities or quasi-conventional necessities as they tend to be : for otherwise they do not yield a sufficiently large revenue. Hence a tax system in which commodity taxes loom large tends to favour the richer

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against the poorer sections of the community, and this would still be the case if the tax were a turnover tax on commodities generally : for a larger proportion of the larger incomes is saved than is true of the smaller incomes. It is true that if it is desired to extract a certain amount of revenue out of the poorer classes of the community, it is easier to do so by means of commodity taxes than by means, say, of a poll tax or a tax upon wages, for the taxpayer is not, in many cases, aware that he is paying the tax and therefore the collection of a given revenue results in less *apparent* suffering. But it still remains true that, in order to make the richer sections of the community pay more, not only absolutely, but proportionately to their incomes, commodity taxes must be supplemented by other taxes, especially taxes upon incomes and inheritances, in such a way as to make the tax system as a whole progressive.

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The distribution of taxation between different social classes is, in fact, one of the most difficult of all the Social Problems of the day. It arises from the fact that the electorate includes the bulk of the adult population of the country, and is consequently inclined towards methods of expenditure which benefit the poorer section of the community to a greater extent than the richer. The combined effect of progressive taxation and expenditure upon public health, education, non-contributory pensions, grants-in-aid towards Unemployment Insurance and the like is towards diminishing the inequality of fortune. Critics see in these developments not only a danger that, if the policy is pushed further, the burden of taxation imposed on the richer sections of the community will become excessive, but also grave moral and political dangers arising from the majority of the population being encouraged to get "something for nothing."

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So far as the moral danger is concerned, a great deal turns upon the precise form which increased expenditure upon the Social Services takes. No one is likely to be demoralised by expenditure which does not involve a direct monetary payment to the beneficiary, but merely takes the shape of improving his physical and intellectual environment. Even direct monetary payments, when they take the form of old-age pensions, can hardly be regarded as demoralising. It may be argued that, in the absence of such gratuitous payments, the workers would be encouraged to make provisions themselves for their old age. But whether their incomes are really large enough to enable them to do so, except by sacrificing immediate enjoyment for themselves and their families, which are so large relatively to their resources that only the most far-seeing and best-off among them will in part do so, is another matter. To sacrifice

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present efficiency for the benefit of the future may, in any case, prove very bad economics. It is true that direct pecuniary payments, where not coupled with any responsibility at all, do involve definite moral risks. But the way to prevent the risk from arising is to improve the economic environment by the elimination, as far as possible, of the causes of unemployment, for it is under this head that the risk of demoralisation most definitely arises. In any case, it has still to be proved that the moral demoralisation arising from the "dole" is worse than the demoralisation arising from mere lack of work and the decline of personal efficiency and self-respect which accompany long spells of unemployment, accentuated, as these would be in the absence of a system of relief, by under-feeding and physical deterioration of the most pronounced kind. On balance, even the payments under the Unemployment Insurance Schemes have

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done more good than harm to the bulk of the recipients.

Moreover, if the problem is looked at with British conditions particularly in mind, the redistribution of well-being which accompanies expenditure upon the Social Services is accompanied to-day by another form of redistribution which benefits in the main the well-to-do sections of the community. So long as Great Britain possesses a National Debt involving an annual debt charge in the neighbourhood of £350 millions, income is being redistributed to the bondholder, which, so long as prices continue to fall, represents an ever-growing volume of *real* income. Or, as it is usually put, the real burden of the National Debt has been rising. Since it is a fixed payment, and since, in time of falling prices, the aggregate money income of the nation declines, the annual interest burden represents a larger proportion of the latter. It is true that, as the

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interest is paid out of taxation, the richer classes as a whole are paying for what they receive in interest, but this payment reduces their effective contribution to the general expenses of the community, other than the Debt Charge. In discussions of the equity of the existing scheme of taxation, this point is often overlooked, but it is obviously vital in attempting to arrive at a true picture of the present situation.

IX

FINANCE AND THE PROBLEM OF PRICES

THE INCREASE in the real burden of the National Debt through the fall in the level of prices is only one aspect of a problem, the significance of which for the whole Financial Structure cannot be exaggerated.

It is natural to think of the apparatus of production in concrete terms—in terms of goods and raw materials, and of plant and equipment, factories, ships and railways. But production has an abstract as well as a concrete side. The whole of the material equipment of mankind has at any moment *a balance sheet value*: investment at any moment involves a valuation, in terms of money, of what is being *invested in*. It

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follows from this that changes in the value of money—alterations in what the pound or the dollar will buy—must affect the value of investments, whether these consist of rights to income or property, or the actual property itself. In a period of falling prices, the value of property must fall, and therefore, if there are prior and residual rights attaching to such property, the net value of the residual rights must decline even faster than the value of the property itself, for whatever the property yields is subject to a fixed deduction. And similarly in periods of rising prices, the value of residual rights must rise faster than the rise of prices, because they are subject only to a fixed deduction, the proportion of which to the total yield falls as that total goes up. Hence rising and falling prices are among the most important of the general factors which affect the process of investment and the value of investments. Moreover, so long as men look to the

future as well as to the present, the problems presented by rising and falling prices are inescapable.

The question thus naturally arises : can anything be done by conscious human effort to reduce the risks which are involved in this way ? There are two main ways of possible escape.

The first lies in devising contractual forms which take account of possible price changes and allow for them in the contract itself. Thus it can be agreed upon between debtor and creditor that if prices rise, the nominal amount to be paid by the debtor shall go up, so as to give the creditor the *purchasing power* which he actually lent, not an amount of money which really is less than this. Or, if prices fall, the creditor is to receive a smaller amount in terms of money than he originally agreed to receive, so as not to force the debtor to pay over an *amount of purchasing power* greater than the amount he contracted to pay.

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The introduction of contracts such as these would involve agreement as to how changes in the value of money, *i.e.* changes in the price level, should be measured, and a condition of success would be a widespread adoption of the principle involved. For a debtor agreeing to pay more to his creditor in money would be in a difficult position unless he in his turn were covered, *e.g.* insurance companies, agreeing to make out their policies in terms of a fixed amount of purchasing power (not a fixed amount of money), could not possibly do so unless their investments in turn covered them against the risks involved.

The alternative is to attack the problem frontally and attempt to stabilise the value of money itself. But to achieve this, even partially, requires an instrument of stabilisation, and the vital issue of the moment is whether it is possible to utilise the powers of the Central Banks for this

purpose. In the modern world, the ultimate basis of the monetary system, gold, no longer circulates as coin, but is kept in the vaults of the Central Banks as part cover of the actual circulating medium, whether notes or deposits. Subject to the requirements of the law, it is possible for the Banks to hold more or less gold against a given volume of purchasing power ; or what is the same thing, with a given amount of gold at their command, they can vary the amount of purchasing power issued against it. They can increase the amount of purchasing power outstanding either by lending more freely, or buying securities more freely, or both lending and buying more simultaneously. The problem of stabilising the purchasing power of money is, then, the problem of so varying the quantity of purchasing power issued directly or indirectly by the Banking System as to keep its value approximately constant in terms of an index number of

prices : increasing the volume if the index number falls, decreasing the volume as the index number rises. To carry out this policy even approximately, however, requires a considerable degree of co-operation, at least between the Central Banks of the more important money markets : and as no attempt has ever been made to carry out such a policy, it is impossible to say what success would attend an effort to do so. The probability is that by means of it a much larger degree of stability could be imparted to prices, even if absolute stability were to remain a scientific ideal, impossible of practical realisation.

