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PRINCIPLES OF
FINANCE AND INVESTMENT

PRINCIPLES OF
FINANCE AND INVESTMENT

by

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VOLUME I

ECONOMIC BACKGROUND COMPANY FINANCE
NATIONAL ECONOMY

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PREFACE

THIS book has been written at the behest of the Councils of the Institute of Actuaries and the Faculty of Actuaries to serve as a text-book for the financial and investment sections of the examination syllabuses. There should be no need to give any explanation as to the reasons for including these subjects in the syllabus. Apart from the desire to ensure that the qualified actuary has an adequate knowledge of the financial and economic conditions in which he will be called upon to practise his specialized skill, there is the compelling need that he should be well equipped to play his part in the responsibilities connected with the investment of large sums of money.

Much of this text-book therefore takes the form of a guide to the corporate investor. Its special application is to the problems of the investment of the funds of life assurance offices. But the fundamental principles, the manner of approach to the problem, and in many cases the translation into practical operation apply in similar manner to the problems facing all other investors.

Many of the general principles apply irrespective of domicile, but it has not been possible to deal with the subject otherwise than from the viewpoint of the British investor. This applies also to such matters as joint stock companies and other business associations, the Stock Exchange, public finance and the national economy, analysis of company accounts, the money market. These subjects are discussed only in so far as they apply to Great Britain.

The construction of the book has been designed to conform to the matter and sequence of the examination syllabus, but, for the information of those readers who are not of the actuarial profession, it can be said truthfully that the author has felt no restraints on that account nor any necessity to depart from what would appear to be a logical development of the subject in hand. The use of arguments, formulae, statistics, and language comprehensible only to the actuary has been studiously avoided wherever possible. Therefore any latent fears that a book written by an actuary for actuarial students can be understood only by an actuarial mind should, it is hoped, be allayed.

The choice of title was prompted by the desire to focus attention as far as possible on *principles*. The word principle is used in the dictionary definition of 'a general truth forming a basis for reason-

ing or action'. It is only by concentrating on this aspect that it is at all possible to avoid falling into the trap of studying each facet of the problem solely in terms of conditions ruling at the time of writing. On the other hand, to ignore the practical aspects, and also the background of current conditions, would be equally wrong.

The aim has therefore been to consider in measured balance the fundamental principles which have little propensity to change, their practical application to the type of problems most likely to be encountered, and the special impact of such forces as are primarily the product of the times. Among the latter are included such factors as the effect on British economy of the losses arising out of two world wars, the nationalization of coal and of certain public services, the marked redistribution of national income as a result of taxation, subsidies, and social security, increased government responsibility for the economic welfare of the nation. All these are of immense importance in the framing of investment policy. Although they may appear new in terms of past decades, although their significance may alter considerably in the future, their effect can by no stretch of imagination be termed transitory. Thus, while there is necessarily some mixing of principles with practice, the object is not to examine a whole series of practical problems with the idea of suggesting set answers to preconceived situations. Indeed, the focus is frequently directed to the question rather than to the answer. It cannot be stressed too forcibly that the ability to ask the right questions is so often the most important prerequisite to the solution of financial and investment problems.

The new syllabus of the Institute of Actuaries was designed among other things to import a more formal 'economic background' to the study of finance and investments. The author was adjured to steer a course between the Scylla of attempting too much and the Charybdis of achieving too little, but no precise chart of the passage was available. Indeed, it is only fair to say that the boundary lines between economics on one hand, and finance, investment, politics, etc., on the other are very indistinct. What has actually been done is to concentrate on examining the economic laws and doctrines which have the most direct bearing on financial and investment problems and to ignore those which are applicable chiefly to conditions no longer ruling or likely to return. A glance at the chapter headings may perhaps give the reader the impression of casual sequence. It might be helpful therefore to give now a

brief synopsis of some of the subjects dealt with – if only to explain the basis upon which the framework of the book has been constructed.

The first three chapters are concerned with the general functioning of the economic life of a modern industrial society. The manner in which Great Britain attained the status of an industrial nation and her special characteristics from a social, political, and economic viewpoint are examined and discussed in chapter 2. It is affirmed that the ultimate purpose of economic activity is the maintenance and increase of wealth. In its economic sense this refers to the satisfaction of material wants. But the word has a wider and less material use as well. For instance, in the closing lines of *English Saga* Arthur Bryant wrote ‘that the wealth of a nation consists in nothing but the virtue of her children and children’s children. That no profits, education, law, custom, or institution that does not contribute to their health and goodness is of any enduring value.’ Thus while economic wealth is a proper objective of economic activity, great care must be taken to ensure that progress towards that end marches in step with – or at any rate does not march counter to – the wider ideal of national well-being, which embraces not only ‘health and goodness’ but freedom, happiness, and regard for the future.

The next three chapters describe the principal types of investment which are normally encountered. As a preliminary, it is necessary to deal with the development and structure of joint stock companies and other forms of business association. The types of investment are dealt with in two sections: first, government securities, loans, debentures, etc., where the status of the investor is fundamentally that of a lender or creditor; second, those where his status is that of a proprietor, usually a joint stock proprietor, holding his investment in the form of preference or equity shareholdings. These chapters are mainly descriptive and do not discuss the intrinsic or relative merits of each class of investment. Since the yield is frequently an extremely important yardstick, opportunity has been taken at this stage to demonstrate, wherever desirable, the basis of calculation to be employed.

Next follows chapter 7, which deals with the facilities for the acquisition and disposal of investments. As will be expected, the Stock Exchange assumes the most important rôle here.

Chapters 8, 9, and 10 are all concerned with the national economy. The proportion of the nation’s monetary turnover which

passes through the hands of government departments is now so high that an examination of the general structure of public finance is an essential prerequisite to the consideration of most investment problems. The assumption by the Government of greater responsibility for the economic life of the nation has already been mentioned. To assist the Government and to inform the public there is now a considerable output of White Papers and Statistical Surveys, some of which – for example, the White Paper on the Sources of National Income and Expenditure, and the Economic Survey – give promise of becoming annual events. The general features of such statistical surveys of the national economy are examined in chapter 9. Chapter 10 touches on the means by which a government may influence the economic life of the nation. A review of the background against which economic thought has developed in past decades is given with a twofold object in view: to provide a proper perspective for viewing current economic problems, and to illustrate the interdependence of economic thought with political and social developments.

Chapter 11 deals with the principles of investment – the general principles which should guide every investor, whatever his status, personal, trustee, or corporate, in the choice of investments.

Chapter 12 is concerned with the analysis of company accounts and is designed to assist the reader in detecting the essential features of balance sheets and profit and loss accounts.

Volume II (chapters 13 to 23) is to a major extent concerned with the many factors influencing the values of different forms of investment. The approach to the problem is generally along the lines of indicating the most important points to be considered and of guiding the reader in the difficult task of trying to draw reasonably correct conclusions.

A factor of supreme importance in nearly all investment considerations is the yield on British funds, colloquially referred to as the gilt-edged yield or sometimes just the 'rate of interest'. In order to explain the forces at work it is necessary to give a brief outline of the basis of the British money market and banking systems. This is done in chapter 13. Next follows a somewhat theoretical examination into the factors influencing the rate of interest. To this is added an examination of the causes which have actually had the greatest effect on the movements of interest rates in the past three decades. This leads up to a detailed study in chapter 15 of the various types of security comprised in the British fund list.

Chapters 16 to 20 relate to the other principal types of investment: Stock Exchange securities; land and property investments, and loans and mortgages thereon. These chapters discuss the main features of each class of investment and draw attention to any special points peculiar to different types of borrower, industry, trade, domicile, etc.

Chapters 21 and 22 apply chiefly to the investment problems of life offices, to the principles which should govern the selection of their investments, and to several matters concerned with administration and supervision.

The final chapter stresses the important rôle which the institutional investor plays in the national economy. It is most unlikely that the significance of this rôle will lessen in the future. The vast sums of money owned by life assurance offices and by many other institutions are accumulations of the savings of the multitude. Those responsible for the investment of this money are, therefore, in a very special position of trust, with the knowledge that the benefits of wise stewardship can extend far beyond the confines of those to whom they are directly responsible.

In a book of this nature the search for truth should be so insistent that wherever possible opinions which are purely personal should be suppressed. There is, however, one matter where it is most fitting that the author should feel free to write in the first person. I refer to the immense help which has been given so generously to me during the carrying out of my task.

The kindly advice and the constructive criticism of many of my professional friends and office colleagues have been invaluable. I owe a debt of deep gratitude also to Professor E. Victor Morgan for his guidance on all chapters dealing with the economic background; to Mr F. R. Althaus and Mr W. J. Prater of Messrs Pember and Boyle for their help on matters relating to British funds, in particular for their work in connection with the charts accompanying chapters 14 and 15 in Volume II; and to Mr W. J. Foster of Messrs de Zoete & Gorton for his wise counsel on problems relating to the Stock Exchange.

To my secretary, Miss S. Callard, who has typed the manuscripts and drafts I would like to offer my sincere personal thanks. She, I fear, is only too well aware of the long distance which has been travelled from the first draft to the final version.

L. G. W.

April 1949.

CHAPTER I

ELEMENTARY TREATISE. WEALTH, MONEY, INTEREST, PROFIT

I Definitions

Finance whether personal or public relates to transactions in terms of money. Investment is essentially an act of immediate sacrifice made in the expectation of future reward. The recompense may take one or more of the following forms: a recurring reward in the shape of interest, profit, or benefit in kind; the return of the original outlay at some future date; or the return of the outlay increased or decreased as the case may be.

From a personal point of view the act of investment usually means the outlay of money for the purchase of such things as savings certificates, stocks or shares, houses, etc. From the point of view of the nation, however, the act of Investment involves the initial construction of such things as roads, railways, factories, houses, cinemas, and so on; and the addition to stocks of materials and goods. Since personal investment can take place through one person buying from another person a house already built in spite of no Investment in a national sense having occurred, it is essential to distinguish between these two uses of the word. Thus whenever investment is used in a personal sense a small initial 'i' will be used; when in a national sense a capital 'I' will be used.

The world could not have grown to its present stage of industrial development without the process of Investment. It could not even function without the use of money. Indeed, finance in all its forms is such an integral part of civilization to-day that its influence is felt in almost every walk of life; in the social order, politics, business, recreation, etc. It should not, therefore, be studied as if it were an isolated science. Nothing could be further from the truth nor more prone to dull the subject. Although the normal means of financial expression are figures and symbols, the difference between success and failure, between wisdom and folly, between efficiency and inefficiency, should never be visualized solely as mere changes in impersonal functions. The larger picture which extends to the consequential influence on human life and happiness should never be forgotten.

Both Finance and Investment fall within the category of *means* rather than of *ends*. In so far as they have an ultimate purpose it is the creation, maintenance, and increase of wealth.

2 Wealth

Wealth in its economic sense implies the satisfaction of material wants. It is a relative term and so a more precise definition would be the *extent* to which material wants can be satisfied. In a similar way poverty is a measure of the failure to satisfy them. The standards of wealth or poverty of a nation will thus depend partly on the wants of its people and partly on its ability to satisfy those wants, or put in another way, on its primary sources of wealth. These are:

(a) Land and natural resources in the form of minerals, forests, waterways, livestock, etc.

(b) The number, character, and skill of the population.

(c) Capital equipment in the form of buildings, factories, communications, etc.

All three are to some extent interdependent and complementary. Natural resources seldom yield abundance without human effort; capital resources usually require skill both in their construction and use.

In most parts of the world it is no longer possible to visualize the natural resources of each community as being readily at hand and in sufficient quantity to satisfy the wants of its own citizens. These wants can only be satisfied by trade, and trade certainly cannot thrive without an adequate medium of exchange. Finance has such an obvious part to play in the exchanging of goods and services that there is no need to enlarge on it at this stage. Finance has, however, an even greater part to play in the creation and growth of the third element of wealth (c) namely capital equipment. This includes such things as houses, public buildings, factories, machinery, roads, railways, docks, mines, and many others; in fact, all those things which are built to satisfy future wants. Some of these may be built by an individual in the expectation of future use, some by a community hoping to share in future benefits, and others by those whose sole interest is to obtain a satisfactory reward from the capital outlay. In all cases the construction of capital involves an act of Investment which is in effect to build for the future by employing the energy and resources of the present.

This is only possible if people of the present generation consume less than they produce, in other words if they sacrifice and *save*. There is thus a direct relationship between the aggregate savings of a people and the amount of Investment which they can undertake.

In earlier times personal investment was usually undertaken by the individuals and communities who hoped to benefit most directly from the subsequent use of the capital project. A man would invest in the construction of his own house, farm building, weaving shed, or ship. Communities would invest in the construction of roads, schools, utilities, etc. Now, by far the greater part of personal investment is made by individuals and corporations in projects where their direct interest in the actual product thereof is usually non-existent or extremely remote. This development was only made possible through the vast expansion in the whole concept and machinery of Investment. The speed with which money can now be subscribed in one financial centre for the development of a project in some far-off part of the world would no doubt have amazed our forefathers.

In spite of the ravages of two world wars the wealth of many nations increased enormously during the past one and a half centuries. Among the many factors which contributed to this two deserve particular mention; the advance of the power-driven machine and the development of the limited liability company. Modern finance and the modern concept of Investment (in both senses) were as much products of the period as part founders of it. Although a big expansion in goods and services of all kinds has already been achieved, because of the accompanying growth of population a vast further increase is necessary before a satisfactory standard of wealth can become universal. Finance and Investment have their part to play in the future in furthering this ideal every bit as momentous as has been their contribution in the past.

Personal investment has been described as meaning usually the outlay of *money* in order to reap a reward in the form of *interest* or *profit*. It is desirable therefore to have as clear a conception as possible of these three functions.

3 Money

The idea of money can usually be considered as falling into two categories. The first is concerned with the receipt of money by way of salary or wages, interest, dividends, pension, and so on,

and with the payment of money for rent, food, clothing, entertainment, and so on. The second is concerned with the amount of money which is kept on deposit with a bank or in a savings account or which is employed in investment. These illustrate the two main functions of money, namely (a) means of exchange, and (b) store of value.

Money is a means of exchange. This seems a self-evident statement. What is not so self-evident is the fact that unless money is accepted as a means of exchange – or has a prospect of being accepted as such – it is virtually worthless. By way of illustration let it be assumed that at a particular point of time coal is priced at 100s. per ton, wheat at 20s. per cwt., and cotton at £40 per bale, then it can be calculated that one ton of coal can be exchanged for five cwt. of wheat or for one eighth of a bale of cotton. If, however, after a lapse of time the supply of coal diminishes and the supply of wheat increases (the demand for each remaining unchanged), then one would expect to find a difference in the relationship between the prices of coal and wheat. The prices might then be coal 120s. per ton and wheat 12s. per cwt. In those circumstances one ton of coal could be exchanged for ten cwt. of wheat.

If at a later stage of time the prices altered again and coal became 200s. per ton, wheat 40s. per cwt., and cotton £80 per bale, then each of these three commodities could be exchanged for exactly the same quantity of the other as in the first instance, yet their value in terms of money would appear to be doubled.

The question must then be asked: Have these three commodities really doubled in value, or does each of them retain the same value just because each can be exchanged for the same quantity of the other as in the first illustration? Now if, for example, it is found that 20s. of money buys the same amount of most other commodities, goods, or services as at the time of the original example, then these three particular commodities have certainly risen in value – they will, in fact, have doubled. But if 20s. of money is found to buy only one half of the same amount of other commodities, goods, or services as formerly, then the inherent values of these three in question have not really altered. What has in fact happened then is that *money* has fallen in value – actually to half its former level.

This may serve to illustrate that money although serving as a means of exchange has little intrinsic value; it has a relative value or what is commonly known as *purchasing power*. Just as the price of coal in relation to wheat will vary according to the relative supply

of each so also will their prices in terms of money depend upon the relative supply of the particular unit used as money. As a rule this is true of major but not necessarily of minor changes in the supply of money.

It is desirable now to consider the other function of money (*b*) store of value. If producers of coal, wheat, and cotton, and indeed of other commodities, were only concerned with exchanging their goods for those of others, then the prices *in relation to money* would not matter – assuming that all commodities were consumed and that no one saved. If, however, some of the producers withheld part of the proceeds of the sale of their commodities – that is to say did not spend it all on the purchase of other commodities, but instead saved in the form of money with a view to spending at a later stage – then those who saved would be very much concerned with the price of commodities *in relation to money*. They would be using money as a *store of value* and would be directly affected by any change in its value at the end of the period of *store*. Thus money must have not only the attributes of a convenient medium of exchange, but should also give promise of remaining as far as possible stable in value. Whatsoever form money takes it is desirable that it should have the following qualities:

(*a*) It should become available in such quantities as bear, within reasonable limits, a direct relationship to the amount required to serve as a means of exchange.

(*b*) It should have a limited non-monetary use.

(*c*) It should be non-perishable.

(*d*) It should be impossible or at any rate very difficult to counterfeit.

(*e*) It should be easy to transfer from one owner to another in any desired amount.

The last four of these require little further explanation. In the case of the first, some amplification is necessary. The required supply of money is not governed by the total amount of goods and services produced by a community, but only by the amount which is normally in the process of being exchanged.

For many centuries gold fulfilled all the above requirements. To a lesser extent so also did silver. The annual output of these two metals was not subject to violent fluctuations. The nature of their deposits in the earth was such as to preclude the likelihood of their

ever being discovered and made readily available in vast quantities. They were pleasant to handle, difficult to counterfeit, and non-corrosive in nature. Their non-monetary use was confined largely to ornamental purposes.

As regards (e) transferability, they were both convenient for sums not too large and not too small. For coins of small value cheaper metals in the form of copper, brass, or nickel were brought into use. For large sums, apart from the obvious disadvantage of bulk, risk of robbery was an important consideration. As regards (a) supply, in spite of the gold discoveries in California in 1848 and later in the century in the Transvaal, the supply of gold, and also of silver, was not sufficient to keep pace with the enormous expansion in world trade in the nineteenth and twentieth centuries. It was necessary therefore to rely more and more on the services of the banks, who were able to provide means of overcoming the limitations of gold and silver coin. Banks accepted for safe custody gold and silver and issued what were really tokens to gold and silver in the form of bank notes. They also gave facilities for transferring money from one person to another without physical conveyance. The more usual means of accomplishing this transfer was by use of the cheque.

Just as nations have different languages, customs, and forms of government, so do they as a rule have their own particular monetary unit; the pound sterling, the dollar, the franc, etc. But trade is to a large extent international and could not operate satisfactorily without an international monetary unit. Gold performs this function, each national monetary unit or currency being expressed in terms of a stated amount of gold. As long therefore as bank notes could be exchanged for gold at a fixed rate everyone would accept them as if they were gold itself; the currency would be in fact on *the gold standard*.

In practice, however, whether or not currencies are on the gold standard their relationship or *foreign exchange* value is expressed not in terms of gold, but in terms of their relationship with one another. For instance, the relationship between the pound sterling and the dollar is expressed in terms of dollars per pound, the rate ruling at the time of writing being \$4.03 to the £.

The exact part played by gold – and silver, too – as monetary units has undergone vast changes since 1914. Gold has now practically disappeared from the coinage, most of the world's supply being in the possession of national treasuries, central banks, and

the International Monetary Fund (to which further reference will be made later on). Its supremacy, however, as an international monetary unit is still unchallenged.

Bank notes in most countries are not now exchangeable for gold coin, so there is no longer any automatic limitation on the amount of notes in issue. Under present conditions they take the form of a *fiduciary* issue, which means literally that their value rests on public confidence: confidence that the bank note will continue to be accepted as a means of exchange and that it will not be allowed to depreciate in value through the printing and issue of more notes than are required to finance the current volume of trade.

Those who hold money as a store of value are as a rule very much concerned with the stability of its purchasing power. This concern is for obvious reasons much greater when the note issue is on a fiduciary rather than on a gold basis. The problem is linked with what is known as the laws of supply and demand (which will be explained later in chapter 3). However, it is sufficiently obvious at this stage that any resort to excessive printing of paper notes will lower the value of money.

Those who save money are usually investors who have in mind one or other of two main objectives. They either (*a*) save with the object of spending later, or (*b*) save in order to free themselves of debt. Included in category (*a*) are such instances as endowment assurance policies, contributory pensions, providing for dependants, or the simple act of saving for a rainy day. Any change in the purchasing power of money is of prime importance to such investors. If there is fear that money will fall in value it may restrain people from saving. If, on the other hand, current prices of goods are high, and if as a consequence money buys little, then saving may be encouraged by the hope that money will buy more at a later date.

The other category (*b*) is concerned with the redemption of debt or with an obligation to pay a fixed sum of money at some future date. For example, suppose that a sum of money has to be set aside and accumulated in order to repay a debt in ten years' time, then in such a case the investor will not be concerned directly with any alteration in the value of money at the end of that period: the express purpose will have been achieved whatever the value (though it should be noted that any marked change in value may affect the *ability* to save).

It is therefore wise for those who save and store money to con-

sider whether they are concerned or not with any subsequent change in the value of money. As will be explained in later chapters, this is one of the matters of prime importance in the choice of the actual type of investment.

Another important aspect of money which should be mentioned is *credit*. When discussing the functions of money as a means of exchange and as a store of value it has been assumed that it is acquired only as a result of work or through the ownership of goods or property; that is to say, that one can only acquire money either by performing a service or as a consequence of something already owned. This assumption means in effect cash trading, and if trade can only be carried out on a cash basis, then no one can buy unless he has money readily available. This would impose definite limitations on the potential volume of trade. Suppose, for instance, that a farmer was convinced that by spending £500 on the purchase of a tractor he would increase the net income from his farm by £100 each year. If he were a member of a community which traded only on a cash basis, then he could only achieve his desired expansion by saving enough each year to accumulate in time to the required sum of £500. But if he were to borrow the sum from someone who already had the money and who had no immediate need for it, then he could reap the reward of increased output in the immediate future. If the reward were greater than the cost of borrowing, then this method would be to his advantage.

In general the greater the opportunities for anticipating future benefits through the system of borrowing the greater will be the expansion in the volume of trade. Indeed, a very considerable proportion of trade is now financed not on the basis of cash or ready money, but by borrowed money, in other words on credit. This is supplied not only by lender direct to borrower, but more frequently through the medium of institutions such as banks, building societies, and others.

4 Interest

The lending or investing of money at interest is done now on such a vast scale and by so many people that there is little difficulty in understanding just what interest means. Basically it is the rate of hire for the loan of money and generally speaking the appropriate rate of interest should represent an equation between the benefit to the borrower and the sacrifice incurred by the lender.

In earlier times interest had a very different meaning from what

it has now, and consequently some confusion of thought still arises on ethical grounds over the whole question of lending or borrowing money at interest. In primitive societies the practice of charging interest for the loan of money or of goods was considered wrong. It was held that the lender should be entitled to the return of what he lent, but nothing more. To claim more was considered to be unjust exploitation of the more favourable position of the lender. With the advance of civilization and with the advent of courts of law the lender received the support of judicial power to enforce the return of goods and money let out on loan. Roman law recognized his right to receive something in addition to what was lent, but by way of damages for delay in repayment and as an indemnity for the risk of possible loss. Indeed, the indemnity was fixed usually more by reference to the damage suffered by the lender through delay than by any possible benefit to the borrower.

It was under such conditions that the lending of money at a pre-determined rate of interest was prohibited under the interdicts against usury. In those days usury meant lending money at any fixed rate of interest and was condemned. To-day usury means lending money at an *exorbitant* rate of interest.

Up to the end of the eighteenth century and at times even during part of the nineteenth century the moneylender was a discredited man in the eyes of society. This was largely because he was in a position to exploit his possession of money at the expense of those who were obliged, more by necessity than by choice, to borrow money. But when conditions arose under which it could be at least as profitable to the borrower to borrow as to the lender to lend, then the earlier attitude of mind towards interest changed. Formerly the circumstances under which money was borrowed were so frequently the consequences of some misfortune that the debt could only be repaid by saving out of future earnings – often at considerable sacrifice to the borrower. The payment of interest appeared then to be an unjustifiable burden. But if money were borrowed for some productive purpose which was likely to increase the earnings of the borrower to a greater extent than the amount of interest paid on the loan, then both borrower and lender could be satisfied.

In a non-industrial community opportunities for the profitable employment of borrowed money are limited, but during a period of great industrial expansion such as took place during the last hundred years or so the possibilities are very great. A simple

example will serve. In an area where industrial development is taking place a housing shortage exists. Estimates show that houses can be built for £1,000 each and that each house can be let at a rent to give a net return of £60 per house. If money can be borrowed at 4% it is obviously advantageous to borrow and to build. Indeed, as long as such conditions last the incentive to build will be strong. But those who have money available for lending will naturally want to lend where they can get the best terms. For instance, if at the time in question a manufacturer decides that an extension to his factory would increase his earnings by an amount equal to, say, 10% of the outlay, then it would pay him to borrow money at a higher rate than the rate which the housebuilder could afford, and for this reason the lender would be more willing to lend to the manufacturer.

The greater the opportunity for embarking on capital projects on profitable terms the greater will be the demand for the borrowing of money. But the amount of money available for lending is subject to many restraints, and if the supply is restricted, then loans will go first to those able to pay the highest rate of interest. Thus the rate of interest which can be agreed between borrower and lender will depend largely on the relationship between the demand for borrowed money and the supply of money readily available for lending. But the demand itself will be influenced by the rate of interest charged. In the example mentioned above houses will be built with borrowed money only if the rate is lower than 6%. If the rate is higher the demand from housebuilders will be withdrawn. There are, in fact, forces at work which are pulling towards a state of equilibrium, the chief motive power being the profit motive – profit to both borrower and lender.

When money is borrowed at an agreed rate of interest the amount of the loan is termed the principal or capital sum. Interest is usually payable annually or at more frequent intervals and is calculated on the principal or capital. It sometimes happens that borrower and lender agree that interest should not be paid over in cash on each due date, but instead be re-lent on the same terms, that is to say at compound interest. For purposes of illustration consider the case of a loan of £1,000 at 5%; under terms of simple interest £50 would be paid each year and the principal sum of £1,000 would be paid when the loan falls due for repayment, say, in ten years' time. If, however, the loan agreement provided for compound interest no payment would be made for ten years and

then at the end of that time the sum of

$$£1,000 \left(1 + \frac{5}{100} \right)^{10} = £1,628 \text{ 17s. 10d.}$$

would be payable. Of this sum £1,000 represents the original capital or principal and the balance £628 17s. 10d. represents the accumulation of compound interest. Is this latter sum now interest or capital?

A great deal of confusion often exists as to what exactly is principal and what is interest. A person saves something out of his annual income, then in a few years' time his income suffers a decrease and he draws on his past savings. Is he then living on his capital? It is difficult and indeed sometimes impossible to give a definite answer. It depends not only on how the money arose, but also on how it is spent. Principal and interest are expressed in the same token, namely money, but in terms of that money they don't carry distinctive labels. Generally speaking, money is principal or capital when it is producing interest or income. If, however, interest or income remains temporarily unspent, and provided the owner has every intention of spending it ultimately, then it still retains its original status, though in the meantime it may be put temporarily to productive use.

Before leaving the subject of interest there is one aspect which it is important to bear in mind. Differences in rates of interest are as a rule of lesser importance when a loan runs for only a short period of time. For example, the total amount due in respect of principal and simple interest in the case of a loan of £100 for five years is £115 if at 3% and £130 if at 6%, i.e. a difference of 13.0%. If, however, the loan were for twenty years and at compound interest the amounts would be £180 12s. 3d. and £320 14s. 3d. respectively, i.e. a difference of 77.6%.

5 Profit and Loss

The words profit and profitable have been used already, but without any definition beyond the implication that they are to a person's advantage. It is not always easy to determine whether an undertaking is achieving a profit or a loss or to be able to measure the extent of it. It is, however, most essential to have as clear a conception as possible of the principles which underly its determination.

Profit is not a static condition. It is the measurement of gain or improvement over a chosen period of time. The period of measure-

ment is most frequently the calendar year. It is not just the difference between outgo and income, between expenditure and receipts. It is this difference taken together with a comparison of the state of affairs at the beginning of the period with the state of affairs at the end. This applies to the financial operations undertaken by individuals, partnerships, companies, all forms of business association, and sometimes to the operations of public authorities.

Many of the more important principles underlying the calculation of profit and loss can be illustrated by examining the financial transactions of a business owned by one man trading in a single commodity. The illustration which will be taken is the business of a fruit vendor who neither owns nor rents any premises, but sells peaches off a barrow. He will require as capital at least enough to purchase his barrow and to buy a stock of fruit for the first day's trading.

He starts trading by buying 1,000 peaches at 3d. each and sells the lot in one day at 4d. each. He has made a profit therefore of 1,000d. or £4 3s. 4d. His barrow is in the same state at the end of the day as it was at the beginning, so the sum of £4 3s. 4d. is a true profit for the day's trading. On the second day he starts again by buying 1,000 peaches at 3d. each. Encouraged by his success on the previous day, he charges 5d. each, but is able to sell only 600, leaving 400 unsold. As he has made 2d. on each peach sold, namely, 1,200d. or £5, he is tempted to assume that he has improved on the first day's trading and that his profit for the second day is £5.

On the third day he begins by buying 600 at 3d., making, with the 400 unsold on the previous day, his full complement of 1,000. He charges 5d. each, but makes little progress, selling only 100 at that price. He realizes then that the peaches bought on the previous day have deteriorated and that if they remain unsold much longer they will become worthless. He therefore carries out successive price reductions selling 200 at 4d., 500 at 3d., and 200 at 1d. His average price for the day is 3d., so he feels that he has made neither profit nor loss. He calculates that the three days' trading have brought in a total profit of £9 3s. 4d., which is correct. But in considering his profit for the second and third day he reckoned only on his cash transactions during the day and made no comparison between the state of his affairs at the beginning of the day and at the end. It is necessary therefore to make an adjustment in order to obtain the true profit for those days.

At the end of the second day he had in stock 400 peaches which had cost 3d. each. Their worth at the end of the day was undoubtedly less than their cost price, not only because of deterioration during the day, but probably because the best of the peaches had already been selected by the purchasers. Let it be assumed that a fair price for the unsold peaches was $1\frac{1}{2}$ d. each, then it is necessary to deduct from the £5 gain on the 600 sold a sum of £2 10s., i.e. $1\frac{1}{2}$ d. each for 400 peaches, to allow for *depreciation* of stock. The true profit for the second day is therefore £2 10s. Similarly it can be calculated that since he started the third day with 400 peaches at $1\frac{1}{2}$ d. each his profit for the third day was £2 10s. In practice, however, profit and loss are seldom calculated each day, but the principles involved in calculating over a longer period are the same. When the fruit vendor makes up his accounts for a whole year's trading he will almost certainly have to make a deduction to allow for depreciation in the value of his barrow owing to wear and tear during the period.

The above is an extreme simplification of the problem, so consideration will be given now to another example; the business of a cloth manufacturer owning a factory and machinery and employing several operatives. His capital will consist of his factory and machinery, stocks of material in various stages of manufacture, and probably some ready money. His profit for the year will be determined by deducting from the proceeds of the sale of cloth all expenditure in the form of raw material costs, salaries and wages, fuel and power, repairs, taxes, agents' selling commissions, advertising, etc. An adjustment will then have to be made to the resulting figure to allow for any difference between the state of affairs at the beginning of the year and at the end. This adjustment will reflect not only any changes in the quantity of stocks of material held, but also any changes in their value. Allowance will have to be made also for the gradual wearing out of machinery. For instance, if it is estimated that it will last ten years then one tenth of the value should be set aside each year in order to replace the machinery at the end of that time. Similarly allowance will have to be made for any deterioration in the value of the factory.

There is one practical qualification to this. Business capital consists partly of *fixed capital* and partly of *circulating capital*. The components of the circulating capital are always being changed or *turned over* in the process of manufacture. Any alterations in the prices of materials, etc., comprised in the circulating capital are of

immediate concern to the business. But the fixed capital in the form of factory and machinery is not held for purposes of sale, but for purposes of production. Any change in value here is therefore of more remote concern, having little immediate influence on the results of trading. But changes in the value of fixed capital can be of a relatively large order and would cause violent fluctuations in the profit and loss account if account were taken of every such alteration in value. One of the main purposes of calculating profit, however, is not only to record the profit actually achieved, but to measure *profitability*, i.e. the capacity for profit. Changes in the value of fixed capital have often little direct connection with the current trading operations of the business and may be caused by wholly extraneous factors. It is customary therefore to eliminate as far as possible from profit and loss calculations any such changes in the value of fixed capital. If they are of a minor order with no established trend they are ignored. If the changes are in an upward direction they are usually not brought in to augment the profit. But if they are in a downward direction a deduction from profit is often considered prudent.

In the examples mentioned above it was assumed that the state of affairs or capital position was capable of monetary valuation. But there are many instances where no such calculation is possible, though balances between expenditure and income are often struck and given the attributes of a profit and loss account. Take the case of a professional man. His capital consists largely of his knowledge and skill. For instance, a barrister may spend part of his time in remunerative practice and part in adding to his mental equipment. The income from his practice is not therefore his whole profit; there is something further in addition, though it is almost impossible to place a monetary value on it.

The statement of national income and expenditure presented with the budget speech is sometimes looked upon erroneously as a nation's profit and loss account. Not only does this statement often include items of a capital nature, but no link is established nor indeed could be established with the state of the nation's capital at the beginning and at the end of the fiscal year. Similarly local authorities may produce figures showing surpluses in the balance of payments under their control. These may be quite meaningless as an indication of profit in the true sense of the word if it happens that some of the sources of revenue have in the meantime undergone material changes, such as, for example, might be caused by

migration of population, by changes in the location of industry, or by nationalization of local authority undertakings.

The part played by profit and profitability in most financial and investment considerations is vital. It is only possible to deal here with some of the general principles and to endeavour to inculcate the correct approach to the problem. The subject will be given more detailed examination at a later stage.

CHAPTER 2

THE PRESENT AND THE PAST. GREAT BRITAIN'S ECONOMIC AND SOCIAL WAY OF LIFE

I Conspicuous Features of British Economy and Society

Economic and social problems seem now to abound everywhere and in one form or another pervade our whole existence. They absorb by far the greater part of parliamentary time. The popular Press no longer shuns the use of statistics, and economic matters often provide front-page items of news. The number of economic problems awaiting solution appears to increase year by year. The pressure on men's minds is often so great that there is a risk of viewing everything in terms of the present or immediate future. But no solution or cure can be certain of success without proper diagnosis. It is seldom sufficient to know just how things are; one must know also how they became so. A psychiatrist when examining a patient will often enquire into his early past and find there a key to the cure he should prescribe. So, too, will be found sometimes the key to the cure of social, financial, and economic ills. At any rate, no true appreciation of the present position can be made without knowledge of the past.

Among the more outstanding features of Great Britain's economic structure at the present time may be included the following:

(a) The production of food at home is insufficient to feed adequately more than about half the population. It is necessary therefore to make up the deficiency by trading with other lands. As Great Britain has no substantial surplus of raw materials at her disposal, she can only import food by exporting manufactured goods. Not only is she deficient in food (in relation to the size of the population), but also in many of the raw materials which are required for the manufacture of finished articles. Such raw materials must therefore be imported also, thus swelling the total amount of exports which are required if a balance of overseas trade is to be achieved.

(b) Power for the manufacture of goods is available in the form of ample reserves of coal.

(c) Her people have the skill and craftsmanship necessary for a manufacturing nation.

(d) She is well equipped with all the many essentials of an island trading nation; shipyards, ships, internal communications, financial services in the form of banks and insurance offices, etc.

(e) In the political and social scene there is a propensity to proceed by way of evolution rather than by revolution. The Commonwealth is an association unique in the annals of the world. British constitutional law is largely an unwritten one; flexible and adaptable, it is the envy of many.

(f) In the realm of social security services embracing the care of health, unemployment insurance, old age pensions, industrial injury, education, etc., there has been a record of steady advance over many decades, the credit for which belongs in varying degree to all political parties.

Many of the most important and durable features of British life to-day have their roots in the past. How have these originated, developed, and matured?

2 Great Britain as a Mercantile Power

A nation may be described as a mercantile power when it holds a prominent position as a merchant and carrier of international trade. While the primary function of a merchant is usually the exporting of goods produced or manufactured at home and the importing of foreign produce, so long as goods are purchased from those seeking to sell and sold to those seeking to buy, then the functions of an international carrier are fulfilled. It is virtually impossible to carry on international trade on a large scale without an adequate shipping fleet and without the guarantee of safe passage.

Great Britain's position as a mercantile power was not achieved solely because she happened to be an island nation nor because she had built a large shipping fleet. The latter would have been of no avail without naval supremacy, nor could it have been used to full advantage without an ardent desire to sail the seas. Although the challenge to British sea power was successfully met at the time of the Spanish Armada and again during the wars of the Grand Monarch, it was during the century following the Napoleonic wars that her supremacy was most freely acknowledged and when her mercantile trade enjoyed its most rapid expansion.

It was only natural that, concurrent with the growth of inter-

national trade, expansion should take place also in the business of banking and insurance. No shipments of any importance could be carried out without arrangements being made for the transfer of money from buyer to seller. Facilities for the provision of credit were often necessary as well. In addition, both ships and cargo had to be insured against the perils of the voyage. It is interesting to note that three of the large insurance offices in business to-day were founded over two centuries ago.

The importance of the rôle played in Great Britain's island economy by shipping, banking, and insurance can perhaps be understood best when it is realized that for several years prior to 1939 the income from these services to overseas customers exceeded the cost of the entire nation's imports of wheat and flour.

3 Great Britain as an Industrial Nation

During the latter part of the eighteenth century Great Britain was still primarily an agricultural nation. Most of her people were employed in *subsistence* agriculture – that is to say in growing just enough food for their own needs – and in the *cottage* industries such as spinning, weaving, brewing, etc. The centre of social life was the village, much of the farming still being done on common land or in the open fields. Those who lived in the country were generally content with their lot; at any rate they were not active malcontents.

It is not proposed to delve deeply here into the origins and causes of what is known as the Industrial Revolution. The examination will be confined to what actually happened rather than to the reasons; particular attention will be paid, however, to any lasting consequences.

Towards the end of the eighteenth century the enclosing of common land took place on a substantial scale. Communal tillage was becoming an anachronism. Men like Coke (and in an earlier period Townshend) were demonstrating the value of new and scientific methods of farming. They showed that it was possible to feed cattle and sheep throughout the winter, thus putting an end to wholesale slaughter each autumn. Scientific breeding was introduced and better husbandry increased the yield of all cereal crops. At the same time a marked improvement in the condition of roads facilitated a substantial increase in wheeled traffic.

About the year 1770 James Watt invented the steam engine and Sir Richard Arkwright the spinning frame. These inventions had a

profound influence on the course of industrial development in the ensuing century.

The improvement in farming and the increased yield from the land came just in time to keep Great Britain largely independent of foreign food during the Napoleonic wars. But the price of home grown food increased several fold. Largely as a result of a fall in the death-rate the population was beginning to increase with great rapidity. The plight of the labourers became very serious. The land could provide work for only a limited number, so they were driven to the new growing towns to seek whatever work they could obtain. As the town industries grew, aided by steam power and machinery, the foundations of the cottage industries of the countryside were undermined by this new competition and the drift from country to town grew apace.

No industrialization of any country is possible without there being at hand an adequate supply of fuel and power. For many centuries wood had served as fuel even to the extent of being used in the form of charcoal for the smelting of iron. Fortunately for the nation, just as the supply of wood began to decline seriously through the denuding of the forests, coal took its place. The discovery and development of the British coalfields and the production of coal at a low cost provided the full amount of cheap and plentiful power which was needed for the gathering speed of the Industrial Revolution.

Soon all the other ingredients necessary for a rapid industrial development became available. In addition to coal mines, there were canals, railways, ironworks, woollen and cotton textile mills operated by machinery – and cheap, very cheap labour. The conditions of many of the workers in the towns during the first part of the nineteenth century were appalling. Yet those very conditions which might more logically have been expected to halt the growth of population moved in the other direction. Child labour was usual in most industrial towns. Children were breadwinners at a very young age. The greater the poverty of a family the greater was often the need to bring yet more children into the world.

The opportunities for profit to the owners of the new factories and industries were substantial. Little difficulty was encountered in selling their products. Labour was cheap, so also was the motive power for the factories. The incomes of the owners were frequently large and saving seldom imposed much sacrifice; it was, in fact, often unavoidable. Money was therefore readily available for

founding new businesses, for building property, and for other forms of investment. The new owners of industry were seldom the heirs of the landed nobility with their tradition of *noblesse oblige*. They were often men who had risen from the ranks, craftsmen who had mastered the technique of the new machinery and as owners were able to put it to more profitable use. They were able and energetic; devout disciples of the prevailing economic doctrine that it was right to buy in the cheapest market and to sell in the dearest whatever the social consequences.

The second half of the nineteenth century saw Great Britain sailing on the full tide of industrial supremacy. The repeal of the Corn Laws in 1846 had ushered in an era of cheap food. Conditions of labour in the factories were steadily improving. Her economic position was truly complementary with the rest of the world. It was said that Great Britain had become the workshop of the world and the rest of the world had become her granary. She was able to satisfy the increasing demand for manufactured goods, particularly for textiles. The construction with British money of railways overseas was opening up the vast wheatfields of the American continent and the new iron ships built in Britain carried the grain home-wards. Emigration was both a cause and a result of the development of overseas territories, each emigrant from the British Isles being potentially both a customer and a salesman of British goods.

But the new lands abroad were not content to rest for ever as providers of cheap food for Britain and passive purchasers of her manufactures. Neither were European powers such as Germany and France content to resign themselves to a secondary rôle in the march of industrialization and colonization. The expansion of the United States of America was so rapid that for many decades prior to the outbreak of the first world war her home demand absorbed nearly all her manufacturing capacity and much foreign capital as well. Germany, on the other hand, became a serious competitor well before the turn of the century in the field of manufactured goods designed for export. Between 1870 and 1910 Britain's contribution to the world's production of manufactured goods fell from one third of the total to one sixth.

During the first world war Britain was obliged to sell many of her overseas investments to pay for food and munitions. But at the end of that war she had still sufficient left to yield in interest and dividends a sum which, together with receipts from shipping,

banking, and insurance services, paid for about 40% of her total imports. The nation was therefore able owing to the thrift of earlier generations to consume considerably more than it produced. But after a shortlived recovery in the volume of exports a recession to well below the pre-1914 level took place. Exports of cotton yarn and cloth amounted to over £350,000,000 in 1921; they fell to £50,000,000 by 1935. New mills in India and Japan, with their cheaper labour costs, had completely undermined Britain's competitive position in the export market for the cheaper textiles.

During the second world war not only were most of the remaining overseas investments sold, but new debts to countries overseas were incurred on a vast scale. Britain had become a debtor nation. Many of the benefits achieved and stored as a result of the great industrial expansion of the previous century had gone. Many of the legacies remained, perhaps the most important being a population greatly in excess of what could be fed by home agriculture – and the memory of a relatively high standard of living. Britain can only survive and thrive by exchanging wanted manufactured goods and services for food and raw materials. In spite of the ravages of two world wars the manufacturing capacity of the world has increased. The potential demand for food has also increased, but the supply available for world markets is still a long way short of what is required to give a satisfactory diet to all.

If there is any lesson to be learnt from a brief study of Great Britain's industrial development it is probably this. The past may well serve as a guide to the future more by way of contrast than by way of similarity.

4 Trade Unions and Relations between Employer and Employee

Out of the aggregate private incomes in Great Britain in the year 1947 40% was received by wage-earners. As a rule wages are fixed as a result of negotiations between employers on the one hand and representatives of the employees on the other. In some cases the employers act jointly through their trade associations or employers' federations. Employees are nearly always represented by their trade unions.

The close affiliation of the trade unions with one of the major political parties places them in a unique position of power and responsibility. The manner in which this power and responsibility is used and the traditions which the trade unions themselves estab-

lish have therefore an important influence on the country's economic and social life.

Before the Industrial Revolution industries were organised under their various guilds. These promulgated laws and customs for all those engaged in each craft or trade. There was no separate representation of employers and employed. On the contrary, there was a close personal association, the employee starting as an apprentice and often residing in his master's own house. Apprentices, journeymen, country labourers were often a contented people. But when they and their children began to move into the industries of the new towns of the early nineteenth century their lot was anything but happy. The need for organized representation was probably greatest in those early days. But trade unions were suppressed during the Napoleonic wars under the Combination Acts of Pitt. So strong then was the reaction in England against the extremes of the French Revolution that no workmen were allowed to combine for the express purpose of bettering their wages and conditions of work.

The Combination Acts were repealed in 1824. Trade unions then strove to improve the conditions of the workers. At the same time more enlightened employers such as Robert Owen were setting examples to others. Lord Shaftesbury in 1847 succeeded in obtaining the passage of the Ten Hour's Bill. Later in the century, although Disraeli could still refer to his 'two Englands', the position of the worker gradually improved, helped considerably by the growth of the trade unions and of other associations for mutual help such as friendly societies.

An event of great significance occurred in 1901; this was the Taff Vale judgment. Certain employees of the Taff Vale Railway Company had been found guilty of unlawful acts committed during a strike. Instead of suing the individuals the railway company sued the trade union and was awarded substantial damages against it. As a consequence the immunity of trade union funds was rendered insecure, especially when strike action was being taken. This weakened the collective bargaining power of the trade unions and had the result of impelling the wage-earner to look more to the Labour Party to represent and protect his interests. Five years later an Act was passed which had the effect of reversing the Taff Vale verdict and of making trade union funds immune from seizure – but the impetus given to the growth of the Labour Party was not stilled.

Trade unions acquired a new lease of life and their influence grew steadily until the general strike in 1926. Public conscience was disturbed then by the way in which the country could apparently be held to ransom by a general strike or by the threat of one and the Trade Disputes Act which substantially reduced the powers of the unions was passed in 1927. This Act was subsequently repealed in 1946 by Mr Attlee's Socialist Government.

Trade unions now exist for almost every occupation where a standard rate of wage or salary is the rule. The inhibition which had lasted so long on the affiliation of civil servants' trades unions with political bodies was removed in 1946. Quite apart from the separate functions of individual unions the Trades Union Congress acts as a central and advisory organisation. The power of the unions for good or for ill is immense. It would be very difficult to put into operation any economic, industrial, or Investment policy on a national scale without their goodwill and co-operation. Fortunately the long period of growth and development has been accompanied by a more mature understanding of the broader points at issue. The fiery advocacy of the earlier trade union leaders has mellowed into the more responsible and judicial attitude of the leaders of modern times.

5 The Development of Social Security Services

The amount of money paid out by public authorities in 1947 in the form of social security services of all kinds, including sickness and disability benefits, unemployment allowances, pensions, family allowances, protective food products, etc., was £430 million. In years to come it is expected that this figure will increase substantially when additional items such as maternity benefits, death benefits, industrial injury allowances, etc., will swell the total. The aggregate will be sufficiently large in relation to the total income of the population for it to be a factor of great importance in the economic life of the country. Here again the process of development has been gradual and has extended over a long period of time.

In the early days of the Industrial Revolution social security services were confined almost entirely to relief afforded under the Poor Laws. In the pre-industrial era the majority of the population were able to subsist on the products of their village and it was on the parish that fell the responsibility for administering the Poor Laws, the necessary money being obtained from local rates. When

in the closing years of the eighteenth century the agricultural labourer was suffering greatly – not only from low wages, but also from high food prices – an abortive attempt was made to fix a minimum wage which would fluctuate with the price of bread. But instead of this the system colloquially known as the ‘Speenhamland Act’ was adopted throughout most of the country. Under this system wages were subsidized out of local rates. The dole was to increase with any increase in the cost of bread. The effect was to throw the responsibility of providing for a living wage on the parish and not on the employer. Indeed, the system enabled the employer to depress wages further and thereby increase the burden placed on all who paid local rates; the result in the end was to accelerate the drift from country to town.

New Poor Laws were enacted in the second quarter of the nineteenth century, but the demand for relief was enormous and the amount afforded was scant. The conditions under which it was administered were deplorable. The vivid descriptions in *Oliver Twist* will be called to mind. Although in the latter half of the century conditions showed some considerable improvement, the development of social security lay more in the growth of voluntary associations such as friendly societies.

In 1897 an Act to ensure compensation for injured workmen was passed. The first Pensions Act was passed in 1908. Compulsory health insurance was made law in 1911 and in 1920 unemployment insurance was made fairly generally applicable. Subsequently several new Acts were passed. These dealt with each problem separately and usually on a joint contributory basis, contributions being shared between the individual, the employer, and the state – but applying only to those whose incomes were below a certain limit.

The first step towards a comprehensive unification of social services was the publication of the Beveridge Report.¹ The report made recommendations for the unification of social services and for the granting of benefits on a subsistence level. They were to apply to all persons irrespective of their incomes and were designed not to supplant voluntary action by the individual, but to provide a base upon which the individual would be free to build.

The extent to which the recommendations have been implemented or modified in subsequent legislation is now fairly well

¹ *Social Insurance and Allied Services*. Report by Sir William Beveridge. Cmd. 6404.

known. What is probably not yet affirmed and may not be known for some time to come is the answer to the question which was bound to arise in the minds of many people. Does the provision of a basic subsistence level inspire the individual to greater effort through the release of energy which might otherwise be absorbed in trying to avoid the risks of unemployment, ill health, injury, etc., or does it act in the opposite direction through reducing the incentive to work?

6 Economic Doctrines and the Trend towards Collectivism

There was a time when it was considered the essence of good government to confine its interference in business and industry to a minimum. Out of this theory grew the doctrine known as *laissez-faire*.

This doctrine was accepted by the majority with little question during the nineteenth century and it retained some strong adherents during the early part of the twentieth century. Adam Smith's book entitled *An Enquiry into the Wealth of Nations*, published in 1776, had an enormous influence on opinion. It propounded not only the arguments in favour of *laissez-faire*, but explained the great benefits to be derived from the division of labour; greater wealth being derived, it was said, from the labourer applying himself to one particular job of work than to a multiplicity of processes. It was in the interest of the employer to obtain his labour and materials as cheaply as possible, irrespective of their place of origin. It was also in his interest to sell his products in the dearest market, irrespective of their destination. As far as the owners of capital were concerned this economic philosophy not only sounded very sensible, but in practice it worked wonders and undoubtedly added to the total wealth of the community. This was facilitated by the abundant supply of cheap labour and raw materials and by the strong demand everywhere for British manufactures.

Another publication which had a big influence on opinion during the earlier years of the Industrial Revolution was Malthus's *Essay on Population*. His examination of population statistics and his forecasts of population trends led him to the opinion that a satisfactory standard of living for the increasing population was an economic impossibility. Poverty was considered to be the inevitable lot of the majority of mankind. This belief was shared not only by the employers of labour, but even by those who were taking the most active part in bringing about the abolition of the

slave trade. The evangelical conscience which had done so much for the black slave was not stirred in the same way to improve the lot of the industrial worker and farm labourer. Their low standard of life was looked upon as part of the pre-ordained order and attempts to better it were considered not only bad for the country's economy, but almost heretical. Before the Reform Acts were passed there was little chance of much intervention from the state. The landowners and industrialists were themselves the Government.

After the battle for electoral reform had been won, and after the fight for the repeal of the Corn Laws had been carried against the landowners, the doctrine of *laissez-faire* took on a new lease of life. The gradual improvement in the conditions of the workers accompanied by the rapidly growing national prosperity gave it a rather kindlier aspect. Great Britain had become firmly wedded to the principles of free trade – which were not discarded until 1932. In this aspect of *laissez-faire* it was not just the theoretical doctrines of free trade which made such a compelling appeal. The practical advantages were enormous. Ample supplies of cheap food were being transported from the plains of North and South America and for a long time British manufacturers were almost free from any form of foreign competition. The consequential decline of home agriculture seemed of little importance compared with the vast increase in total wealth. But the economic aspect was not the only one. It was not just a question of substituting one form of industry for another, but of altering fundamentally the manner of British life.

The first real attack on free trade was launched by Joseph Chamberlain near the turn of the century. He advocated tariff reform to help the new developing industries in the British Empire and Colonies overseas. However, little was done in this direction. When Britain emerged from the first world war the majority of opinion still saw in free trade the greatest hope for her economic future. But the surrounding world conditions were rapidly changing. India and Japan had become serious competitors in the textile field and the United States of America had taken steps in 1922 to surround herself with a high tariff wall for the protection of her manufactures. In 1932 free trade gave way to protection, gradually at first, but later with growing acceptance as being the correct and proper policy for the country.

Prior to 1914 state intervention in business life was small. It was

confined largely to fiscal measures in the form of levying taxes and customs and excise duties, to the Factory Acts, and to the control of rates on public services such as transport, gas, electricity, and others. There was nothing in the nature of a planned economy. When peace came in 1919 there was little reason to question the pre-war economic doctrines and practices. This complacency vanished when mass unemployment appeared to have become endemic and Britain's share of international trade had shrunk alarmingly.

An uneasy period of recovery in world trade lasted between 1924 and 1929 and culminated in the American stock market crash. This was followed by a slump of unparalleled proportions. The 1930's saw state control become supreme in Russia, Germany, and Italy. In the U.S.A. a measure of state intervention appeared in the form of the New Deal, but the rigid American Constitution kept a tight check on its growth and the underlying faith in free enterprise and non-intervention was only slightly dimmed.

In Great Britain the Government was assuming an increasing responsibility in the struggle to counteract the low volume of trade and the high level of unemployment. Action was made easier by the growth in the size of the units of industry and commerce. Amalgamations were proceeding apace. Public boards such as the British Broadcasting Corporation, Central Electricity Board, London Passenger Transport Board, and others were formed. But on the whole industrialists were fairly free to manage their own affairs and the worker was free to seek employment where he chose.

The outbreak of war in 1939 brought about the surrender to the state of a large part of personal freedom. It was recognized that the circumstances of the time made this inevitable. It was hoped, however, that the subsequent return of peace would restore part of that surrendered freedom, although it was realized that the consequences of the war with its enormous destruction of wealth would require increased state responsibility during the period of reconstruction.

In 1944 a White Paper entitled *Employment Policy*¹ was issued by the Coalition Government. This was a landmark in that the Government (then consisting of all parties) assumed responsibility for promoting 'a high and stable level of employment' – a responsibility which no subsequent Government could disown. It was assumed that many wartime controls over production would soon

disappear and that government employment policy would operate largely through financial and fiscal measures.

The first post-war election brought into power a Government committed to a limited programme of nationalization. The nationalization of certain basic industries and services marked an important and almost irrevocable step in the direction of increasing the responsibility of the state and of lessening the responsibility of the individual.

A long way has indeed been travelled since the days when *laissez-faire* was the doctrine of the day. *Laissez-faire* brought wealth to the efficient and to the privileged. It increased the total trade of the community; but it was often in conflict with social objectives. Totalitarianism may perhaps increase the output of goods and services over a limited area, but it is the negation of freedom. Too great an emphasis on distribution of wealth as distinct from production of wealth usually reduces total output of goods and services, since it saps initiative and enterprise and because it is so much easier to make rich men poor than poor men rich.

No doubt the debate on the proper relationship between the state and the individual and on the proper degree of state control over business will continue for a long time yet. There is, however, a large measure of agreement on the broad objective – which is to combine the search for private profit and personal happiness with the achievement of public benefit.

CHAPTER 3

INTRODUCTION TO THE STUDY OF ECONOMICS

I Preliminary Comments

In this chapter it is not proposed to delve deeply into the study of economics. The intention is rather to confine the discussion to a few only of the more important aspects of the subject. For without some acquaintance with the general principles difficulty may be encountered later in appreciating several of the factors which have a bearing on financial and investment problems.

The economist is like the physician in that his work is to examine, diagnose, and where necessary advise. The advice may be directed to the maintenance of an already satisfactory state of health or, in the case of ill health, will go further and seek a remedy. But unlike the physician, the economist can seldom approach his patient as an individual; he is concerned instead with groups. As a rule he will be unable to isolate his patient from surrounding influences. Since he deals with groups, his data will usually submerge all individualities and emerge as a series of common features or standard measurements – in other words as statistics.

Economic expressions like *factors of production, goods and services, capital, income, profit, consumption, saving, Investment, supply and demand*, are mostly abstract terms and, as such, difficulty is sometimes experienced in understanding them. When, however, they are applied to the activities of one person little difficulty arises. Take, for example, the economic activities of a baker. He is a *factor* in the *production* of bread; he supplies *goods* in the form of bread (and probably cakes, scones, buns, etc., as well); he performs a *service* in delivering his goods to his customers or in being ready to sell them over the counter; his *capital* consists of his shop and equipment (which, because these aid him in producing his goods, are also factors of production), stocks of flour, and other materials; he receives by way of *income* the *profit* on his business. He spends part of this income on the *consumption* of other goods and services which he requires for his livelihood; he *saves* the balance of his income and *invests* it either in his own business or in some other

manner. He is dependent all the time on there being a *demand* for the *supply* of his bread.

The economic activities of a single baker can be readily examined; so, too – provided the information is available – can the economic activities of *all* bakers in a community be examined. Much of the data will be expressed in terms of money; for example, the aggregate of bakers' incomes and their total output of goods. Other data such as stocks of flour will more likely be expressed in terms of weight. If the data cover one year the economist can by examination make certain calculations and deductions. For instance, he can calculate the average annual income per baker and the average output per baker.

But if statistics are available for a longer period, say for several years, a comparison year by year may reveal a great deal more. For instance, it might show that the income of the bakers was decreasing although their output in terms of money was increasing. Further examination might show that this apparent paradox was due not to any increase in the demand for bread but because flour had cost more and so had put up the price of bread: the baker, however, might have been unable to pass on to the consumer the whole of the increase in the price of flour, because had he done so the demand for bread might have decreased even further.

So far, the activities of a person or of a group of persons of similar occupation have been considered in isolation. But in the course of *production* the baker is also a *consumer* of other peoples' products. For example, he must purchase flour from the miller and the miller must in turn purchase wheat from the farmer. The baker will also consume the goods and services produced by multifarious persons in order to supply his daily wants. Thus when it comes to examining the economic activities of a whole community it must be realized that as a whole the community is to a large extent the consumer of its own output.

The compilation of statistics relating to the income and output of a whole community is a subject for more advanced economics, especially when complications such as government finance and external trade enter into the calculations. But two important points may be mentioned here. It is feasible to include only those goods and services which are paid for in terms of money; the rest are excluded, perhaps the most noteworthy example being domestic work done by the wife or by some other member of the family. The other point is that duplication must be avoided. For example,

goods which pass first from factory to wholesaler, then from wholesaler to retailer, and ultimately from retailer to consumer, must be reckoned once and not three times.

It was said earlier that the economist's rôle is to examine, diagnose, and advise. He is dependent upon statistics and upon the correct interpretation of them. Much of his statistical nomenclature is couched in abstract terms and many deductions made from them have an affinity with algebraic formulae. Statistics as a rule record a state of affairs at a given point of time, or at a series of points of time. If they are comprehensive and complicated it may only be possible to record them at infrequent intervals, and a considerable lapse of time may well occur between the date of observation and the date of final compilation. They may thus have the characteristics of a series of photographs of separate parts of a larger scene taken at different points of time. In order to arrive at a true diagnosis the economist desires a cinematograph effect of the whole. In order to obtain this from a limited series of photographs he must know a good deal of the motive forces at work. It is proposed therefore to discuss at greater length some of these forces.

2 Supply and Demand

The laws of supply and demand enter into every investment consideration, because one of the most critical factors there is the relationship between the cost or price and the expected reward; and that relationship is always influenced directly or indirectly by the operation of these laws.

In their general application the laws of supply and demand are supremely logical. There are three basic laws and two principal corollaries:

(a) If at a given price demand exceeds supply, then the price will tend to rise.

(b) If at a given price supply exceeds demand, then the price will tend to fall.

(c) The price will tend to reach the level at which demand equals supply.

Corollaries of the first two are:

(d) An increase in price tends to increase supply and reduce demand.

(e) A fall in price tends to reduce supply and increase demand.

There is thus a continual tendency towards the state of equilibrium

indicated in (c), and, as soon as equilibrium is upset, forces are again set in motion which operate towards restoring it, though not necessarily at the same level of price.

So long as these laws can apply to one article in complete isolation from all competitive influences, then their validity is absolute. But in practice this seldom happens. Suppose, for instance, that the supply of bread diminishes, thereby putting up its price, under the laws of supply and demand the price should continue to rise until supply has been increased and demand reduced to the point where equilibrium is again achieved. But suppose also that at the same time an increase takes place in the supply of potatoes, thereby reducing the price of potatoes, it is probable then that part of the demand for bread will be diverted to and satisfied by the increased supply of potatoes. Consequently the price of bread will not rise so high nor the price of potatoes fall so low as would be the case were the laws of supply and demand to operate in respect of bread and potatoes separately and in complete isolation from the influences of each other.

The word *price* in the laws of supply and demand is used in a very comprehensive manner. It relates not only to the price of goods, but to the price of labour, i.e. salaries and wages, and to the price of the hire of money, i.e. the rate of interest.

In the case of salaries and wages it has been observed that a rise in wage rates does not always bring in its train a desire to work longer hours. Indeed, the opposite is more usually the case. Is this one of the exceptions to the law of supply and demand? To answer this completely would involve a full examination of the questions of profit motive and incentive to work which will be touched on later, but all that need be said here is that it is only an apparent exception. What really happens is that when wages rise to a certain level the demand for the fruits of labour lessens and the demand for the fruits of leisure increases.

So far, attention has been paid to the *direction* only of changes in price, supply, and demand. A fuller question must now be posed. Is there any direct relationship between a given rise in price and the consequential increase in supply or the consequential fall in demand? This depends entirely upon what is known as *elasticity*. The demand for the necessities of life is inelastic. For example, no fall in the price of water will increase the personal demand from a community already adequately served. But supply may be elastic and in a desert community on the verge of thirst the price

of water would be extremely sensitive to any changes in supply. On the other hand, the demand for luxuries is often very elastic.

Several commodities are produced or consumed in joint supply. For example, lead is usually found in ore bodies containing zinc and silver as well. The laws of supply and demand therefore cannot operate faithfully in respect of any single one of these three metals. Then turning to a case of joint consumption mustard is as a rule only wanted with meat. The price of mustard is, however, but a tiny fraction of the price of meat. No ordinary increase or decrease in the price of mustard would therefore affect the level of demand, so in the case of mustard alone the laws of supply and demand are largely ineffectual.

It has been assumed so far that the laws of supply and demand are allowed to operate freely. This is not always so in practice; indeed, the restraints against their free operation have increased very greatly in recent years, partly as a result of government legislation, and partly as a consequence of some form of monopoly. It is only necessary to mention a few examples. Any form of rationing places a limit on effective demand (but not necessarily on potential demand) and is usually accompanied by a fixing of the price of the rationed article by government decree. Immediate response to the operation of the laws of supply and demand depends upon free and unfettered competition. Monopoly is the denial of competition, whether it is a state-owned monopoly, a monopoly operating under state sanction, or a business which has established an effective monopoly by eliminating its competitors.

One of the prime purposes of trade unionism is to prevent the laws of supply and demand depressing wages below a certain point. In so far as trade unions can enforce a 'closed shop' then they, too, establish a monopoly. It must not be thought, however, that restraints such as those which have just been mentioned can set aside indefinitely the operation of important economic laws. The greater the artifice the tighter will the control have to be. If economic forces are suppressed too forcibly and too long, a latent power will grow in strength until either an outlet is found or the restraining influences are modified or removed.

There is a statistical angle of supply and demand which is worth mentioning. As a rule statistics are available for both price and supply, but seldom can demand be measured accurately. It is usually known, however, whether demand exceeds or falls short of supply. In the former case stocks start piling up. In the latter

case purchasers soon find out that they cannot all be satisfied. Statistics are seldom available for (a) unfilled orders, and never for (b) the volume of orders which would be placed were goods available, nor is it known (c) how many of the orders already placed are in fact duplicated and liable to subsequent cancellation. This latter is indeed more a matter for a poll of public opinion than for statistical measurement.

There is another point which should be mentioned before leaving the subject of supply and demand, and that relates to the speed with which equilibrium, once it has been upset, can be restored. For example, there is an enormous difference in the length of time which would normally be required to equate the supply and the demand for small electric appliances such as lamps, irons, and so on, and the supply and demand for electric power. The former can be turned out rapidly under mass-production methods; the latter involves the construction of heavy generating plant which may take many years to complete.

3 Profit Motive and Incentive to Work

The profit motive does not really need a general explanation. It is inherent in mankind. It is the main driving force of all that part of economic activity where the benefits of profit and the disadvantages of loss can be felt. Profit arises from trade and commerce where goods and services are sold and where labour is usually employed. The profit motive has been attacked on the grounds that profit is made at the expense of either the customer or the employee or both. The attack may be justified where excessive profit is made or where profit arises from an unreasonable exploitation of monopoly. But remove the profit motive altogether and the mainspring of the economic mechanism snaps.

The majority of working men and women belong to the status of employee and do not work for their own account. Their profit motive is more directly connected with the size of their salary or wage packet than with the profits of the employer, though in some cases their earnings may be supplemented by means of participating in profit-sharing schemes. Thus in the economic system as a whole the driving force as regards the employer or owner of capital is the profit motive, but as regards the employee the driving force can be more correctly described by the phrase *incentive to work*. These are the two special cases of the universal desire to better oneself.

Now, why do people work? What is the primary incentive? It is generally for one or more of the following reasons: because work itself brings dignity and satisfaction; or because it is a necessity; or because the reward is greater than the effort expended.

In the case of those who work for the first reason the incentive is often entirely divorced from the monetary reward; but these people form a somewhat small minority.

The second category includes those where the law of supply and demand appears to operate in reverse. The higher the wage the greater will be the opportunity to satisfy basic needs, and so the remainder of the potential working time is liable to be diverted to the search for leisure.

The third category includes those where once their basic wants are satisfied there is a finely balanced equation between the extra effort expended and the reward achieved. For example, wages for overtime are invariably paid at a higher rate than for normal working hours. This is because the effort required is usually greater and, by reason of the extra reward, people are prepared to make that extra effort. If, however, overtime wages are taxed at a higher rate than for normal hours, then the balance may be tipped in the other direction and so restrain people from working overtime. So also will the amount of extra or marginal effort be determined often by the extra or marginal reward in terms of purchasing power. For example, if shop windows are sparsely filled with indifferent and expensive goods and if recreation brings little pleasure at great cost then the incentive to work will be reduced. If, on the other hand, there are many and diverse ways of obtaining good value for money the incentive to work will be increased.

The profit motive does not necessarily imply a constant striving for the maximum immediate rate of profit, but more often a desire to achieve a soundly established basis for continuance or expansion. The ideal rate naturally varies according to the type of business undertaken, but generally speaking the greater the risk the higher the desired rate of profit (for the risk of loss must also be considered). As a guide to the search for the ideal rate the theory of variable returns is sometimes of assistance.

In most businesses in the process of expansion the returns from the employment of each successive addition of men or capital will usually show a considerable variation. Consider, for example, the hypothetical case of a small undermanned cotton mill. The increase in output to be derived from each successive additional operative employed might be estimated as follows:

		<i>Increase in output per annum</i>	
1st additional operative	.	.	£500
2nd " "	.	.	£600
3rd " "	.	.	£650
4th " "	.	.	£700
5th " "	.	.	£750
6th " "	.	.	£675
7th " "	.	.	£600
8th " "	.	.	£500
9th " "	.	.	£400
10th " "	.	.	£300

Up to the fifth extra operative employed the business would be working under conditions of *increasing returns*; thereafter, a condition of *diminishing returns* would apply. If the wages per operative were £400 per annum it would not pay to employ more than nine extra operatives. Likewise it might be estimated that each successive £1,000 of extra capital put into the business would show a similar pattern of variable returns. Actually it is seldom possible to make any such precise calculations, but as long as expansion is believed to be taking place under conditions of increasing returns the signal lights appear green; but they change to amber as soon as a state of diminishing returns can be detected.

Where the opportunities for expansion under conditions of increasing returns are prevalent throughout a country there is usually a tremendous stimulus to further development. Where diminishing returns apply, as they do only too disastrously in overpopulated agricultural communities, then the impediments to progress are very great.

4 Factors of Production

It was pointed out in chapter I that the primary sources of a nation's wealth are:

- (a) Land and natural resources, in the form of minerals, forests, waterways, livestock, etc.
- (b) The number, character, and skill of the population.
- (c) Capital equipment in the form of buildings, factories, communications, etc.

These are also *factors of production* of goods and services wanted by the community. (a) and (c) represent *capital* and (b) *labour*. The

latter word is used in its widest sense and embraces all men and women who work.

Dealing first with the *capital* factors, the most important feature of land and natural resources is their definite limitation. The production of food and of any growing crop is limited by the size and fertility of the available territory. With wise husbandry the products of such natural resources should continue indefinitely, but the extraction of mineral resources involves for all practical purposes a permanent depletion.

Fixed capital provided by man in the form of buildings, factories, etc., is to a lesser extent subject to the natural limitations of land – witness the city of New York built on the small island of Manhattan. But much of this capital wears out eventually through deterioration and requires renewal from time to time.

Labour is employed in sowing and reaping the fruits of the earth; in direct production of goods and services; in operating capital equipment for the production of goods and services; and in building new capital equipment.

These are the principal factors of production. How can they be used best so as to make the greatest contribution to the common wealth? How can any scarcity of particular factors of production be overcome or avoided altogether?

It is desirable that the factors of production, whether capital or labour, should be employed in producing what they are best equipped to produce and with the minimum of waste. Land should be farmed to the best advantage; cities and towns should be built where the need is greatest; factories should be built near to the source of supply of raw materials or to their markets; labour should specialize. The last is vitally important. A standard of measurement which is frequently used in assessing the efficiency of production is the unit, *production per man hour* – P.M.H. This can never be high unless labour is specialized and skilled not only as regards the daily task of producing the finished article, but also in the construction of capital equipment to facilitate or increase production. The potentialities of P.M.H. will also be influenced greatly by the amount of capital equipment at the command of the worker.

The degree of specialization may vary greatly. Men may be housebuilders capable of building complete houses, or they may specialize further in being bricklayers, masons, carpenters, plumbers, etc. Even within these trades there may be scope for still

further specialization. Where the population of a country is small in relation to its natural resources specialization is not so important. Where it is large it becomes an absolute necessity if a reasonable standard of living is to be attained.

It is not sufficient, however, merely to admit the desirability of specialization *per se* without examining the very difficult problem of how specialization or division of labour can be organized best to meet the requirements of the community. If, for example, there happened to be a big surplus of doctors and a deficiency of architects a considerable wastage of effort would result. The community would derive no advantage from the years of study and training put in by the extra number of medical students. Furthermore, the shortage of architects would limit the number of houses which could be built and perhaps deprive the community of reaping the full benefit of having an adequate supply of skilled building labourers.

How can it be arranged that the supply of skilled labour is always equal to or nearly equal to the demand? There are two fundamental methods of achieving the desired equation. The first is to allow the laws of supply and demand to operate freely; equilibrium will then be achieved and maintained by the operation of changes in the level of salaries and wages. In the hypothesis mentioned above the remuneration of doctors would fall and that of architects would rise until supply and demand were equated. But as both professions require many years of training it might take some considerable time before any disequilibrium could be corrected.

The second method is by the exercise of some measure of government control. This may take several forms. At one extremity is mild exhortation and appeal; at the other extremity is direction of labour. Between the two extremes there is a whole host of different methods which can be and have been used. The following are some examples: the state may pay for the training of people in undermanned professions; entry into overmanned trades may be barred; the state may rely primarily on the operation of the profit motive and take action to guarantee or increase the profitability of certain trades; it may prevent or facilitate the raising of capital.

In the modern era complete reliance on the first method – the mechanism of supply and demand – is obsolete and socially impracticable. Absolute state control is the denial of all freedom and

applies only to totalitarian states. (It should be noted, too, that the efficiency of conscript labour is normally much inferior to that of free labour). In Great Britain what has been adopted is a blend between a moderate version of state control and a limited reliance on the operation of the laws of supply and demand.

5 Inflation and Deflation

Inflation and deflation are not so much basic motive forces as indications of the condition of a nation's economy. Each of them refers to a direction in which there is a departure from a state of equilibrium. They are dynamic not static conditions. Inflation has been described as 'too much money chasing too few goods', that is to say, a state of affairs when demand exceeds supply; the tendency is therefore for prices to rise. Deflation is, of course, the opposite of inflation, that is to say, when supply exceeds demand; the tendency is therefore for prices to fall.

The words inflation and deflation are used principally in connection with a nation's whole economy and not just with a few particular aspects of it. They are concerned therefore with the total supply of money. When a currency is on a fiduciary basis the Government can expand or contract the supply of money almost at will. If it resorts to excessive printing of notes – which is a special type of government borrowing – the supply of money is increased and a state of inflation will probably develop. Indeed, it is only by continual and excessive borrowing and printing of notes that a really serious inflation can occur.

Since inflation and deflation are manifestations of a departure from normal both have been condemned from time to time as undesirable. This is probably responsible for the euphemisms such as *reflation* and *disinflation* which have crept into use. Actually each can be beneficial, neither need be harmful; if only they can be encouraged at the proper times. For example, when many of the factors of production were idle in the 1930's, a state of inflation would have been beneficial. After 1945, when the making good of the ravages of war was straining the country's resources, a state of deflation would have been helpful.

In a time of inflation (when demand exceeds supply) prices rise because producers are able to obtain a higher margin of profit. The rise in prices is then due to what is known as a *profit inflation*. But another inflationary factor may operate quite independently of this. In the long run producers will not sell below the cost of

production; they will refrain from selling at a loss. The cost of production therefore forms a floor to the level of selling prices. If the cost of production were to rise because wages had gone up, then, other things being equal, prices would rise also; the greater the rise in the cost of production the greater the inflation of price. This form of inflation is known as a *cost inflation*. The most powerful factor in producing a *cost inflation* is a rise in cost of wages and materials. The most powerful offsetting factor is improvement in the technique of manufacture.

6 Saving and Investment

The acts of saving and Investing involve an immediate sacrifice made in the expectation of a future reward. From the nation's point of view the reward is reaped in the form of an increase in that special source of wealth which comprises capital equipment in the form of buildings, factories, communications, etc.

If the full resources of the nation are employed solely in producing goods and services for immediate consumption no Investment is possible. If, however, part of the resources are used in producing for immediate consumption and part for constructing capital equipment for future production, then the community will consume less in the present, but reap a fuller reward in the future. The process by which part of the national output is diverted to building for the future is saving on one hand and Investing on the other.

There is a definite link between the total amount of a nation's savings and the total amount expended on Investment. In order to get a clearer understanding of this problem it is desirable to separate the Investment outlay into two categories. The first relates to the construction of such things as roads, railways, factories, houses, cinemas, and so on, which may be termed *voluntary* Investment. The second relates to additions to stocks of materials and goods, which may be termed *involuntary* Investment. When these two categories are added together total *Investment* is equal to total *savings*.

Savings have sometimes been substantially in excess of voluntary Investment and when this has occurred unemployment has usually increased. This in turn decreases production and consequently reduces the ability to save and hence the volume of savings. The level at which equilibrium in the savings-Investment equation is held is thereby lowered.

The subject of saving and Investment is an intricate and complicated one involving a considerable interplay of cause and effect. If the amount of Investment is to be determined by the level of savings, then those who save voluntarily must be convinced that their present sacrifice is adequately compensated by the prospect of future benefit. This will depend largely on their circumstances. If a person has an income barely sufficient to buy the necessities of life any saving will involve a considerable sacrifice. A community consisting solely of persons in such circumstances would find it hard to save and consequently the prospect of adding to its source of wealth by way of Investment would be small.

On the other hand, if a person's income is greatly in excess of what is required to give him a satisfactory standard of life, or if his requirements at a lower standard cannot be satisfied owing to some restriction on spending, then saving will involve no wilful sacrifice; it would follow automatically.

But if the total amount of savings arising from personal thrift is insufficient to provide the amount of Investment deemed necessary for the welfare of the country, then other steps will have to be taken to bridge the gap. This can be done by various means: for instance, the deliberate budgeting for a surplus on national revenue and expenditure account; rationing of consumer goods and thereby reducing the ability to spend; increasing the contributions to social security funds; encouraging companies to place larger sums to reserves.

The part which saving and Investment played in the development of Great Britain was of vital importance; and this is still the case. Her economy has a precarious balance. The needs of her people for the basic necessities of life such as food and clothing are vastly in excess of what can be provided from her own natural resources. The necessary food and raw materials must be obtained from abroad and paid for by the export of manufactured goods. The production of these on a large enough scale and at a competitive price is only possible with the help of substantial and efficient capital equipment.

During the last century, when the industrialization of Great Britain was proceeding at a rapid pace, the profits accruing to the proprietors of businesses were large; taxation took then only a small fraction of a person's income. These people not only lived comfortably, but their incomes were often greatly in excess of what they spent. They could hardly avoid saving, and the oppor-

tunities for profitable investment both at home and abroad were immense. Thrift was praised as a virtue; the spendthrift was despised. But the savings of the nation, though substantial in total amount of money, came from a very small proportion of the population. The incomes of the majority were spent to the full in the struggle for subsistence.

Between 1919 and 1939 savings continued at a fairly reasonable level, though still coming from a small section of the population. But during this period the scope for *voluntary* Investment on a substantial and profitable scale was considerably restricted. The British industries which had in the past absorbed such vast sums in satisfying their capital requirements had either reached saturation-point (e.g. railway construction), or had for one reason or another ceased to be profitable (e.g. coal, cotton, shipbuilding). But savings could not for long remain at a much higher level than the amount employed in voluntary Investment. Equilibrium could only be attained at a lowering level. The small amount of voluntary Investment outlay was one of the prime causes of the mass unemployment which existed so tragically between the two wars.

During the second world war the savings of the community increased sharply, but this was due largely to restrictions imposed by the Government on spending; the principal form of restriction being rationing. At the same time a radical re-distribution of the country's wealth was taking place. Incomes of the wage-earners increased. Incomes of the wealthy were drastically reduced by high taxation.

After the war this redistribution of wealth had a profound influence on the volume of voluntary personal saving. Many of the former savers were no longer able to save; indeed, reduced net incomes and higher cost of living obliged many to draw on capital – to dis-save! On the other hand, where incomes had been increased people were more anxious to taste the fruits of a higher level of consumption than to save for the future. But for the continuance of many forms of rationing, dis-saving by these people as well might have taken place.

Voluntary saving is always much better than any form of compulsory saving. It is a sign of thrift, of good citizenship, and of confidence in the future of a country's currency. But Great Britain cannot thrive and prosper without a vast increase in new capital equipment. This can only be obtained by the process of Investment and to the same extent through the act of saving. Saving is a sacri-

fi ce by the community, each generation receiving the benefit of its predecessors' sacrifice. If the required amount cannot be obtained voluntarily (and the days when this was possible may have passed), then it will have to be obtained by government action or sponsorship. But any democratically elected government needs great courage to enforce a high level of saving and Investment. The country having the highest proportion of national output diverted to Investment in recent years was probably Russia. This reduced the amount left over for spending and resulted in a desperately low standard of living; a standard which no government, removable by the will of the people, could ever in time of peace succeed in imposing.

CHAPTER 4

DEVELOPMENT OF JOINT STOCK
COMPANIES AND OTHER
BUSINESS ASSOCIATIONS

I General Features of Business Associations

This chapter is concerned primarily with the development and working of the joint stock company, since it is the type of association most frequently encountered by the investor. There are, however, many others such as public boards, mutual life assurance societies, building societies, co-operative societies, national boards set up under nationalization Acts, etc. The *raison d'être* of associations is now self-evident: but their growth was gradual.

Before the Industrial Revolution the greater part of the country's trade and commerce was conducted by men and women working alone or for a single master. Outside the sphere of overseas trade it was seldom that men pooled their resources and formed themselves into companies or associations. But once the industrialization of the country got under way with the need for adequate communications in the form of roads, railways, and canals, the resources of single men were no longer sufficient and association in one form or another became inevitable.

The industrial life of the country is now such that by far the greater part of its business is in the hands of the corporate association. The cases where men and women still work on their own account or for single masters are confined largely to the arts, agriculture, shopkeeping, and personal service; even many professional men prefer now to practice in partnership rather than individually.

Although there is a wide difference between, say, a joint stock company and a building society, between a public board and a mutual life assurance society, the requisites of most types of association have much in common with one another. They can be summarized as follows:

- (a) The association must be recognized in law.
- (b) The objects for which it is established must be defined.
- (c) There must be a code of rules or by-laws.

(d) For efficient operation there must be some delegation of power to duly appointed persons.

(e) The rights of members must be defined.

The foundation of these provisions is contained in the charter or statute under which the association is formed. A charter is a privilege granted by the sovereign authority of the state and any association formed thereby receives its own special charter. An association formed under statute may have either its own special Act of Parliament or be constituted under a general Act of Parliament governing a particular type of association. This is as far as it is possible to proceed along the lines of generalization. Different forms of association will now be discussed individually.

2 Joint Stock Companies

It would be difficult to find a better definition of a joint stock company than that contained in the *Encyclopaedia Britannica*. 'The joint stock company may be defined as an association of persons incorporated to promote by joint contributions to a common stock the carrying on of some commercial enterprise.' Although capable of a wider meaning, the expression 'joint stock company' is usually confined to those companies which are incorporated either under a general Companies Act or by special Act of Parliament.

The earliest joint stock companies were formed under Royal Charter and include such illustrious names as the East India Company, the Bank of England, the Hudson's Bay Company; but the process of obtaining a charter was both difficult and costly. In the early part of the nineteenth century, when railway and other public service companies were formed, the most frequent method of incorporation was by special Act of Parliament. In 1844 an Act was passed which by its general application enabled companies to be incorporated without charter or special Act of Parliament.

In those days the liability of stockholders was unlimited. This was considered to be a useful protection to those transacting business with the company, but after some disastrous failures – of which the Glasgow Bank was one of the most memorable – it became more difficult to induce people to subscribe money and to incur the liabilities as well as the privileges of being a stockholder.

After 1844 further Acts relating to company law were passed and in 1862 a Companies Act of particular significance was enacted.

Registration of all associations of more than twenty persons had become compulsory and the new Act enabled the incorporation of companies to take place where the liability of its stockholders was limited. The fact that liability was limited had to be clearly revealed. Normally the liability was limited to the amount of capital subscribed; that is to say, once a stockholder had made his subscription in full all further liability ceased. His loss was limited to the amount subscribed. If the company failed and could not meet its debts its creditors could no longer look to the stockholders to make good any deficiency.

It will be convenient at this stage to refer to the difference between stock and share, stockholder and shareholder. Fundamentally there is little difference, at any rate no more than the difference between one pound and twenty shillings. The capital of a company may be expressed either as so much stock, say, £100,000 stock or, if in shares, either as 100,000 shares of £1, or 400,000 shares of 5s., or indeed any other subdivision which may be decided upon. The distinction refers primarily to the form in which the holder retains or may transfer his investment rather than to any difference in rights. Throughout this book the choice of which to use, *stock* or *share*, will be determined by whichever appears from the context to be the more appropriate.

The timing of the 1862 Act was perfect. Industrial expansion was proceeding fast. The privilege of limited liability induced investors, freed from their former inhibitions, to subscribe willingly to new capital. On the other hand, owing to the general growth of confidence, credit was as a rule forthcoming in spite of the greater risks involved. Many companies of note in the present era were incorporated not long after the passing of the 1862 Act; Staveley Coal & Iron Company Ltd. in 1863, Cunard Steam-Ship Company Ltd. in 1878, J. & P. Coats Ltd. in 1884, and Bass Ratcliff & Gretton Ltd. in 1888. All these companies started from small beginnings and their issued capital has expanded with their growth.

As was only to be expected the passage of time exposed deficiencies and brought new requirements in the form of company law. Further Acts were passed at frequent intervals, and in the present century the more noteworthy include the Acts of 1908, 1929, and 1948, the last being a consolidation Act taking the place of the amending Act of 1947.

Turning to the requisites (a) to (e) mentioned on pages 44 and

45, it will be realized now that joint stock companies owe their legal recognition either to a charter, to a special Act, or to a Companies Act. The few companies incorporated by Royal Charter and still in existence include the London Assurance, the Royal Exchange Assurance, the P. & O. Steam Navigation Company, and the British South Africa Company. The special Act companies included as a rule those which provided public services in the form of transportation, gas, electricity, etc.; most of these have now been transferred to public ownership under various nationalization Acts. Thus the great majority of public companies at present in existence are those which were incorporated under the general – as distinct from the special – Companies Acts.

3 Joint Stock Companies Incorporated under the Companies Acts

The objects for which a company is established (*b*) are defined in its memorandum of association. This sets out the name of the company, its objects, and the nature of the business to be conducted. It will often be found that in the memorandum of association of many companies the objects named are almost fantastically wide and varied. For example, a company formed for the purpose of carrying on the financial business of an investment trust may have power among other things to build and operate railways, tramways, docks, etc. Others formed for purposes of manufacture may have power to engage in agricultural pursuits. The reasons for this apparent absurdity are twofold. First, a company incorporated under the Companies Act has no power to do anything not authorized by its objects clause in its memorandum of association; hence the desire to avoid any risk of acting *ultra vires*. Second, once a memorandum of association had been signed it was – prior to the passing of the 1948 Act – an expensive and often difficult process to alter it. Sanction had to be obtained from the Court and the application for this had to be supported by good and valid reasons.

As there was in normal practice no disadvantage to a company in having power to do many things it had no intention of doing, it had become the practice of those responsible for the formation of a new company to visualize every conceivable type of business which it might possibly want to transact in the future – and to provide accordingly. But the ingenuity of lawyers could not foresee every possibility. For example, at the time when many shipping

companies were formed the idea of air transport was in the realm of fantasy. Therefore, when these companies wanted to engage in air transport it was necessary to apply to the Court for power to alter their memoranda of association. Under the 1948 Act, however, the objects of a company may be altered by a special resolution, sanction of the Court not being required unless holders representing not less than 15% of the capital object.

The memorandum must also state and define the liability of its members and specify the initial capital of the company.

An important distinction between a *private* company and a *public* company should be noted. A private company may have no more than fifty members apart from those employed or formerly employed by the company and must not offer its capital for public subscription. A public company is not restricted in these ways.

The requisites (c), (d), and (e) are contained in a company's articles of association. These three, the code of rules and by-laws, the delegation of power, and the rights of members, are to a considerable extent interdependent.

The directors of a company are normally elected by its shareholders and are responsible to them for the efficient operation of the business. The articles prescribe the number of directors, giving usually a minimum and a maximum number. As a qualification for office each director is usually required to hold a specified number of shares. His fees may be fixed by the articles and may be amended by resolution of shareholders in general meeting.

The powers of directors are carefully defined. They may themselves have power to delegate their powers by appointing one or more managing directors. They may appoint officers and must appoint a secretary to the company. In addition to doing all that is necessary for the proper conduct of the business, they are as a rule given power on the company's behalf to borrow a limited amount of money; this must not be confused with the issue of stock or share capital. Rules are prescribed for the meetings of directors at which proper minutes must be kept. Directors in rotation may be due for retirement or re-election by the shareholders in general meeting – usually every third year.

Although, with the exception of a few special cases, the election and re-election of directors is the undoubted prerogative of the shareholders, in the case of large public companies – provided always that they are not mismanaged – this amounts in practice to little more than a mere formality. New directors are as a rule

ominated by the remaining directors, the choice seldom coming from individual shareholders. Indeed, many of the general rights and powers vested in members, such as, for example, the right to attend meetings, etc., are seldom exercised so long as reasonable access is achieved.

Among the general rules or by-laws are found such matters as the following: proceedings at meetings of shareholders; the form of issue and method of transfer of stock and share certificates; use of the company's seal; preparation of accounts; payment of dividends; treatment of reserve funds.

A company must hold an annual general meeting at least once in each calendar year and within fifteen months of the previous annual general meeting. Ordinary resolutions at these meetings require a simple majority of those present and voting in order to be passed.

Extraordinary general meetings, as the name would suggest, are convened for special purposes and may be requisitioned at any time on due notice being given by holders representing not less than one tenth of the total voting power. These meetings are convened for purposes such as to consider proposals to alter the company's articles of association, to wind up, to remove a director, etc. Resolutions (other than ordinary resolutions) proposed at extraordinary general meetings require, in order to be passed, a three-fourths majority of those present and voting. Resolutions are usually submitted first for decision on a show of hands, that is to say, each member personally present casting one vote. On resolutions of a critical or debatable nature a poll is frequently taken — and may at times be demanded by members or by the chairman himself. In such case votes are cast according to the size and voting rights of each shareholding represented at the meeting.

Provisions are made whereby members may vote by proxy at any meeting. A proxy need not also be a member.

Companies must keep a register of their shareholders and must issue a certificate under the seal of the company specifying the amount of stock or shares held by the member and the amount paid thereon. Any instrument by which stock or shares are transferred from one member to another must conform to certain requirements. Directors may sometimes have the power to decline to register new transferees of whom they do not approve, but this power is rarely exercised in the case of fully paid shares of a *public* company. Where, however, a *private* company is concerned,

directors often give very careful consideration before accepting or refusing the registration of a new shareholder.

Every company must have a seal, its use being tantamount to the company's formal signature. In the case, however, of many routine matters an official may sign on behalf of the company without affixing the seal. Regulations governing the use of the seal are set out in the articles and these usually provide for its attestation by one or two directors and countersigned by the secretary or by some other designated officer.

Every company is obliged to keep proper books of accounts showing among other things all sums of money received and expended by it, all sales and purchases of goods, all transactions of a capital nature, etc. It is also required to keep a register of any charges which may affect its properties. Once a year a balance sheet and profit and loss account must be prepared, and these together with a report by the directors giving an appreciation of the state of the company's affairs must be sent to every member of the company. The annual balance sheet and profit and loss account must be audited by auditors duly appointed by the shareholders.

The preparation and the manner of presenting accounts are of vital importance. For those who desired it was possible, before the passing of the Companies Act, 1948, to conceal much important information. That Act, however, required the publication of accounts in far greater detail than formerly and at the same time forbade many devices through which information could have been concealed.

As most shareholders in public companies are virtually sleeping partners, taking little active interest in the conduct of their business, the matter of greatest importance is very often the payment of dividends. With certain exceptions no dividend may be paid otherwise than out of profits, that is to say, it cannot be paid by means of a refund of subscribed capital. Dividends are recommended by the directors and require the approval of members in general meeting. Shareholders may move to reduce the amount recommended, but cannot move to increase it. Directors may pay interim dividends if profits justify.

Power is given to the board of directors to set aside out of profits such sums as they think fit to place to reserve for purposes of providing for contingencies, equalization of dividends, or for any other proper purpose. Formerly the amounts set aside for reserves

did not need to be disclosed separately in the published profit and loss account and balance sheet, but the 1948 Act makes such disclosure obligatory. Special exemption is, however, allowed in the case of banks, discount companies, and assurance companies.

Turning now to the respective rights of members little explanation is necessary where only one class of capital exists. The capital of a company is, however, often divided into two or more classes, the most usual form of subdivision being into preference and ordinary capital. In such case the rights of each class of capital should be carefully and unambiguously defined in the articles. These relate not only to the payment of dividends, but to voting rights, to any pre-emptive rights to subscribe to further issues of capital, to the respective rights as to repayment of capital in event of winding up, to the pledging of any specific reserve funds, etc.

The objects for which joint stock companies are formed obviously vary with the nature of the business to be transacted, but unless otherwise specifically stated in the memorandum of association one object common to all is to make a profit. That is implied in all sections of the memorandum and articles which relate to the efficient conduct of the business. Indeed, some would go so far as to say that the fundamental duty of directors is to make a profit and as large a profit as is consistent with the maintenance of the business in a healthy condition. Legally, directors are elected by and are responsible to their shareholders (unless any special provisions to the contrary apply), subject only to the due observance of their statutory obligations. But in the normal course of business companies employ men and women and carry on trade with their customers. The interests of these other parties – the employees and the customers – must of course be looked after too, so that in fact the responsibility of directors extends to a much wider sphere.

It might be thought that the interests of stockholder, employee, and customer would often be conflicting. But in the long run no business can thrive fully without satisfying all three. It is therefore not surprising that as a rule directors do not restrict their sphere of responsibility to the strictly legal interpretation, but are prepared to rest on the theory that the good of all enhances the profit of each.

The memorandum and articles of association is a form of constitution framed so as to apply to both members and directors. But as regards the financial operations of a company the toll of the tax-gatherer is now so great as to invest him with the significance

of an additional party to the contract. The proportion of profits absorbed in the payment of taxes is not only sadly high, but the precise manner in which taxes are assessed may well affect materially the relative values of the rights of different classes of a company's share capital.

4 Public Boards

In the case of an association formed to carry out a public service, especially when a monopoly right has been granted, it is inappropriate that there should be no restraint on the permissible rate of profit. Many companies formed for such purposes were incorporated by special Act of Parliament and while operating for profit were subject to provisions in their Act which protected the interests of the consumer by restricting the rate of profit allowed.

The constitution of public boards as a rule goes one step further and virtually eliminates the profit motive. Provision is usually made in their constitution to enable the board to earn just sufficient money to defray expenses. Consequently there is no capital entitled to a variable rate of dividend and the requisite finance is usually restricted to borrowing at an agreed rate of interest.

Examples of public boards include the following: Mersey Docks and Harbour Board, Metropolitan Water Board, Port of London Authority, and prior to being taken over by national boards, the London Passenger Transport Board, and the Central Electricity Board. The several Acts of Parliament under which these boards are constituted state their objects and specify the powers and duties of directors. In particular the manner of appointing directors is defined, since, unlike a joint stock company, appointment by shareholders' vote is inappropriate. Usually the chairman and directors are appointed either by a minister of the Crown, by the local authorities in whose territory the board operates, by representatives of consumers' councils, or they are automatically elected by virtue of holding some particular public office.

5 Mutual Life Assurance Societies

These are associations formed for the purpose of transacting life assurance and annuity business. There are no shareholders and profits belong entirely to those policyholders who are entitled to participate in profits. Membership is usually, but not necessarily, confined to the participating policyholders.

Most mutual life assurance societies were incorporated by special Acts of Parliament, and their powers, rules, and regulations are defined in those Acts. Directors are elected, not as in the case of joint stock companies by vote of shareholders, but by the policyholders, and their qualification for office consists usually in their effecting on their own lives a participating policy for a specified minimum sum assured.

Some mutual life offices were founded on the guarantee of a number of farsighted and public-spirited individuals who had no shares in the association and whose guarantees were discharged in due course when success was assured. Others were founded originally as joint stock companies having an ordinary share capital whose holders were entitled to participate in profits – though usually on an agreed basis as between shareholder and participating policyholder. Later such offices went through the process of mutualization, under which the policyholder became the only party entitled to share in profits. But in some of these cases the original subscribed capital remained in existence, bearing either a fixed rate of dividend or being held in trust solely for the benefit of the policyholders.

There is one aspect of mutual life assurance societies which is of interest when comparing them with other forms of association: that is the immense difficulty which would be incurred now in starting a new society. The first policyholders could not by themselves provide the necessary reserves without which it would be impossible to start business – and gratuitous guarantees are not often easy to obtain!

6 Co-operative Societies

The legal recognition of co-operative societies is derived from the Industrial and Provident Societies Acts. The object is to carry on business under a system whereby member, shareholder, and customer are virtually synonymous. Each society has its own rules and by-laws, delegates power to a committee of management appointed by the members, and defines the rights of its members.

In the early stages of co-operative society development the aim was to sell at cost price, and profits, should they be made, were to be applied in adding to capital for the benefit of the members. Later, a group of people known as the Rochdale pioneers, of whom the leading figure was Charles Haworth, devised a system which forms now the basic concept of co-operation. Each member is

charged the normal retail price and is credited with a share in the surplus of the society in proportion to the value of purchases made. He has to subscribe to a minimum amount of share capital which bears a specified rate of interest, and the statutes require also that this personal shareholding should not exceed a certain maximum. The surplus available for distribution to members as dividends or *divis* in respect of purchases is viewed officially as a rebate and not as a profit, thus avoiding liability for tax.

There are two main types of co-operative society: the retail general supply store, and the wholesale or producing society. The latter supplies as a rule to the former. The giant organisation, the Co-operative Wholesale Society, not only manufactures and distributes to the retail stores, but provides also banking, insurance, and other services to its members.

7 Building Societies

The name here is rather a misnomer, as generally speaking building societies do not build. Property purchase finance societies would describe more correctly their activities. Building societies are associations incorporated with limited liability under the Building Societies Acts. The directors are elected by the shareholders and the rules, by-laws, and powers are defined in the rules of each society. Unlike the capital of a company incorporated under a Companies Act, the capital of a building society may expand or contract as a matter of course. Members acquire shares by subscription and may after due notice withdraw and obtain repayment of the money subscribed. The rate of interest paid on the capital is fixed from time to time by the directors. Shareholders do not participate directly in profits, but the rate of interest paid is influenced by their level.

In addition to the raising of money by means of subscription to share capital, building societies borrow by means of accepting money on deposit. The rate of interest paid is usually less than the rate paid on share capital, but the facilities for withdrawal at short notice are greater. The precise function of a building society is to lend money by way of mortgage for the purpose of building or purchasing property, the loan representing as a rule about three-fourths of the value of the property. Repayment by annual instalments is usually required. It is not infrequent that building societies attract more money by way of shareholding and deposit than they can employ always in the granting of loans. In such

cases the surplus money is customarily invested in British Government stocks or in other safe and readily realizable securities.

The building society movement grew rapidly between 1918 and 1938. After contracting during the second world war the expansion was resumed after 1945, stimulated by the search for housing accommodation and by the substantial rise in the value of house property. The movement had far-reaching social and economic consequences. It encouraged many people to buy their own homes rather than to rent them. This tended to restrict the movement in population from one area to another and accordingly to impart a somewhat undesirable rigidity into the nation's economy. The growth of home ownership, however, brought in train a greater awareness of civic responsibilities and obligations.

8 Unit Trusts

A unit trust has many of the features of an association, but it is really more in the nature of an investors' pool. It provides a useful means whereby investors may spread a small amount of money over a large field of investment. There are two distinct forms: fixed trust, and managed trust.

In the former case a number of separate investments, say twenty or thirty in all, are purchased in fixed amounts and are designated a *unit*. The specified portfolio of investments is vested in the name of a trustee, who then creates, say, 2,000 sub-units; the holder of each sub-unit being entitled to $\frac{1}{2,000}$ th part of the beneficial interest in the investments held. A trust deed is drawn up defining the precise terms of the duties of the trustee. The actual number of separate units held in trust will be governed by the demand for the acquisition of the sub-units. Managers are appointed to carry out the purchase and sale of investments and to provide a market for the purchase and sale of sub-units. Holders are given facilities for realizing their sub-units at any time, either by selling to the managers or by virtue of the trustee selling the appropriate amount of the investments held in trust. The duration of the trust must be limited and the trust deed will define the date or contingency under which the trust must terminate – unless extended for a further limited period by universal consent.

Managed trusts differ from fixed trusts in that the managers are given power to vary within the prescribed limits of a permitted list the investments held by the trustee.

9 General Comments

The above gives a somewhat brief summary of the main features of those associations which are of chief interest not only to the investor, but to the financial community. One other which should not be omitted from mention is the partnership. This is the form of association most frequently encountered among professions such as solicitors – though not barristers – accountants, doctors, stockbrokers, and others. The constitution of a partnership is the partnership agreement, which is either a verbal one or a deed signed by all partners and defining the basis of partnership.

Generally speaking, the form of association usually chosen is the one most appropriate to the particular purpose. The choice is also influenced by the privileges to be gained – privileges which not infrequently are granted to one form of association, but are denied to another. The actual value placed on such privileges and also on the obligations is liable to change during the passage of time. Furthermore, the advent of new legislation may itself bring important changes. Consequently there have been some clearly perceptible trends in the choice of the most appropriate form of association. Some of these trends will now be examined.

The privileges of limited liability defined in the 1862 Act brought in its train a vast increase in the number of limited liability joint stock companies. There has also been a tendency for very many years now for business partnerships to re-form as limited liability companies.

One of the disadvantages of partnership from the point of view of finance is that capital is usually withdrawn on the death of a partner. Provision has then to be made, often at short notice, for the replacement of such capital. So long as death duties remained low and particularly when the estate of a deceased partner was as often as not inherited by junior partners of blood relationship, then partnership had many attractions for businesses not depending on the public for the subscription of capital. But when death duties were raised to a higher level, thus increasing the risk of immediate withdrawal of capital on the death of a partner, the attractions of the joint stock company *vis-à-vis* the partnership were enhanced. Limited liability companies were also favoured as compared with partnerships in the case of those undertaking a particularly hazardous type of business, thereby lessening the risk of personal bankruptcy.

Public and private companies may each enjoy the same privi-

leges as regards limited liability but the private company has a valuable additional privilege as compared with the public company in that its financial affairs may be kept secret. Until modified by the 1948 Act, no private company was under obligation to file (and thus make available for public inspection) its annual accounts. This privilege of secrecy was highly prized – the number of private companies in the United Kingdom increasing from 95,598 in 1930 to 169,205 in 1944. During the same period the number of public companies decreased from 16,263 to 13,303, part of the reduction being caused no doubt by conversion into private companies.

Before the passing of the 1948 Act it was possible for a public company to own shares in a private company and be under no obligation to file the accounts of the private company. It was even possible for a public company to confine its entire assets to the holding of shares in a private company and thereby conceal from its shareholders all but the barest minimum of financial information. Now, the privilege of privacy is confined to those private companies which are effectively associations of private individuals and in no sense under the control of any other corporate bodies. Thus an opportunity for abuse on a considerable scale has been removed.

The privilege of privacy is still highly prized, particularly by small companies. Publication of financial results is often thought to endanger a company's competitive position and is sometimes believed to place the directors at a disadvantage when negotiating over wages and terms of employment. But the effect of high rates of taxation and death duties may greatly embarrass individual shareholders and this consideration may override any advantages of privacy. A man who has invested the greater part of his capital in the shares of a private company may be faced with a serious problem. On his death his executors may have to pay in death duties a sum representing a not inconsiderable proportion of the value placed on the shares by the Estate Duty Office. The only way of realizing enough money to pay the duties may be to sell part of his shareholding; but this is often a difficult matter, especially as the directors of a private company may exercise their prerogative of refusing to register new transferees and in any case cannot admit more than a certain limited number of shareholders. Furthermore, if the deceased shareholder was a managing director of great value to the company, the business – and so, too, the value of the shares – may suffer as a result of his death.

It was largely for these reasons that during the years following the ending of the second world war, when taxation and death duties had reached such high levels, at any rate in comparison with earlier years, many public companies were formed to carry on businesses formerly conducted by partnerships. For similar reasons the necessary steps were taken to convert many private companies into public companies.

Another factor of great significance having a bearing on the form of association under which businesses are conducted is the series of Acts by which among others coal, telecommunications, transport, electricity, and gas have been transferred to public ownership. There have been different methods of acquisition. In the case of coal and telecommunications the fixed capital assets of companies were acquired, payment being made to the companies concerned in the form of cash or government stock. The companies were left in existence in their rump form to seek out their future as they chose themselves, subject only to certain special provisions should they choose to wind up.

In the case of transport, electricity, and gas, all undertakings engaged in these businesses – whether public board or joint stock company – were acquired in their entirety, their separate entities being extinguished. This was made effective not by compelling the undertakings to cease business, but by the compulsory purchase of the stock and shareholdings of their members. The representatives of the state then stood in the place of the former members and became absolute owners of the undertakings.

The boards which were formed to take over coal, transport, electricity, and gas are all national boards, and it is interesting to compare certain aspects of their constitution with those of public boards and joint stock companies. Each national board is constituted by a separate Act of Parliament. The appointment of the chairman and members of the board (or commission) is the prerogative of the appropriate minister; for instance, in the case of coal, the Minister of Fuel and Power; in the case of transport, the Minister of Transport. There are no members in the form of stockholders to whom the board are responsible, except in so far as it might be said that the electorate are the members, and that the designated minister is accordingly responsible to the electorate. But this can only be strictly true if the minister can be made to account fully for his actions to the representatives of the electorate, i.e. to the members of the House of Commons.

National boards, unlike joint stock companies, are not constituted for the express purpose of making a profit, but are required to provide an efficient service and to conduct their business in such a way that revenue and expenditure should balance. In this respect they are more akin to the public board, except that the public board is dependent on its own resources in event of failure to pay its way, while the national board can finance its loss from the national exchequer. The capital stock of a national board consists entirely of stock carrying fixed rates of interest and is guaranteed as to interest and principal by the Treasury.

There are, of course, no memoranda and articles of association for national boards. Powers, rules, and by-laws are derived from the appropriate Acts of Parliament. In the case of joint stock companies the delegation of power to directors is certainly defined, but in practice considerable latitude is exercised in order that the directors should conduct the business in whatever way they consider to be most advantageous. In the case of national boards, although power is sometimes given to the minister to make regulations, the powers and duties are usually much more closely defined, especially as regards delegation of power and responsibility. Accordingly the scope given to those responsible for the day-to-day management is usually more circumscribed.

Enough has probably been said now to give a broad idea of the basic principles governing most business associations. Vast changes have taken place in the past and no doubt the future will provide its own variants. Many influences are at work, many interests are concerned, but the essential objectives should remain as before: the increase of wealth; a just reward for member, worker, and customer; and a system under which wastage can be eliminated and efficiency rewarded.

CHAPTER 5
INVESTMENT IN CONTRACTUAL
OBLIGATIONS

I General Observations

Many investors have a wide choice in the selection not only of individual investments, but also of the particular type or class of investment. Although these types are many and varied, it is possible to divide them into two distinct categories. The first relates to those where money has been borrowed and where a debt has accordingly been created. The second relates to those where the investor has a proprietary interest, the most usual form being a holding of stock or shares in a joint stock company. It is proposed to deal in this chapter with the first type.

Usually the creation of a debt is implemented by some form of contract fixing the rate of interest and defining the terms and conditions of repayment. In the event of failure to fulfil the terms of the contract the investor may avail himself of all rights open to him at law to take remedial action. The investor may be either the original lender or he may have purchased the rights and benefits under the original contract.

Certain types of debts or obligations seldom change hands during their currency, the person who originally lends the money being the same as the one who collects repayment on maturity. Others are of a type where ownership may change hands frequently and where facilities are available for such transfer. The price need not necessarily be the same as the face value of the debt; indeed, in most cases it is not. Where the price is less, it is referred to as being at a *discount*; where more, at a *premium*. The Stock Exchange is, of course, the chief place where investments can be bought and sold, and fuller reference to this will be made in chapter 7.

The principal yardsticks by which the merits of investments in debts and obligations are measured are (a) the yield and (b) the degree of probability that all the terms of the contract will be fulfilled.

The yield is a measure of the relationship between the money invested and the reward expected. Where a debt is due for repayment at its face value, i.e. at par, or where the debt is perpetual,

no difficulty arises in calculating the yield. But where the price on redemption differs from the price paid by the investor the yield then becomes a function not only of the rate of interest in relation to the price (known as the *flat* or *running* yield), but also of the profit or loss on redemption. This composite yield is known as the *yield to redemption* and may be obtained by adding to or subtracting from the flat or running yield the profit or loss on redemption converted to an annual rate at a rate of interest equivalent to the yield to redemption. (There are in existence several publications of extensive tables giving yields to redemption for various prices, terms, and rates of interest.)

In all cases where the terms of contract are precise the yield can be calculated exactly. But the calculation is based on the assumption that the terms of the contract will be duly fulfilled. The existence of this assumption must therefore always be borne in mind when comparing the yields on different investments. Indeed, until the investment is realised any calculation of yield is in a varying degree hypothetical. If there is any small doubt about the due fulfilment of the contractual terms, then that doubt will normally be expressed in the basis upon which the investor is prepared to invest his money; the bigger the doubt, the bigger the yield required. Hence the two yardsticks mentioned above can be more conveniently referred to as (*a*) yield, and (*b*) degree of safety.

The principal types of investment which fall into the category of contractual obligations will now be mentioned and described. Only brief comment will be made on the second yardstick, degree of safety (this will be considered fully in later chapters), but detailed attention will be paid to the question of yield. The calculation of yield is a prerequisite to the examination of almost every investment. In many instances the borrower has some choice as to the manner of repayment, and it is therefore necessary to decide upon what assumptions as to repayment the yield calculations are to be made.

2 Deposits

The lending of money on deposit is the simplest form of temporary or short-term investment. Money may be deposited with banks on current account or on deposit account. In the former case it is withdrawable on demand and carries no interest. It is therefore not attracted to the banks for the primary purpose of investment, but for safe keeping and in order to make use of banking services

such as cheque-drawing facilities. Money placed on deposit account is normally repayable on short notice and the rate of interest, if any, is very small.

The banks in turn lend money to the Treasury on deposit account. This form of investment is known as Treasury deposit receipts. In 1948 the rate of interest was $\frac{5}{8}\%$ and the term of the deposit was six months.

Money may also be deposited with the Post Office and Trustee Savings Banks. These deposits earn a considerably higher rate of interest than in the case of money deposited with the commercial banks, but the amount which can be placed in the name of any one person is limited to a comparatively small sum.

Deposits may be arranged with building societies at rates of interest rather more favourable than that obtainable from the savings banks. Most building societies place a maximum on the amount which they will accept on deposit in the name of any one person, and notice required for withdrawal varies from immediate demand to several weeks.

Some public authorities and a few joint stock companies, in particular mortgage companies and investment trust companies, accept money on deposit for fixed terms of years, usually for 3, 4, or 5 years. Although called deposits, they are really loans for fixed periods, since as a rule repayment cannot be demanded before maturity.

The form of contract for all kinds of deposit is usually an entry, made by the body accepting the money, in a book which is the property of each depositor. Sometimes a formal receipt is given acknowledging the debt and specifying, where appropriate, the rate of interest and date of repayment. Where the credit of the borrower is unimpeachable the risk of default is negligible and any possible difficulty is more likely to take the form of a delay in repayment than any ultimate loss of money. The calculation of yield presents no problem. It is the deposit rate of interest.

3 Bills

A bill is an order for payment drawn by the creditor on the debtor and usually provides for payment to be made at a named date in the future. The *contract* is completed by the debtor acknowledging or *accepting* the bill. It is used frequently in the settlement of overseas trade, since it is appropriate that a period of time should elapse in order to enable shipment and delivery to be

made of goods purchased. As many bills are acknowledged by traders whose credit worthiness may be known to only a few people it is usually necessary that the due fulfilment of the debt should be guaranteed by some recognized banking institution before the bills can be readily transferred as a saleable or negotiable instrument.

This process of guaranteeing – and it is also referred to as *accepting* – is done by an *acceptance house* endorsing its name on the bill. It is the business of acceptance houses to have an intimate knowledge of the credit worthiness of those with whom they do business. They receive their remuneration for accepting bills by charging the drawer of the bill (i.e. the creditor) a commission. The accepted bill is then a form of debt which can be negotiated freely by the process of discounting, the sum receivable being the money due at maturity less the discount for the intervening period at an agreed rate.

There is a fine difference between the rate of discount and the yield as defined earlier in the chapter. The following example will serve as an illustration. A bill due in nine months' time is discounted at $1\frac{1}{4}\%$:

Sum due in 9 months' time	= £100.0000
Sum payable for bill discounted at $1\frac{1}{4}\%$	
$£(100 - 273/365 \times 1.25)$	= $\frac{99.0651}{}$
Interest for 9 months	= $\frac{£0.9349}{}$
Yield = $\frac{.9349 \times \frac{365}{273} \%}{99.0651}$	
= 1.262%	

The British Treasury has for many years borrowed money every week by the issue of bills due in ninety days' time. The rate of discount (in 1948) was approximately $\frac{1}{2}\%$. Treasury bills are obtainable only in multiples of £5,000 and are of chief interest to banking and other large institutions.

4 Loans, Bonds, Mortgages

These all relate to a method of finance often found convenient to those who wish to borrow and to those who wish to lend. Such debts are seldom transferred, the lender usually expecting to see his money out on loan until the debt is repaid. The precise terms will be agreed between borrower and lender – e.g. the rate of interest, the date of repayment, etc. The rate of interest will be

fixed partly by reference to prevailing conditions and partly by reference to the opinion formed as to the *degree of safety*. The date and conditions of repayment will be determined by the circumstances of each case.

Now anyone who contemplates making a loan will want to enquire very carefully into the prospects of getting his money back. He will want to know much about the finances and the integrity and the business ability of the borrower – whether an individual or a corporation. This information is not always easy to obtain, nor can one always be sure that, even if a satisfactory answer is forthcoming, it will hold good throughout the currency of the loan. It is largely for this reason that the basis of contract under which many loans are arranged enables the lender to rely on something more than the mere written undertaking of the borrower to meet his engagements. For example, one or more parties may be brought in for the purpose of guaranteeing the loan. But the more frequent form of *secured* loan is for some property of value to be pledged as security for the loan.

The forms of contract where property is pledged differ in England and in Scotland, but fundamentally the purposes are very similar. The debt is either made a charge on the property or else the latter is, in effect, vested in the lender subject, however, to the borrower's right of redemption. In addition the deeds showing the borrower's title to the property are as a rule given into the custody of the lender. In England the usual type of contract is a mortgage or charge; in Scotland a bond and disposition in security. In the event of default steps may be taken by the lender for satisfaction of the debt out of the income from the property or out of the proceeds of sale, the expenses incurred in the process being the liability of the borrower.

The form of mortgage or bond most frequently encountered provides for repayment at the end of some fixed period of time – perhaps only six months ahead – but so phrased as to allow, in fact, for an indefinite extension. Repayment may take place ultimately when either the borrower elects to repay or the lender calls for repayment. In either case notice is usually required. Where, however, repayment is to be made by annual instalments (which is a frequent stipulation in mortgages and bonds from building societies) no such automatic facilities for postponement would normally apply.

The law does not allow the lender to extort a fine for delay in

payment of interest. As a consequence it is not unusual to provide in the deed for a somewhat higher rate of interest, but to make the lower rate operative so long as payment is made promptly (e.g. within one month of the due date).

Investment in mortgages and bonds will be considered more fully in chapter 20.

5 Ways and Means of Repaying Debts

The degree of safety afforded to the investor depends largely on the *ability* of borrowers to repay their debts, and it will be convenient at this stage to examine and discuss some of the ways and means open to them to achieve this object. The choice of methods by which repayment is effected usually depends on the type of debt or obligation. With banks and other institutions where money is placed on deposit and withdrawn from deposit as part of the daily business, the money required for withdrawals is as a rule provided by money received from new depositors. It is all part and parcel of a revolving process.

As regards bills, those which are used to finance trade are generally self-liquidating. The trader on whom a bill is drawn purchases goods, not as a rule for permanent acquisition, but for resale or for processing for resale.

Mortgage loans and bonds are usually repaid either through the conversion of part or all of the pledged security into cash by sale or otherwise, through the application of other monetary resources belonging to the borrower, or through borrowing elsewhere. Repayment by instalments can be most easily made when surplus income is available. A way of repaying by instalments often found satisfactory by borrowers is by means of a sinking fund policy or a life assurance policy. The premiums are paid by the borrower and the policy is pledged as additional security; when the policy monies fall in they are set against the debt due under the mortgage or bond. It should be noted that under this method the borrower provides for repayment by instalments, but the lender receives repayment in one sum at the end.

Where a debt has been contracted for a long period of time the method of repayment to be employed requires careful consideration. Usually the borrower of money on a long-term basis is satisfied as to his ability to repay when the time comes; and as a matter of common prudence he will aim at synchronizing the time of repayment with his ability to repay. When a business venture is

launched an expression frequently used to describe the method of finance is to *float* a loan or share capital issue. This has given rise to the expression *sinking fund* to denote a method of repaying the loan. A more technical expression is *amortization*, which is simply the process of *bringing to death* or extinguishing the loan. A sinking fund can serve two purposes: the essential one of repaying the loan before the purpose, for which the money was borrowed, becomes redundant or unprofitable, or before a wasting asset has lost its value; or the desirable one of freeing the venture from debt within a certain period of time.

A sinking fund may be *simple* and operate by repayment of equal annual instalments of principal, or it may be *cumulative*, the annual principal sum increasing each year by an amount equal to the saving of interest on the amount redeemed in the previous year. In the latter case the annual amount required for interest and repayment combined is constant.

6 British Government Securities

The securities issued by the British Government comprise many and varied types. There are, however, two essential distinctions:

(a) *Funded Debt*: loans which have no fixed date for redemption.

(b) *Unfunded Debt*: loans which are redeemable on a definite date with or without an option to repay on an earlier date.

Before examining the securities according to these two categories there is another important distinction which should be mentioned. Some, of which the most important are Treasury deposit receipts and Treasury bills (which have already been described), are suitable only for banks and other large corporate investors. At the other end of the scale are certain securities specially designed to serve the needs of the small investor. The yields on the latter are generally higher than those ruling on British Government stocks quoted on the Stock Exchange, but the maximum amount which any one person may hold is limited.

These *restricted* securities comprise the main stock in trade of the National Savings Movement and are particularly suitable for the investor of limited means. Deposits with the Post Office and Trustee Savings Banks have already been mentioned. Savings Certificates are issued (in 1948) in units of 10s. No annual interest is paid, but they are repayable at the end of ten years at 13s. The yield is therefore obtained from the formula $.5 = v^{10} \times .65$ and is £2 13s. od. %₀. There is no liability to income tax or surtax. Repay-

ment prior to maturity can be obtained at short notice, the repayment price depending upon the length of time for which the Savings Certificates have been held. The yield in such case usually follows a pattern where the shorter the time held the smaller the yield.

Defence Bonds were issued first in 1939. They carried interest at 3% and were repayable at 101% in seven years' time or at par on any earlier date on six months' notice from the investor. The terms ruling in 1948 are 2½% redeemable at 101% in ten years' time or at par on any earlier date on six months' notice from the investor. The yield to redemption on these bonds is £2 12s. 1d.%, but as the interest is liable to taxation it is not comparable with the yield on Savings Certificates.

(a) The *funded debt* comprises now a relatively small proportion of the total government debt. At one time it was the aim of the Chancellor of the Exchequer of the day to see that as large a proportion as possible of borrowing was done by means of funded debt loans. It was thought to be an undoubted advantage to be free from the obligation to repay on a stated date. The reasons why the fashion changed were probably twofold. One, before the first world war – indeed, for some years afterwards, too – the possibility of repaying the unfunded portion of the national debt at some distant date was considered not entirely impossible and at any rate a most desirable objective; but the debt is now of such vast dimensions that the means of repaying loans as they mature is almost always that of borrowing afresh. The other, the rate of interest which the Government would have to pay on funded debt loans, is usually higher than on most unfunded debt loans and certainly much higher than the rate payable on short term or *floating debt* securities such as Treasury bills and Treasury deposit receipts.

The doyen of the unfunded debt securities is 2½% Consols; it is redeemable at any time at par by notice from the Government, but otherwise has no fixed date of redemption. The yield, of course, is a direct function of the market price of the stock. For example, at a price of 80 the yield is $2\frac{1}{2} \times \frac{100}{80}\% = \text{£}3 \text{ 2s. 6d.}\%$ Unless and until such time as the Government can borrow at a cheaper rate of interest than 2½% on a stock nearly comparable in type the possibility of redemption at par need not be taken seriously.

Another example is the 3½% War Loan, which may be redeemed

at the Government's option in 1952, or failing redemption then may be redeemed also at the Government's option at any later date on three months' notice. This loan was issued by way of conversion to holders of the 5% War Loan 1929/47 (an unfunded debt security) and the operation thus amounted to a funding operation. The redemption terms of 3½% War Loan are referred to simply as '1952 or after'.

It was said earlier in this chapter that, until a debt is actually repaid, any calculation of yield is in a varying degree hypothetical. This applies with special emphasis to the marketable securities which have no fixed date of redemption. The basic hypothesis upon which to work in the calculation of yields is to select the terms of redemption which appear most likely to be chosen by the borrower. Thus in the case of 3½% War Loan, if it appears likely that the Government will be able, after the first optional date of repayment, to reborrow on more favourable terms to itself, then it must be expected that it will take the first opportunity for redemption. In such circumstances the price of 3½% War Loan is likely to stand at a premium and in any yield calculation it should be assumed that it will be repaid at the earliest date, i.e. 1st December 1952.

On the other hand, if the ruling rate for long-term borrowing happened to be 4% the price of 3½% War Loan would then be around 87½. There would be no expectation of repayment in 1952 and the yield would be simply the flat yield of

$$3\frac{1}{2} \times \frac{100}{87.5} \% = \text{£}4 \text{ os. od.}\%$$

Other funded debt stocks include 4% Consolidated Loan (1957 or after), 3% Treasury Stock (1966 or after), 2½% Treasury Stock (1975 or after), and 3½% Conversion Loan (1961 or after). The latter is the only one where any special feature exists. Whenever the price falls below 90 a sinking fund of an amount equal to not less than 1% of the amount outstanding at the close of the previous half-year is to be applied during the next half-year in the purchase in the market for cancellation. The loan was issued in 1921 at prices in the lower 60's and until 1932 the sinking fund was in operation. The primary purpose of the sinking fund was to provide some support for the market price on the Stock Exchange, since by the actual terms, 1% of the amount outstanding, not of the amount *originally* in issue, it could never redeem the entire loan.

The catalogue of British Government Securities includes a wide variety of names such as National War Bonds, War Loans, Savings Bonds, Defence Bonds, Victory Bonds, Funding Loan, etc. The names apply to the purposes for which the loans were issued and do not relate to any special features of the individual securities. Nor is there in practice any real difference in this connection between 'stock', 'loan', or 'bond'.

(b) *The unfunded debt* securities are repayable not later than a specified final date, with the Government having the power in the majority of cases to repay within a defined period of time prior to the final date. For example, 3% Savings Bonds 1965/75 are due for repayment on 15th August 1975, but the Government has the right to repay all or part at any time after 15th August 1965, provided it gives three months' notice.

Just as the Government has the advantage of having a decade in which to choose its time of repayment – and repayment usually implies fresh borrowing – so does the investor suffer a corresponding disadvantage through not knowing exactly when repayment may be expected. He should infer, however, that it will occur when conditions are deemed to be most favourable to the Government.

The calculation of yield on 3% Savings Bonds 1965/75 should always allow for redemption. The only doubt is what date, within the range of those ten years, should be taken. If the price of the loan is at a substantial premium the earliest date (1965) will obviously be assumed, if at a substantial discount the latest date (1975) will be taken. If, however, the price is close to par, indicating that 3% is the ruling rate of borrowing, it is really impossible to form any rational opinion as to the most likely date. Therefore the only practical method is to be quite dogmatic and take the earliest date if the price is above par and the latest if below – recognising at the same time the hypothetical nature of the answer.

As a rule the shorter the original term of the loan the narrower is the gap between first optional date and the final date of redemption. For example, the series of National War Bonds issued during the second world war had a maximum life varying between seven and eleven years. These all had a spread of two years between first and final dates. The series of 3% Savings Bonds issued at about the same time had considerably longer lives and the gap between first and final dates was ten years. As has been said earlier, the right to choose, within defined limits, the date of repayment is an advantage to the borrower. But if the spread is too great the

resulting disadvantage to the lender can only be offset by offering a higher rate of interest or a lower price of issue. So there is an effective deterrent to the borrower obtaining too great an advantage in this respect.

There are still a few unfunded debt loans in existence which were issued in the days when an annual sinking fund was considered not only desirable, but practicable. Two examples will be given; 4% Victory Bonds and 3% Funding Loan 1959/69.

The 4% Victory Bonds were issued in 1919 at 85%. The bonds are for fixed amounts varying from £50 to £5,000. Each bears a separate number and the bonds are redeemable by drawings by ballot each year at 100%. To provide for interest and drawings there is set aside each half-year an amount equal to $2\frac{1}{4}\%$ of the original amount of the loan. As the rate of interest is 2% per half-year this means a cumulative sinking of $\frac{1}{4}\%$ per half-year (though, in fact, operating only at annual intervals). Now, it can be shown that $\frac{1}{4}\%$ per half-year accumulated at a rate of interest of 4% per annum will take just over 56 years to accumulate to 100. Therefore the last annual repayment will take place in 1976. Another way of viewing the loan as a whole is by treating it as an annuity for 56 years – and a fraction of a year longer.

The yield on 4% Victory Bonds can be calculated as follows. Since the actual date of redemption for any one holder is largely a matter of chance, it is possible to arrive at a yield calculation only by reference to holders as a whole. The amount issued in 1919 was £359,531,845. The half-yearly amount required for the service (interest and sinking fund) of the bonds is $2\frac{1}{4}\%$ of that amount, i.e. £8,089,466. This applies to each half-year up to and including 1975, with approximately £350,000 due in 1976. The amount outstanding after the drawing in 1947 was £269,710,145. Therefore the loan was equivalent then to a half-yearly annuity of 3.00% per half-year until 1975, with a final payment of .13% in 1976.

The yield is then obtained from the formula

$$P = 3.00 a_{\overline{56}|} + .13 v^{57}$$

Where P is the price of the bonds and z is the yield. This formula is not quite accurate, since drawings take place yearly while interest is payable half-yearly. Any error is, however, negligible.

Since in practice yields on redeemable stocks can be more readily calculated (or the answer obtained from tables of yields) if redemption is due to take place – not by instalments – but at one

point of time, it is helpful to calculate an equated single date of redemption. The equated term for Victory Bonds is obtained from the formula

$$3 \cdot 00a_{\overline{56}|} + \cdot 13v^{57} = 2a_{\overline{2n}|} + 100v^{2n}$$

where n is the equated term of years. There are two points to bear in mind here. First, the equated term is measured from the date of calculation; so the equated date moves forward as time passes. Second, the equated date will be found to vary slightly with variations in the yield. For practical purposes, however, an approximation to the nearest half-year is usually quite sufficient.

There is another interesting feature about Victory Bonds. They may be tendered for the payment of death duties and accepted at par for that purpose. This privilege is only of value so long as the price is below par, as it was for each year from 1919 to 1931. Altogether over £100,000,000 has been used in this way. But – and this is most important – the bonds accepted for death-duty purposes are not cancelled, but are held by the National Debt Commissioners until drawn by ballot under the terms of the loan. If they were cancelled, without any corresponding reduction in the sinking fund, the redemption of the bonds remaining in the hands of the public would be accelerated. When the price was below par the bonds were obviously more attractive to personal holders than to institutions. To prevent exploitation of the privilege it applied only to those who had held the bonds at least six months prior to date of death.

The 3% Funding Loan 1959/69 is redeemable at par on 15th April 1969, or earlier at any time on or after 15th April 1959 on three months' notice from the Government. There is a cumulative sinking fund of $\frac{1}{2}\%$ per half-year which is to be applied in this way. If the price of the loan is less than 100 the sinking fund purchases on the market for cancellation. When the price is above 100 it *may* be applied either in buying on the market or be otherwise invested under the control of the Treasury. The sinking fund cannot be applied in drawings, so the holder can never be *compelled* to part with his holding prior to the redemption date. Therefore for purposes of yield calculation the sinking fund can be ignored.

7 Debenture Stocks

The borrowing of money by the creation and issue of debenture stock is a method of finance used frequently by public boards and

joint stock companies. The exact nature of the security and the degree of safety offered to the debenture stockholder will be dealt with in subsequent chapters. Attention will be confined here to ways and means of repayment and to some of the problems connected with the calculation of yields.

Perpetual debenture stocks are those where there is no obligation to repay so long as the borrower continues in business. But in the event of the business winding up and going into liquidation the stock must, under the terms of the debenture contract, be repaid at the agreed price applicable to such event. In that sense therefore the word *perpetual* requires qualification. For practical purposes, however, the possibility of repayment of a perpetual debenture stock can be ignored unless the borrower has a definite option to redeem in certain circumstances or unless the purpose for which the business was formed has an apparent limit as to time. Subject to these qualifications the yield on a perpetual debenture stock is therefore the flat yield.

Most debenture stocks have, in fact, some definite provision for repayment and are usually known as *redeemable debenture stocks*. Where there is one fixed date of redemption or an ultimate date with option to repay earlier, but without the operation of an annual sinking fund, no new problem arises in the calculation of yield. The choice of the date is affected by the same principles as apply to the government loans mentioned above. Many debenture stocks are, however, redeemable by sinking-fund operations, and the following examples may serve to illustrate some of the problems likely to be encountered.

(a) *Eagle Oil & Shipping Co. Ltd. 4½% Debenture Stock*

This is chosen as an example of a stock redeemable solely by the operation of a sinking fund. £3,000,000 was issued in 1939. In 1941 a cumulative sinking fund of £95,628 per annum began to operate by drawings at par or by purchases in the market if stock should be available at or under par. Redemption will be completed on 15th January 1960. As long as drawings at par may be expected the calculation of yield follows the same principles as for Victory Bonds. If complete accuracy is required the stock must be treated as an annuity. For practical purposes, however, it is sufficient to use an equated date.

(b) *London County Freehold and Leasehold Properties Ltd. 3% First Mortgage Debenture Stock*

This stock was issued at a price of 101 in 1947. It is redeemable by the operation of a cumulative sinking fund equivalent to 1.446% of the amount originally issued. It commences in 1952 and operates either by annual drawings at 101% or by purchase in the market if obtainable at or under 101%. The sinking fund was designed to redeem the entire debenture stock by 1989, and the company has the option to repay the balance outstanding at 101% in or after the year 1958. The yield at the issue price of 101% is easy to calculate; it is simply the flat yield of £2 19s. 5d.%, since at that price there is no profit or loss on redemption.

But assume, for example, that the price fell to 90; how at this new level is the yield to be calculated? Two fresh problems arise. First, the stock is redeemable ultimately not at par, but at a premium, and second, there is a strong probability that the sinking fund will be able to buy annually a larger amount of stock (because it is buying on cheaper terms) than originally expected and so accelerate the process of redemption.

Dealing first with the second point, i.e. the ultimate date of redemption; since the price is below 101 it must be assumed that the company will not exercise its option to repay the balance of the loan in 1958. If the sinking fund is able to purchase stock at the price of 90, and since it is the amount of money expended and not the amount of stock bought which is fixed, then instead of redeeming in 1952 1.432% *viz.* 1.446% $\times \frac{100}{101}$ the percentage will be

1.607% *viz.* 1.446% $\times \frac{100}{90}$. If *all* sinking fund purchases were

made at a price of 90, then the stock will be redeemed in n years from 1952 where n is obtained from the formula $1.607 s_{\overline{n}|3\%} = 100$. Since n is found to be $35\frac{1}{2}$ years, the date of final repayment is estimated at 1987. It will be seen therefore that the date of ultimate redemption is a function of the prices at which the sinking fund can acquire stock in the future.

The calculations of yield in cases where sinking funds operate by drawings are only possible on the basis of treating the entire issue of stock as a whole, as was done in the case of Victory Bonds. The stockholder has no influence on the pace of redemption of his investment and he can only base his expectations on the assumption that his own holding will be drawn and redeemed on the same

average basis as for the whole issue. But where the sinking fund operates effectively by purchases in the market the holder has full freedom of choice as to whether or not he sells to the sinking fund. The date of redemption for yield purposes therefore becomes the date or dates when the holder will be obliged to accept repayment, i.e. in the case under discussion, and on the assumption just made, the year 1987.

It will be realized, of course, that any assumption as to the prices at which the sinking-fund can purchase stock means taking a view as to the market price of the stock for the remainder of the term, and in practice this cannot have any more scientific basis than that of a guess. That is why there is no point in making any precise assumption as to prices for each sinking fund purchase. But it must be recognized, however, that normally the market price will approach the final redemption price as the date of ultimate redemption draws near. A useful rule-of-thumb method would therefore be to assume an average price half-way between the market price at the time of calculation and the price which the sinking fund will be obliged to pay on the occasion of the final redemption. In the case under discussion the price would be half-way between 90 and 101, i.e. $95\frac{1}{2}$. The sinking fund would then be assumed to commence in 1952 at the rate of 1.514% viz.

$1.446\% \times \frac{100}{95.5}$ per annum and would effect final redemption in 1988. It will be observed that the sinking fund would have to make its purchases substantially under the redemption price in order to effect any material acceleration of the final date of redemption.

Having decided upon the estimate of the final date it is possible now to turn back and see how the first of the two fresh problems can be solved, that is to say, the fact that the stock is finally redeemable at a *premium*, not at par.

Since the yield to redemption is obtained from the formula

$$P = ia \overline{a}_n + 100v^n$$

and as redemption yield tables are constructed from the formula

$$P = ia \overline{a}_n + 100v^n$$

all that it is necessary to do is to divide both price and rate of interest (i.e. 90 and 3%) by 1.01 and interpolate the appropriate columns in the redemption yield tables.

(c) *Lewis's Investment Trust Ltd. 5% Debenture Stock 1965/85*

This stock was issued in 1931 and is redeemable by a sinking fund of $\frac{1}{2}\%$ per annum which began in 1935 and operates by drawings at par or by purchases at or under par. The stock is redeemable finally in 1985 and the company has the option to repay at par the outstanding balance in 1965 or after. Since 1935 the price of the stock has been above par, so the sinking fund has operated solely by drawings. For the same reason it must be assumed also that the balance of the stock will be repaid in 1965. For purposes of yield calculation it is necessary to divide the stock into two parts: the one which is redeemable by the operation of the sinking fund prior to 1965, and the other which is expected to be redeemed in 1965.

The service of the stock requires £82,500 per annum. The amount outstanding in 1948 was £1,367,616, and it can be calculated that approximately a further £332,000 (equivalent to 24.3%) will be redeemed by the annual sinking fund, leaving the balance of approximately £1,035,000 (equivalent to 75.7%) to be redeemed in 1965 through the exercise of the company's option. What is required now is to obtain an equated outstanding term for the first part, and then a weighted term for the whole. For the first part this can be calculated at 9.5 years, for the second 17 years; so the weighted mean is $.243 \times 9.5 + .757 \times 17 = 15.2$ years. The yield is then calculated on the basis of a 5% loan redeemable at the end of, say, $15\frac{1}{4}$ years. A degree of approximation is involved by using an equated term, but when it is realized that the yield is in any case a hypothetical one and that it assumes that drawings will take place exactly according to average, it should be found to be perfectly adequate for all practical purposes.

In the above three examples the borrowers have the option to repay on or after a certain date at a fixed price, but it quite often happens that the price is made to vary according to the date on the option to repay is exercised. For example, in the case of Telephone and General Trust Ltd., 4% Debenture Stock 1957/67 the company has an option to repay in whole or in part at 102% between 1957 and 1962, and at 101% between 1962 and 1967; any stock not previously redeemed must be repaid at 101% on 31st August 1967. There is no rule-of-thumb method of selecting, for yield purposes, the most likely date of repayment except to estimate (and it will often be little more than a guess) what would be most favourable for the borrower and to assume that he will act accordingly.

Where debenture stocks are redeemable by means of a sinking fund the cumulative form is by far the most popular. This is because the service of the stock, i.e. the requirements for interest and sinking fund, is a constant figure. There are, however, cases where redemption is effected by a simple sinking fund of equal amounts each year. In such cases for practical purposes of yield calculation it is sufficient to take an equated date of redemption midway between the dates of the next ensuing payment and the final sinking fund operation.

8 Incidence of Taxation

In all the calculations of yield so far discussed the question of taxation has been ignored. For many investors tax is assessed only on interest, any profit or loss on repayment being excluded. Since in such cases the yield to redemption is a combination of flat yield plus an adjustment for gain or loss on redemption, it will be realized that tax liability cannot apply to the redemption yield in a uniform way. That is to say a true net yield – after deduction of tax – cannot be obtained by simple deduction of tax from the gross redemption yield. What must be done is first to deduct tax from the actual rate of interest; then a true net yield to redemption can be calculated in the normal way. That is to say, with tax at a rate of 7s. 6d. in the £, a 4% redeemable stock becomes a stock bearing a net rate of interest of $2\frac{1}{2}\%$. Adding back tax at a uniform rate to the resulting net yield to redemption will give what is known as the *equivalent gross* yield to redemption. The bigger the profit or loss on redemption in relation to the flat yield the greater will be the difference between the gross redemption yield – ignoring the incidence of tax – and the equivalent gross redemption yield.

9 Force Majeure

Throughout this chapter it has been tacitly assumed that borrowers and lenders have, subject to the laws of the land, sovereign rights in the observance of the terms of their contracts without intervention or frustration by any third party. But, in fact, as a consequence chiefly of nationalization, the contract between borrower and lender has at times been overridden. The state has been empowered, by virtue of Acts of Parliament, to acquire stock holdings of investors in nationalized industries, the market prices on the Stock Exchange being used frequently as a basis of compensation. In such cases any former calculations of yields were as a

rule completely falsified by the subsequent intervention of the state.

It was said earlier in the chapter that until an investment has actually been redeemed any calculation of yield is in a varying way hypothetical. The context referred then to any flexibility in the redemption terms and to the question as to whether the investor chooses to hold his stock until final redemption. It is necessary however, to add another consideration; the possibility of earlier termination of the original contract through the compulsory purchase of the investment by the state.

CHAPTER 6

INVESTMENT BY WAY OF PROPRIETARY INTEREST

I General Features of Proprietorship

In the previous chapter investment in the form of debts, loans, or other contractual obligations was considered. In this chapter consideration will be given to cases where the investor has the status of a proprietor. He may be a sole proprietor, a partner, or a member of a joint stock company. It is the latter which will be encountered most frequently, the more familiar description of such investor being, of course, stockholder or shareholder.

Usually sole proprietorship is confined to those businesses which provide not only a livelihood to the proprietor, but also the place of his daily work. The investment aspect is a secondary consideration. There are, however, still some instances where investment is the primary consideration even if the business is owned by a sole proprietor. Examples of these include hotels, farms, property ownership, etc. Here it is often necessary for the proprietor to appoint an agent or manager to manage the business for him. Remuneration is on an agreed basis, depending sometimes on the level of profits, but the right to own and control belongs solely to the proprietor.

Partnerships are usually found among the professions and small businesses. The partnership agreement defines the terms upon which each partner subscribes capital and also the basis upon which profits and losses are to be divided. The division of profit depends partly upon the relative amount of capital subscribed and partly upon the contribution made to the profits of the partnership by the work of each partner. Although the usual practice is for each partner to contribute to the prosperity of his firm by means of his daily work, it is not infrequent that a partner's sole function is to provide a certain amount of capital. The former are known as *working* partners, and the latter as *sleeping* partners.

In the case of joint stock companies the general body of shareholders are as a rule the sleeping partners, the working partners being the directors and executive officials. Although directors do usually hold shares in their company, their primary function is

seldom that of passive investors. They do not hold office primarily in order to safeguard or fructify the capital which they themselves have subscribed; their responsibility extends to the capital of all members. For this reason their qualifications for office should not be confined to owning a minimum amount of the company's capital, but should be determined by their general fitness for the job.

The shareholder, *qua* investor, is therefore only concerned in the direction or management of his business to the extent that he votes on the election or removal of directors and on others matter which are his prerogative. Apart from these, his function is to subscribe his capital and await his reward. But he is nevertheless a proprietor, and although he may seldom exercise all his powers he has the full legal right to do so.

Anyone contemplating the investment of money in the capital of a joint stock company should examine carefully the following factors:

- (a) The nature and prospects of the business to be undertaken.
- (b) The integrity and efficiency of the directors and management.
- (c) The exact basis upon which capital is subscribed and profits divided.

(a) and (b) involve the exercise of judgment rather than the ascertainment of fact and are subjects for later chapters. (c) is usually capable of precise assessment, and it is this which will be considered now in detail.

2 Main Distinction between Preference and Equity Capital

The full catalogue of names given to various forms of capital is a lengthy one, but there are two outstanding breeds: *preference* and *equity*.

Preference capital, or preferred capital as it is sometimes called, but without distinction as to meaning, implies that it has a preference either in regard to dividend or capital or both over some other form of capital. The *preference* is expressed in terms of a rate of dividend and of an amount of capital, each of which must be satisfied before the equity stock becomes entitled to participate in profits or in the distribution of capital.

Equity stock – or ordinary, or common stock – is entitled to the residue of profits and capital after satisfying the rights of any preference stocks.

The rights as between one class and another are defined in the articles of association, which among other matters prescribe rules as to the way profits and capital are to be divided. In the case of a debt or loan any failure to fulfil the contract gives the creditor some enforceable right of remedy. Not so in the case of failure to meet the preferential rights of a preference stockholder. He is a joint stock proprietor and cannot sue other proprietors. He can always exercise whatever voting power is available to him, and it frequently happens that this power either only comes into operation (or is increased) when his preference rights are not met in full. Usually the voting power of the equity stockholders exceeds that of the preference stockholders, since the former are considered to run greater risks and should therefore, it is thought, have a larger voice in the company's affairs.

3 Dividend Rights of Preference Stocks

Preference stocks may be either cumulative or non-cumulative. If cumulative, the dividend must not only be paid in preference to the payment of any dividend on the equity capital in respect of the same accounting period, but in the event of failure in the past to pay the full preference dividend the deficiency must be made good subsequently before dividends can be paid on the equity capital. The accumulation of arrears is, however, *simple* not *compound*; that is to say, the arrears of dividend do not themselves bear interest. Another word for non-cumulative is *contingent*, that is to say, the dividend is contingent upon the profits for the year being sufficient to pay the preference dividend. The descriptive title of a preference stock usually contains the words 'cumulative' or 'non-cumulative'.

The capital of a company may include more than one class of preference stock. If so, the articles of association must define their relationship one with the other. The stocks may be called 'first', 'second', 'third', etc., in which case they rank for dividend in that order. They may be either cumulative or non-cumulative. It is not unknown for a first preference stock to be non-cumulative and a second preference stock to be cumulative. But in the event of any failure to pay the dividend on the second cumulative stock, the first, though non-cumulative, still retains its preferential rights over the arrears as well as the annual dividend on the second stock. The only proviso to note is that the arrears of dividend on the second preference stock must be made good before any dividend can be paid on the equity stock. The order of preference is often

referred to as the order of seniority, the equity stock being the *junior* security.

On the other hand, where two or more preference stocks are issued by the same company, the articles may define their respective rights as ranking *pari passu*. Although they may carry different rates of preference dividend, they share the same place in the queue for payment. If profits allow payment of a part only of the preference dividends then proportional scaling down must take place.

It is unusual but not unknown for a company to have issued a first preference stock, where part only of the dividend ranks in priority to that of the second preference stock. For example, the City of London Brewery and Investment Trust Ltd. Cumulative First Preference Stock is entitled to a cumulative dividend of $5\frac{1}{2}\%$, then the second preference stock is entitled to a non-cumulative dividend of 6% , after which the first is entitled to a further cumulative dividend of $\frac{1}{2}\%$. Another example of an unusual feature is Platt Brothers & Company (Holdings) Ltd. 7% Second Preference Shares. In this case the dividend is cumulative only to the extent of 5% and non-cumulative to the extent of an additional 2% .

Where the same company has issued more than one class of preference stock the rates of preference dividend often differ one from the other. There need not be any special significance in this. Where they were issued at the same time and rank not *pari passu* but in order of priority the senior stock usually carries the lowest rate of dividend. But where they rank *pari passu* any difference in rates usually implies that the stocks were issued at different times, the rate of preference dividend no doubt being fixed at the times of issue in the light of conditions in general and of those applying to the company in particular.

Sometimes the rate of preference dividend is fixed by reference to the *net* rate receivable by stockholders after paying income tax at the standard rate. For instance, in the case of a 5% *tax-free* preference stock the company would have to pay a gross dividend at such a rate which, after deducting tax at the standard rate, would provide a net rate of 5% . The freedom from tax may not always be unlimited. In the case of some companies which have *tax-free* preference stocks in issue the articles of association provide for payment free of tax up to a certain rate, say 6s. in the £. If the standard rate of tax exceeds that rate, then the preference stockholders have to bear the difference.

4 Capital Rights of Preference Stocks with Special Reference to Redeemable Preference Stocks

The dividend rights of preference stocks are in evidence year in, year out. Capital rights, on the other hand, are most conspicuous when capital is thought likely to be repaid. Since few companies have any precise limit to their existence, most therefore being expected to continue indefinitely, it might be thought that capital rights are seldom of much practical importance. This might have been the case prior to 1929. Not only was the possibility of compulsory acquisition by the state an extremely remote one, but company law did not then permit the issue of redeemable preference capital. Therefore the circumstances under which the question of capital rights was most likely to arise were when resolutions for winding up, amalgamation, or reduction of capital were under consideration.

The Companies Act 1929 sanctioned the issue of redeemable preference capital, but stipulated that redemption could only be effected out of profits otherwise available for dividend, or out of the proceeds of a fresh issue of capital. The reason for these provisions was to protect the position of creditors and debenture stockholders. For, if preference capital could be redeemed without any such restraints, it might well be possible for preference stockholders to receive payment of their full capital rights and yet leave unsatisfied those who had a prior claim on the resources of the company. But, should a preference stock be redeemed out of the proceeds of a fresh issue of capital made for that purpose, the security of the creditors and debenture stockholders would in no way be impaired; if redeemed out of accumulated profits, the safeguard is not quite so great, though usually considered adequate.

Since allowed by the 1929 Act the issue of redeemable preference stock as a method of finance has grown in popularity with company directors. In the early days of a company's development it was often necessary to decide on a relatively high rate of preference dividend in order to attract subscription to an issue of preference capital. Later if and when the company achieved success in its trading the appropriate rate might then be substantially lower, but there was no satisfactory way by which the equity shareholders could derive benefit on that account, since the original rate would remain in operation indefinitely.

The precise ways in which the redemption of a redeemable preference stock is to be carried out is defined in a company's articles

of association. The terms may specify: that the company has an option to redeem on or after a certain date without any requirement to repay; or that the company is required to redeem on a certain future date with perhaps the option to redeem earlier; or that partial redemptions are to take place annually; or a combination of any of these. The price at which redemption is to take place will, of course, be stated.

It will be realized that the objectives of redemption provisions are very similar to those applicable to redeemable debenture stocks. Any close comparison, however, is likely to be misleading. As already stated, a company may redeem its preference stock if allowed by its articles, but only if profits are available, or out of the proceeds of a fresh capital issue. If it is obliged to repay a loan or debenture stock on a certain date any failure to do so invites remedial action by the lender. But if the articles provide for redemption of preference capital at a certain date, and if the company cannot comply (through inability to raise fresh capital or if profits are insufficient), then the preference stockholders have no right of remedy beyond the exercise of such of their rights as are given to them under the articles. These may give them increased votes, or the directors may be prevented from making any distribution of profits to junior stockholders until the redemption provisions are fully met.

Redemption by way of annual instalments is a method frequently chosen, since such payments can often be designed to synchronize with the capacity of the company to redeem. This is comparable in objective with the redemption of debenture stocks by means of a sinking fund. The annual instalments may be regular, either on a simple or compound basis, or the amount may be made to depend on the precise level of profits. Unless otherwise stated, any annual requirements in the way of preference stock redemption must be satisfied before dividends can be paid on junior stocks.

As regards calculation of yield on preference stocks, where no redemption provisions exist, the yield is a flat one and is a direct function of the rate of dividend and the price of the stock. Where redemption provisions are contained in the articles, the date or equated date of redemption must be assumed to be that which seems likely to give the greatest benefit to the equity stockholders. The principles behind this choice are similar to those applicable to government loans and redeemable debenture stocks (outlined

in chapter 5). But bearing in mind the nature of the hypotheses involved it will usually be found that the calculations of yields to redemption on preference stocks carry less conviction as to ultimate reality than in the case of redeemable loans or debenture stocks.

5 Miscellaneous Rights of Preference Stocks

Up to the present the dividend rights and the capital rights of preference stockholders have been considered in the light of the articles of association as they stand, and the concern has been more with the *distribution* of profits rather than with their actual *level* or with changes in their level. This may be appropriate in the case of companies where stability and immunity from change are the order of the day. But such cases are few. Many companies are in the process of expansion and their requirements as to capital expand similarly. Some achieve a level of profits or losses very different from what was expected when the articles of association were drawn up. Others have seen the heyday of their prosperity and struggle to adapt themselves to less favourable conditions. Therefore anyone examining the merits of a particular stock should not confine his vision to the static position existing at the time of examination, but should envisage the possibilities and consequences of changes in the future.

In this connection he should consider how his position as a stockholder may be affected by any proposals in the future: to borrow additional sums of money; to increase the amount of capital; to vary the rights of different classes of stockholder; or to cease business altogether and go into liquidation. In all these cases a great deal depends upon voting power and it is the percentage of the total votes belonging to each separate class of stock which is often the most critical factor. In practice it quite frequently happens that only a small proportion of stockholders exercise their votes, but for the purpose in hand one can only assume that all will, in fact, use their voting rights (or at any rate that abstentions will be uniform).

As was said earlier, it is usual for voting power to be weighted in favour of the equity stockholders. It is quite customary, too, for the voting rights of preference stockholders to depend upon the financial state of the company. If the full preference dividend is being paid, voting rights may be nil or relatively small. If, on the other hand, preference dividends are not paid in full, or if important

proposals such as to increase or to reduce capital, to wind up, etc. are submitted, then the preference stockholder is usually entitled under the articles to increased votes. It is desirable therefore to ascertain, first, the actual circumstances in which a stockholder may vote and, second, what proportion of the total votes belongs to his particular class of stock. When this has been done the following general principles may be applied. If the votes of one class of stock represent more than 50% of the total, then that class of stockholder is in a strong position to protect his rights at all times. If the percentage is below 50% but above 25%, all resolutions which require a three-fourths majority, i.e. special resolutions or extraordinary resolutions for such purposes as winding up, alteration of capital, or removal of directors could be defeated if thought fit. If the percentage is below 25% the power of his vote will have little more than nuisance value.

Unless otherwise stated any resolution to vary the rights of any class of stock must be passed not only by a meeting of all stockholders, but by each class voting separately. Thus the possibility of rights being varied to the detriment of any one class is usually a remote one.

Stockholders of all classes of capital are naturally concerned with the amount of money which may be borrowed by their company. The articles of association usually limit the amount of money which the directors are authorized to borrow on behalf of the company, distinction usually being drawn between what may be borrowed by way of a bond, debenture, or mortgage charge, and by way of bank overdraft to finance trade in the ordinary course of business. No further borrowings in excess of the permitted amounts can be made unless sanctioned by the stock holders in general meeting.

As regards additions to capital, the memorandum and articles specify not only the amounts which have been issued – the issued capital – but the amounts which the directors are authorized to issue – the authorized capital. If the limit of the authorized capital has not been reached the directors may issue the balance on terms as specified by the memorandum and articles. Such terms may be precise or wide. The steps which must be taken in order to sanction a further increase in authorized capital are defined and very special attention should be paid to these.

As a rule any proposal to increase capital implies business expansion, and this is more frequently associated with a flourishing state

of affairs than otherwise. But it must never be assumed as a consequence that the issue of fresh capital is necessarily a good thing for *all* existing classes of stockholders. When the finances of a company are both stable and satisfactory there is seldom any conflict between different classes of stockholder. But when fortunes change either through expansion or contraction, then the interests of different classes of stockholder are more likely to diverge.

If a proposal is made to issue fresh capital the preference stockholder is in a position rather similar to that of a man standing with his ration book at the head of a queue outside a shop selling rationed goods. He is not directly concerned with any excess of goods in the shop over and above the amount required to satisfy his ration nor with the number of people in the queue behind. His real concern is to keep his place in the queue and to ensure that his ration is always honoured.

Thus the preference stockholder should scrutinize most carefully any proposal to issue a class of stock having a prior right to his own or to increase the amount of his own preference stock. Some companies have sections in their articles which make the future issue of any stock ranking prior to or *pari passu* with an existing stock dependent upon the sanction of the stockholders concerned voting at a separate class meeting. Failing such provision and without adequate voting powers at a general meeting a stockholder would be powerless to prevent the issue of fresh capital which might well prejudice the due fulfilment of his rights. He could not prevent queue-jumping or his being obliged to share his place with others, thus making him liable to pool his ration book with theirs in the event of a shortage.

Fortunately expansion is more frequently encountered than contraction or demise. But in the latter cases a clash of interests between one class of stockholder and another is more likely than not, since the relative values of each class of stock in a going concern are usually very different from their relative values in the event of liquidation.

Capital may be paid back to stockholders by means of a reduction in capital – the direct opposite to an increase in capital. Proposals for capital reduction have to conform to the rights and requirements as defined in the articles of association, have to be passed by the stockholders by a three-fourths majority, and must be confirmed by the Court, which is concerned primarily with satisfying itself that no creditors or debenture stockholders will be prejudiced

and that full compliance with company law has been made. If a company proposes to cease business altogether and to wind up, then capital will be repaid according to the respective rights in liquidation of each class of capital.

In either case, partial reduction of capital, or liquidation, the relative voting rights of each class of stockholder are critically important. Upon that depends the ability or disability to defeat any proposals which is against the interests of one particular class. The question of rights of preference stockholders and also of debenture stockholders in the event of capital reduction or liquidation is a very important subject and further reference will be made to it in later chapters.

6 Equity Stocks

The more usual name given to equity stocks in Great Britain is *ordinary*. Its counterpart in the U.S.A. is *common* stock. Other names include *deferred*, *deferred ordinary*, or just *stock*, or *share* without any descriptive adjective. The easiest way to understand exactly what is meant by equity stock is to think of the word *residue* – what is left over. The dividend and capital rights of equity stocks are defined by reference first to the prior rights of any other class of stockholder, equity stockholders then sharing in any balance remaining after satisfying such rights. The examination of the equity stockholder's rights in other matters should follow the same sort of procedure and embody similar principles to those applicable to the preference stockholder. Voting power is most important.

The investor will have to be on guard to see that no special provisions exist in the articles which might have the effect of watering down the value of his equity. For example, if the business were prosperous and if the equity capital were valued at a substantial premium, any obligation to give to parties other than the equity stockholders a pre-emptive right to subscribe to additional issues of equity capital (which might be made at a price well below the current market price) would undoubtedly prejudice his position.

The more usual practice is for each company to have in issue only one class of equity stock, but there are cases where this is not so. Where the capital is in the form of shares there may be different denominations of shares (e.g. £1 share, 5s. share, 1s. share), but the rights may in other respects be the same. Sometimes two

classes of equity capital exist, the only effective difference being in their voting rights; those having the greater voting power being for the most part in the ownership of the founders or original proprietors. In such cases the distinction is usually made by naming the one *ordinary*, and the other "*A*" *ordinary*.

7 Participating Preference and Convertible Preference Stocks

So far preference and equity stocks have been considered in their thoroughbred form. There are, however, a considerable number of crossbreeds; part preference, part equity. Here, too, the examination and consideration of their rights should be approached in similar ways to those already indicated. It is desirable also to try to recognize which is the predominant strain.

There are a few preference stocks in existence which have a fixed preference as to dividend yet, as regards distribution of capital in the event of liquidation, rank as equities. Spillers Ltd. 6% Cumulative Preference Stock is a case in point. Unless there is a strong presumption that liquidation is likely to take place, such a stock will be assessed primarily as a preference stock; that is its predominant strain. But even if liquidation is in prospect the preference stockholder should not too readily assume that he will necessarily participate in any undistributed profits. The possibility should be borne in mind that prior to liquidation exceptional dividends might be paid to the equity shareholders out of previously accumulated profits. This was actually done by the Eastern Telegraph Company, which paid a special dividend of 100% tax free to its equity stockholders when it became apparent that liquidation might follow as a consequence of the nationalisation of telecommunications.

Participating preference stocks are entitled to a fixed preference dividend and to participate in surplus profits if available. Such further participation may be limited or unlimited. The following examples may serve as useful illustrations.

(a) *British Electric Traction Co. Ltd. Participating Preference Stock*

This stock is entitled to a cumulative preference dividend of 6%. It is also entitled to participate to the extent of a further 2% making 8% in all. There are two stocks ranking junior to the participating preference stock – a preferred ordinary stock, and a deferred ordinary stock. The preferred ordinary stock is entitled to

receive a non-cumulative dividend of 8%. After payment of that dividend the participating rights of the preference stock come into operation. It is entitled to a further dividend at the rate of 1% (but not exceeding 2% in all) for every sum equivalent to 1% on the preferred ordinary stock which may be paid as dividend on the deferred ordinary stock.

This sounds unnecessarily complicated and such provisions are unusual, but there is a reason behind it all. Prior to 1939 it was customary for this company to issue additional amounts of deferred stock each year, the amount of preferred ordinary stock remaining constant. Therefore, if the preference stock participated in direct relationship with a rate of dividend paid on the deferred ordinary, any marked increase in the amount of the latter in issue would tend to water down the value of its participating rights. By relating these to a stock more likely to remain unchanged in amount their intended value was correspondingly preserved.

Actually for many years the maximum rate of participating dividend has been earned and paid with a substantial margin. The participating preference stock has no right to participate in surplus assets. It is entitled to receive par and no more. Therefore the predominant strain in this stock is overwhelmingly that of a preference stock.

(b) *S. Smith & Sons (England) Ltd. Preferred Ordinary Shares of £1*

The senior class of capital is the 7½% cumulative preference share. After satisfying this preference dividend, the preferred ordinary is entitled to receive a non-cumulative dividend of 7%. After that the remaining profits belong half to the preferred ordinary and half to the deferred ordinary shareholders. This division does not necessarily mean equal rates of dividend, but that the total sums of money paid by the company in dividends on the two classes of stock (i.e. the *extra* dividend on the preferred ordinary and the *whole* on the deferred ordinary) should be the same. In so far as the share has the right to receive a non-cumulative dividend of 7% it is like a second non-cumulative preference share. In so far as it is entitled to share rateably in the full residue of earnings it is an equity share.

In such a case the determination of the predominant strain is capable of fairly precise calculation. If the price of the share is 70s. and if one could expect that a 7% non-cumulative second

preference share – without any participating rights – would be priced at 30s., then the share is to the extent of three-sevenths a preference and to the extent of four-sevenths an equity share. Such calculations are not just a theoretical exercise. Without some assessment along those lines it is difficult if not impossible to appreciate the real nature of the security.

The rights as to capital are not so important so long as the prospect of their coming into operation is remote. In the case of S. Smith preferred ordinary shares the assets are applied first in satisfying the preference shares at par, then the preferred ordinary shareholders up to £2 13s. 4d. per share – but no more – the equity rights of capital belonging solely to the deferred shareholders.

(c) *Barrow Hepburn & Gale Ltd. Participating Preference Shares of £1*

These shares are entitled to a 6% cumulative preference dividend and participate to the extent of receiving an additional $\frac{1}{4}$ % for every 1% paid in excess of 6% on the ordinary shares. The participation is limited to a total of 3%, making a maximum dividend on the preference of 9%.

For many years prior to 1946 the preference shares received 6%, but no more. For 1946 7% was paid and for 1947 the full participating preference dividend of 9% was paid. The amount of ordinary shares in issue in relation to the preference shares is not large, so that the latter shareholders would no doubt be on the alert in the event of any future proposal being made to increase the amount of ordinary capital.

(d) *Lancashire Cotton Corporation Ltd. 5% Non-Cumulative Preference Stock*

This stock is entitled to a non-cumulative preference dividend of 5%. It is convertible without payment into the same amount of ordinary stock at the option of the holder on one month's notice expiring on 31st March of any year up to and including 1951. So long as the right of conversion is not exercised the stock has no participating rights either as to dividend or capital. Once conversion has taken place the holder has no option to re-convert.

When the company was paying a dividend of 5% on its ordinary stock the holder had then no incentive to exercise his option to convert; the preference stock gave as good a return and had in addi-

tion priority for dividend. Later, when the ordinary dividend was raised to $7\frac{1}{2}\%$, preference stockholders by converting would have received a higher dividend, but would have incurred a greater risk. Only part of the holders actually exercised their option at this stage. Later, when the dividend was increased to 10% accompanied by growing confidence that the higher rate would be maintained, the incentive to convert became much greater. In such circumstances it was hardly worth while accepting only 5% on the preference stock, compared with 10% on the ordinary stock, in return for a greater measure of safety which was only likely to be tested in what appeared to be a remote contingency.

8 Nomenclature

It is necessary to devote a little space in order to attempt to explain the reasons for the varied nomenclature given to different classes of capital. This is also bound up with the larger question of what are the predominant motives guiding a company in the choice of different forms of proprietors' capital. Names by themselves may be very misleading. It is imperative to examine the provisions of each stock in order to know its real nature. An *ordinary* stock – especially when followed by a junior stock in the form of a *deferred* stock – may not have the remotest connection with an equity stock, e.g. Wall Paper Manufacturers Ltd. Ordinary Stock. A *preference* stock, on the other hand, may have every affinity with an equity stock, e.g. Jute Industries Ltd. Preference Stock.

As regards choice of class of capital by the company, the overriding decision should be to choose that type which is most appropriate to the nature of the company's business. Only too often that is not possible. Consideration has to be given as well to the terms upon which the company is most likely to be able to obtain subscription to its capital and to the desires and requirements of the type of investor who is likely to subscribe. The incidence of taxation is another factor of considerable importance. For example, a heavy distributed profits tax assessable on preference dividends, but not on debenture interest, would by itself encourage the raising of money by the issue of debenture stock rather than preference capital.

The specific names given to different classes of stock depend usually on the origin of the stocks in question. Preferred ordinary and deferred ordinary are names often given where one stock only

was originally issued and where subsequent division into two parts took place. Preference stock and ordinary stock would equally well define such relationship. There is no real distinction between preference and preferred, though the latter is perhaps more frequently used when the equity stock happens to be a deferred stock. *Guaranteed* stock was a name frequently given to the cumulative preference stocks of railway companies. The designations, *capital* stock, *consolidated* stock, or *stock* by itself are sometimes used as names for the equity capital. Of course, uniformity would be most desirable. It does, in fact, apply over by far the greater part of the capital of joint stock companies. The inconsistencies are not mentioned here in order to confuse, or to suggest that they are greater than actually exist, but in order to serve as a warning that the exact nature of a stock cannot always be deduced automatically from its mere name.

It has been assumed throughout this chapter that the rights of any class of proprietors' capital will be obtained and examined by reference to the original documents; and that is no doubt the correct approach for a text-book. In practice, however, reference books and statistical services are available which give an adequate summary of most of what is required. In this connection should be mentioned the Stock Exchange Official Year Book – an immense volume of over 3,000 pages – the Exchange Telegraph Company, and Moody's Services. Examination of some of the finer points is usually undertaken only by investment experts, the lay investor relying normally on the advice of his stockbroker.

CHAPTER 7

THE ISSUE AND EXCHANGE OF INVESTMENTS

I General Survey of Facilities

In the two preceding chapters the principal types of investment were described, particular attention being paid to their special features and to the methods by which yields should be calculated. Beyond mentioning that in many cases a market price existed, practically nothing was said about the processes by which investors obtained the actual ownership of their investments. This is the purpose of the present chapter.

There are two main processes of acquisition: initial subscription, or purchase. The second applies only to those investments which are transferable from one party to another.

The placing of money on deposit with banks, savings banks, building societies, etc., and its subsequent withdrawal is a simple operation. The title (meaning the legal instrument as evidence of ownership to the deposit) is an entry in the depositor's book or an acknowledgment or receipt made out in the name of the depositor. Deposits are not normally transferable. Withdrawal can be required at any time either on demand or on expiry of the requisite period of notice.

National Savings Certificates and Defence Bonds are obtainable by direct subscription to the Treasury; post offices, banks, national savings centres, etc., acting in the rôle of agents for the Treasury. In the case of National Savings Certificates each holder is given a registered number and his title consists of certificate(s) for the amount subscribed. National Savings Certificates are not transferable by sale to another person. Subscriptions to Defence Bonds are acknowledged by entry in the bondholder's book. The bonds may be transferred, but only by private arrangement between transferor and transferee; there is no recognized market for them.

Bills are orders for payment at a future date. When accepted they may be transferred by the process of discounting. Treasury bills can be obtained by subscription each day (tap issue), or by competitive tender every Friday (tender issue), for an amount the

limit of which is determined weekly by the Treasury. All bills where the creditworthiness of the debtor – that is to say the measure of his ability to honour his debt – is undoubted can be bought or sold freely as negotiable instruments in the discount market, the price being expressed in terms of the rate of discount. The buyers and sellers of bills include bill brokers and all kinds of banking institutions. The *market* does not consist of one particular place where buyers and sellers meet on the floor and transact business. It is wherever contact can be established; in bank parlours, in recognised meeting-places, and most frequently of all over the telephone.

Mortgages, loans, and bonds are negotiated either directly between borrower and lender or with the help of an agent. The appropriate document is usually prepared by a solicitor; it specifies the terms of the loan, names the property which is pledged, and is signed by the borrower. It is customary, though not obligatory, for the borrower to pay all the expenses relating to the drawing up and signing of the deed. The loan may be transferred from one lender to another by executing an instrument of transfer, though such cases are rather exceptional.

Government stocks, debenture stocks of boards and companies, and all classes of capital stock of public companies are – with a few exceptions – marketable on the Stock Exchanges. Except in the case of placings (which will be explained later), the buying and selling relates to investments already created. It does not mean that a purchaser of a company's stock pays money to that company; he pays it to the seller – and can only buy stock if a seller can be found. But before investments can become the marketable securities of a Stock Exchange they must first be created and original subscribers obtained. The originating processes will therefore be considered first.

2 The Financing of New Issues

A method frequently adopted for the purpose of inducing the public to subscribe to a new issue of stock is the advertisement and circulation of a prospectus. This is a highly important document and forms the basis upon which the investor agrees to subscribe.

Whether or not the disaster of the South Sea Bubble has placed on posterity the obligation to protect the unwary investor at all costs, it is a fact that a vast amount of thought has been given by company law reformers to the law relating to the issue of pros-

pectuses. The Report of the Committee on Company Law Amendment¹ under the Chairmanship of Mr Justice Cohen, and which was submitted in 1945, devoted more space to this question than to any other single subject. Penalties for the wilful making of untrue statements in a prospectus are very severe.

Before proceeding to examine the requirements of a prospectus the question may well be posed: What exactly is the aim of the law-makers in this connection? It is in no way to stultify the legitimate development of business; it is not to side with the investor to the extent of obliging the promoters to decry their wares; it is not to approve some types of business or disprove of others. It is to ensure that the intending investor has a fair chance of knowing all the relevant facts relating to the investment offered for subscription and to have these facts presented in such a way as to minimize the possibility of evasion or distortion and to prevent the obtaining of money by false pretences or by misleading omissions.

When a public issue of stock is under contemplation the usual procedure is for the concern requiring the money to employ the services of an intermediary. In the case of government, local authority, and public board issues, the intermediary is usually a bank acting on behalf of the borrower. Where debenture stocks and preference and equity stocks of a company are concerned the company will as a rule employ the services of an intermediary in the form of an *issuing house*. These people are specialists in the financing of new issues. The issuing house may be a firm where such business is their sole function. Or it may be a merchant banking house where new issue finance forms a part only of their total general business. Some stockbroking firms either act in conjunction with an issuing house or fulfil themselves the function of an issuing house.

The services rendered by issuing houses are many and varied, but there are two of prime importance. The first is to give advice on the terms of issue, especially on matters of price; the second is to ensure that the required amount of money is subscribed. The latter is usually done in the form of a guarantee or underwriting contract, which itself is frequently the subject of sub-underwriting contracts made between the issuing house and its clients, *qua* investors. Underwriting is a procedure whereby the underwriter guarantees to subscribe for that part of an issue of stock which is not subscribed for by the public. He, in effect, assumes a contin-

¹ Cmd. 6659.

gent liability to subscribe and in return for this he is paid a commission based on the amount of stock guaranteed or underwritten – not on the amount he may ultimately have to subscribe for. If the issue is fully subscribed the underwriter is accordingly relieved of his liability.

The issuing house may act either as an agent or a principal. In the former case it performs its services for an agreed fee. In the latter case it subscribes to the whole issue of stock and then resells to the public, receiving its remuneration by way of the profit represented by the difference between the buying and the selling price. The resale need not necessarily take place immediately, but when it does it is then called an *offer for sale* and, if for public subscription, it is subject to the same laws as apply to the issue of prospectuses. The remuneration of issuing houses is not based on any scale fee, nor is there any fixed margin of profit between purchase price and resale price. It depends on several factors such as the amount of the stock to be issued, the length of time taken in preparing the issue, the risks deemed to be run, the condition of trade in general, and whether the issuing house itself undertakes to bear any of the printing and advertising expenses incurred in the issue.

The purpose for which capital is required will determine the precise amount to be raised; the nature of the undertaking will influence the choice of the type of stock to be issued. The preparation of a prospectus may take a great deal of time. The legal and accountancy work may be far-reaching and, if property is involved, the report of a qualified valuer is usually required. It is not infrequent that the actual price of issue is one of the last matters to be fixed, since this depends upon the conditions ruling immediately prior to the date of issue. When everything is ready the underwriting contract, if the issue is being underwritten, is signed and arrangements probably made for sub-underwriting. The contract specifies the rate of commission payable to the underwriters and the period for which the guarantee applies.

3 Prospectuses and Offers for Sale

(a) *Application and Allotments*

Every prospectus (or offer for sale) issued for the purpose of inviting subscription from the public is accompanied by a form of application. This, together with the information in the prospectus, specifies the terms upon which application and allotment are to be made. The terms comprise: the price of issue; whether paid for in

instalments or in one payment; the time and date when the lists of application open and close; to whom application is to be made and the name of the bank(s) who will receive payment. The investor applies for the quantity he desires 'upon the terms of the company's prospectus (or offer for sale)', encloses a cheque for the amount due on application, and requests that he be allotted that quantity or any lesser figure. He also authorises the company to register himself as a holder of the stock.

If an issue is received favourably by the public it often happens that the total quantity of stock applied for is much in excess of what is offered. Applications must therefore be scaled down. This is done either on a strictly *pro rata* basis or preference may be given to applicants for smaller amounts. For example, amounts up to £100 might be allotted in full; those between £101 and £500 might receive 75%, and all in excess of £500 might be scaled down further to 50%. If the applications are overwhelmingly large, allotment is sometimes done partly by scaling down and partly by elimination by a system of ballot. If any preferential allotment is to be reserved for a pre-selected group of applicants, this fact must be stated in the prospectus. Whatever method is chosen for scaling down applications the responsibility for the decision lies with the directors – though they will probably be guided by the advice of the issuing house or bank.

The normal practice is to offer stock at a fixed price, but in a few cases, especially where a public authority or a company supplying a public service is concerned, an *issue by tender* is made. Here, a minimum price is fixed and subscribers apply for the stock on the basis of a price (not below the minimum price) which in their judgment is most likely to secure allotment on favourable terms. Competition from other subscribers must, of course, be borne in mind. In reality, the stock is put up for a concealed auction.

When the stock has been allotted, whatever the manner of issue, each successful applicant receives an interim receipt in the form of a letter of allotment together with the return of any excess of application money in the event of the issue having been oversubscribed. The allotment letter forms the holder's title to the stock until such time as it can be exchanged for a stock certificate. An allotment letter may be split into smaller amounts and the holder may transfer in favour of another party by signing a form of *renunciation*. The operations of splitting or renouncing are usually allowed only once.

Most stocks which are offered to the public for subscription are subsequently marketable on the Stock Exchange. Applicants to new issues are as a rule very much concerned with the question as to whether or not *permission to deal* on the Stock Exchange will be granted. The Stock Exchange Council, in whose hands the responsibility for the decision rests, scrutinises with great care every application for permission to deal, but since its decision will depend not only upon what is in the prospectus, or offer for sale, but also upon the manner of subsequent allotment, the decision cannot be reached until after the subscription lists have been closed and the allotment letters posted.

Every prospectus and offer for sale must state whether or not permission to deal is being sought and this is deemed to form one of the conditions upon which application is made. Should permission to deal not be granted the applicant, prior to the coming into operation of the Companies Act, 1948, had no redress against what he considered to be a denial of an expected privilege. That Act, however, gave the following measure of protection. No delay beyond three days after the date of the first issue of the prospectus is allowed in applying for permission to deal. If the time limit is overstepped or if, within three weeks from the date of the closing of the subscription lists, application is refused (unless extended for a further period of three weeks by the Stock Exchange), then the application money must be refunded.

(b) Information

Every prospectus and offer for sale must give the minimum information required by law. It is customary, however, to go further and to give a more complete picture than legally required. To ensure that the public shall have a reasonable opportunity of examination, the particulars must be published or circulated not less than two whole days prior to the opening of the subscription lists.

The necessary information can be considered most conveniently under the following sub-headings: directorate; capital provisions; purpose of issue and general information; auditor's report; provisions relating to non-company issues.

(1) *Directorate.* The names, descriptions, and addresses of the directors or proposed directors must be given; also the names and addresses of the auditors. It is usual to give as well the names of the company's bankers, solicitors, stockbrokers, and the name of the issuing house (if any) concerned. The qualification of a director (as regards his holding of stock in the company) and the basis of

directors' remuneration must be stated. Full particulars must be given of the nature and extent of the interest, if any, of every director in the promotion of the object for which subscription is invited; that is to say, if the issue is for the purpose of acquiring property, the interest (e.g. as vendor), if any, of every director in such property must be stated. If, on the other hand, an offer for sale is made the interest, if any, of every director in the stock being offered must be stated, whether this interest occurs through ownership or as a result of a service contract with the company or in any other material way. It is usual to give adequate information about any contracts under which one or more directors have agreed to serve for a period of years in the capacity of managing director(s).

(2) *Capital Provisions.* The prospectus will, of course, state the amount of stock to be issued, the price of issue, and the manner in which the subscriber makes payment. The amounts of the authorised and issued share capital of the company and figures for loan capital in the form of mortgages and debenture stocks will also be shown. Unless the share capital consists of only one class, the respective rights of each class as to dividend, capital, and votes must be shown. Particulars must be given of any options which may have been granted to persons to subscribe to future issues of capital on prearranged terms. This is important, since such options, if valid for a long time or if exercisable at low prices, may be extremely valuable to their holders, and consequently may well prejudice the rights of those of the public from whom subscriptions are invited.

It is necessary also to state the amounts of any share capital and debenture stock which have been offered for public subscription within the two preceding years; particulars must include not only the amounts offered, but the amounts subsequently allotted and the sums received in payment. Such information is not only of general interest to the public, but prevents the oversight of any unsuccessful attempt to raise money by public issue.

The Cohen Committee on Company Law Amendment considered very carefully the question of requiring that particulars should be given not only of the borrowing powers of the issuing company and of any of its subsidiary companies, but also of any power to guarantee the payment of capital and interest in respect of other companies. Since the importance of any such powers would vary considerably, it was suggested that it was more appropriate that the Stock Exchange Committees should take such

factors into consideration when deciding whether or not to grant permission to deal. The Committee expressed the view that 'the matter is one that can be more suitably covered by the flexible machinery of the Stock Exchange Committees than by rigid provisions in an Act of Parliament'. Indeed the disclosure of such facts is now an invariable requisite to the granting of permission to deal.

(3) *Purpose of Issue and General Information.* Any investor considering the merits of a new issue of capital is naturally interested in the nature of the business undertaken and perhaps more important still in its prospects. While it is only legally necessary to give bare facts relating to the purpose for which a new issue of capital is being raised, any prospectus or offer for sale is of limited value unless it gives an informative description of the business. In the case of an offer for sale the chairman of the company usually supplies the desired information in a letter addressed to the issuing house. Where an issue of stock is made by direct subscription the prospectus usually contains a synopsis of the company's business and prospects. Although this information is not statutory, the directors are held responsible for the accuracy and good faith of any statement made.

One of the items of statutory information required is the minimum amount of money to be raised in order to: provide the purchase price of any property purchased or to be purchased; to defray the expenses of the issue; to repay any moneys borrowed for the foregoing purposes; and to provide working capital. Failing the subscription (by the public or by the underwriters) of this minimum amount no allotment can be made. Also required are the names and addresses of the sellers of any property purchased or acquired by the company and which is being financed by the proposed issue of stock; the amount or estimated amount of preliminary expenses; and the amount paid within the two preceding years by way of commission for subscribing to or agreeing to procure subscriptions to the issue.

Full particulars must be given of the dates and parties to every material contract entered into within the preceding two years and not being a contract entered into in the ordinary course of the company's business. A reasonable time and place for the inspection of such contracts must be provided. These contracts may be very extensive and the particulars may occupy a considerable space in the prospectus. They are often relegated to small print and con-

tain some information of no account and some of vital importance. In order to help to draw attention to the latter the Companies Act, 1948, required further that the *general* nature of all such contracts should be stated. This is particularly important in directing attention to the names of the vendors concerned in an offer for sale and to the prices received by them.

(4) *Auditors' Report.* It seldom happens now that subscription to an entirely new venture is invited. In most cases the company or, in the case of a newly-formed holding company, the operating company or companies have been in existence for several years and here company law stipulates that a minimum amount of information regarding the financial history of the concern must be given in a prospectus. While it had been the practice for some time for many companies to volunteer a lot of additional information, the Companies Act, 1948 provides that the previous minimum requirements should be considerably augmented.

The requirements take the form of a report signed by the company's auditors and which gives the following information: profit and loss accounts for the previous five years and dividends paid; the balance sheet as at the date up to which the last accounts were made; if any of the proceeds of the issue of stock are to be applied in the purchase of another business then similar figures are to be given for that business; where subsidiary companies are involved, the profit and loss accounts and balance sheets of each company must either be shown separately or dealt with as a whole (i.e. consolidated).

(5) *Provisions Relating to Non-Company Issues.* Prospectuses of issues of government and public authority stocks are usually much shorter in form than in the case of public companies. The following information must among others be given; the amount of the stock and the precise terms of redemption; the price of issue and the manner of applying for the stock; the authority by virtue of which the issue is made together with the name of the fund out of which interest and capital are to be paid; whether payment of principal and interest is guaranteed and if so by whom.

(c) *New Issues by Way of Rights to Existing Members*

A method of issue frequently employed by companies raising additional capital is to give their existing members a pre-emptive right of subscription. Usually the price of issue is lower than the market price, or expected market price, and the rights to subscribe

are normally given to members on a basis *pro rata* to their existing holdings. If members do not wish to take up their rights, facilities are available for selling the rights by renouncing a *provisional allotment letter*.

One considerable advantage to the company of this form of issue is that the requirements of a prospectus need not be met in full and indeed may be abbreviated in all cases where the offer of the stock is confined to existing members or to existing debenture stockholders of the company, or relates to shares or debenture stocks which are in all respects uniform with shares or debenture stocks previously issued and already dealt in on a Stock Exchange.

4 The Stock Exchange

The Stock Exchange is a market where stocks and shares are bought and sold. Its major function is to deal in many securities of public authorities and companies where the investments have already been created and initial subscribers obtained. But it serves also as a direct channel through which flow subscriptions to new issues of capital (the method of *placing* is summarised on page 108); and in all cases of new issues the machinery of the Stock Exchange is of the greatest value in providing a gauge for the appropriate price of issue.

It may save possible misunderstanding if it is stated at the outset that the Stock Exchange by itself does not determine prices. It reflects and records the prices at which its clients – the public – are prepared to buy or sell. Members of the Stock Exchange are not the prime initiators of price fixing, but rather the passive recorders of what public opinion thinks fit. It is necessary to make this point because it is sometimes thought – and quite erroneously, too – that the rise or fall of prices on the Stock Exchange is a device primarily designed to suit the wishes of members.

The Stock Exchange is a market in the true sense of the word, the laws of supply and demand operating most of the time. The level of prices is influenced by the relationship between supply and demand and that in turn is influenced by the level of prices. If there are more buyers for a particular stock than sellers of it, the price will tend to rise; but this very raising of price will in its turn encourage more sellers and fewer buyers. Whether prices change little or much the tendency is always in search of equilibrium.

As would be expected the London Stock Exchange takes a special place among the Stock Exchanges of the country. Those in

the big cities such as Birmingham, Edinburgh, Glasgow, Liverpool, Manchester, etc., are represented on the Council of Associated Stock Exchanges. Stockbrokers in some of the smaller cities and towns are members of the Provincial Brokers' Stock Exchange. Most Stock Exchanges have independent constitutions and have power to frame their own rules and regulations.

The fundamental basis of every Stock Exchange is that of an auction market. Every seller aims at selling his stock to the highest bidder: every buyer aims at buying from the cheapest seller. But the method of procedure varies in different Stock Exchanges. London is unique in that its members perform one (and only one) of two distinct functions: broker, or jobber. The broker is the person with whom the public does business. The jobber is the market man, confining his activities to a limited number of investments in respect of which he is prepared to transact business either as a buyer or as a seller and the brokers, acting for clients who wish to buy or sell, come to him.

The broker receives his remuneration in the form of commission. The jobber, on the other hand, makes his profit (or loss) in the form of the difference between his buying and selling prices. This is known as the *jobber's turn*. Brokers and jobbers may not work in partnership.

On the New York Stock Exchange there are no jobbers. Brokers who want to deal in any particular stock assemble at a *post* and buyer is brought in touch with seller by open auction. On the British Stock Exchanges outside London a rather similar but less vociferous procedure is adopted. The use of daily price lists and marking boards facilitate the transaction of business on any Stock Exchange and a multitude of private telephones lines link exchanges with each other and especially with London.

Something should be said at this stage about the constitution of the London Stock Exchange. It has no memorandum and articles of association. The instrument by which the terms of membership are defined and under which the property is owned is a deed of settlement. The number of members is limited. They are elected for one year only at a time and all who desire to continue their membership are obliged to apply annually for re-election. The qualifications for membership depend almost entirely on financial integrity. Because of the limit to the number of members each new candidate must first acquire a *nomination* from a retiring member. This nomination has a monetary value, its price depending largely

upon prevailing conditions. The lowest price paid in recent years was about £45 in 1948 against a high level of around £2,000 in 1937.

The candidate must be supported by sponsors who are themselves members and who are prepared to guarantee his liabilities up to a limited sum. He must pay an entrance fee of 300 to 600 guineas, an annual subscription of 50 to 100 guineas, and must own one Stock Exchange Share. Since this Share is not entitled to receive any dividend it is more in the nature of a membership card than an investment in the normal sense of the word.

The direction and management is entrusted to a Council consisting of not less than thirty and not more than thirty-six members. These are elected annually by ballot in which all members are entitled to vote – although until 1954 Foundation Members (i.e. those who held office as Trustees and Managers prior to alteration of the deed of settlement in 1948) are subject to a different procedure. The Council, elected be it noted on a democratic basis, has full authority over the election of members and has effective jurisdiction on matters of business conduct. It frames the rules under which business may be transacted, fixes rates of commission, acts as sole arbiter in all disputes falling within its jurisdiction. Although appointed by and accountable solely to the members of the Stock Exchange, the members of the Council have for many years been conscious of their wider responsibility. They have not sought to serve sectional interest at the expense of others but have pursued – and successfully, too – an enlightened and broad-minded policy.

The day-to-day activities of the London Stock Exchange can perhaps be described best by examining from start to finish the process of a transaction. The first step is for the investor to get in touch with a firm of stockbrokers; either direct or through the agency of a bank, a firm of solicitors, or a firm of accountants. Most investors (or the agents acting for them) have their own special choice of firm or firms with whom they transact business. The rules of the Stock Exchange do not allow firms to advertise, but a list of their names may always be obtained from the secretary. Stockbroking firms now fulfil two main functions: the actual business of buying and selling; and the giving of advice. The latter function has grown enormously in recent years and many firms employ a number of persons specially skilled in the study of statistics, company reports, etc.

Let it be assumed that the investor, either as a result of his own decision or because of advice given to him through his stockbroker, is now in a position to give his order; say, for example, he wants to buy £5,000 Courtaulds Ordinary Stock. He is told that the stock is quoted at 40s. to 41s. per unit of £1 stock (i.e. the jobber is prepared to buy at 40s. and to sell at 41s.) and he will no doubt be asked by his broker whether or not he wants to name a price limit. This question is important. If a limit of 41s. is fixed and if in the meantime the price of the stock rises and the broker finds he cannot get the stock cheaper than 41s. 1½d. he will have to communicate again with his client. This means further delay and if the limit is subsequently raised to 41s. 1½d. there is still a risk of the same sort of thing happening again (e.g. the price might have risen further to 40s. 3d. to 41s. 3d. by the time the broker returns to the market).

As a rule it is best for the client to give his broker some reasonable latitude as to price limit, unless, of course, there is little margin left. The actual dealing between broker and jobber is a matter of judgment, skill, and sometimes finesse. The broker is therefore placed in a more favourable position to deal to his client's best advantage if he has been taken fully into his confidence. Let it be assumed therefore that a limit of 41s. 6d. has been agreed.

The broker now proceeds to carry out his instructions. He will either go into the market himself or send his *dealer*. Many firms employ one or more dealers whose sole job is that of buying and selling in the market; they are not concerned with interviewing clients or with corresponding with them or with office routine. Their job is to have their fingers on the pulse of the market and to develop a sixth sense as to what is happening. There will no doubt be several firms of jobbers who *make a book*, as it is called, in Courtaulds. The prices which each will quote may vary slightly one from the other. The broker will ask not only what is the quotation but also the size of the market; that is to say, in how many £1 stock units the jobber is prepared to deal. He obtains, say, three separate quotations 40s. 3d. to 40s. 9d. in £2,000 stock, 40s. 6d. to 41s. in £2,000 stock, and 40s. 3d. to 41s. 3d. in £5,000 stock.

Now, he can execute his order straight away by buying £5,000 stock at 41s. 3d., or he can make a start by buying £2,000 at 40s. 9d. and endeavour to complete the balance of the order later on. It is here where the broker's judgment comes in. Until he has actually dealt the jobbers do not know whether the broker wants to buy or to sell. But, if the broker buys £2,000 stock at 40s. 9d.

and continues to ask for quotations in an endeavour to complete his order, one jobber at any rate and perhaps later on others as well know him as an unsatisfied buyer; this will make his task more difficult. But jobbing firms compete one with the other and most would prefer to transact a large volume of business at a small margin of profit rather than little business at a large margin of profit. So the broker is in that way protected against any serious exploitation of his weakened tactical position.

The decision as to what course to adopt will be influenced by the view which the broker takes on the outlook for the market in general and for Courtaulds stock in particular. If he expects a rising tendency he will probably buy the £5,000 stock at 41s. 3d. and complete the deal straight away. If, on the other hand, the market seems to him to have a weak undertone or to be at best merely steady, he would probably buy £2,000 at 40s. 9d. and hope to buy the balance later on.

The deal between broker and jobber is a verbal one, both merely making an entry in their notebooks. The following morning their clerks meet to check the bargain. The price will probably be recorded on the daily marking boards and if so will appear later in the Daily Official List. This important list gives quotations for all securities officially dealt in on the London Stock Exchange, together with prices at which business was actually transacted; it is usual but not obligatory to *mark* bargains, but only one mark appears in respect of all bargains done at the same price. The Official List quotations are usually wider than those quoted by jobbers; for example, the comparable Official List quotation for Courtaulds Ordinary Stock would probably be something like 40s. to 41s. 3d.

The broker sends his client a contract note showing that he is under contract to implement the deal he has carried out. The contract note states that the broker's firm has purchased for and on behalf of his client £5,000 Courtaulds Ordinary Stock at 41s. 3d. The cost is shown, together with the expenses payable. Commission is chargeable at rates fixed by the rules of the Stock Exchange, and few indeed are the cases where the broker has any real discretion in this matter. Rates of Commission vary not only according to the price, but also according to the nature of the stock concerned, whether it is government stock, registered stock, shares or units of stock, registered or bearer. For transactions over and above a certain level a reduced commission may be charged, pro-

vided the commission is not divisible with an agent. For very small transactions, a minimum commission is chargeable irrespective of the precise type of stock.

All deeds, with certain exceptions, transferring stock from one owner to another must bear an Inland Revenue stamp. The exceptions are British, Dominion, and Colonial Government and Municipal securities. The stamp duty is assessed on the amount of money involved in the transfer and prior to 1st August 1947 was at the rate of 1%, after which date the rate was raised to 2%. The stamp duty is payable by the purchaser. The two other items of expense, both of which are of the order of small quantities, are the contract stamp which is affixed to the contract note, and the registration fee payable to the company for registering the stock in the name of the new owner.

The contract note will specify the date of settlement of the bargain. In the case of all British, Dominion, and Colonial Government and Municipal securities settlement is for *cash*, which really means forthwith. In the case of other securities settlement will be due on the date of the next Stock Exchange fortnightly account.

Prior to that date the broker will pass to the jobber a ticket giving his client's full name and address, the amount of stock bought and the amount of purchase money. Through the means of the Settling Department and the jobbers the names of sellers and buyers are brought together. When settlement is due the broker will take delivery of the stock in the form of transfer deed(s) signed by the seller(s) and either accompanied by the appropriate stock certificate or bearing a certification on the transfer deed that the certificate has been deposited with the Share & Loan Department of the Stock Exchange. The broker has then received good delivery and claims the amount due from his client, passing to him at the same time the stamped transfer deed(s) for his signature. When these formalities are completed the broker presents the deed(s) to the registrar of the company and receives in due course a certificate for the stock in the name of his client.

The procedure for selling is very similar, but no transfer stamp or registration fee is payable by the seller and expenses in the way of commission and contract stamp are, of course, deducted from the proceeds of sale. The client must deliver prior to the date of settlement his certificate or other document of title to the stock.

It will be realized that some time may elapse between the execution of an order on a Stock Exchange and the act of transferring

the names on the registrar's books. This may prompt the question as to what happens if in the intervening period a payment of interest or dividend falls due. There is never any doubt as to who is entitled to that payment. In the first place a date is fixed by the Stock Exchange authorities as to when a stock is quoted *ex interest* or *ex dividend*. This takes place usually about a fortnight to a month prior to the due date. Prior to the date fixed by the Stock Exchange the stock is *cum interest* and the interest payment in question belongs to the buyer. After the stock is quoted *ex interest* it belongs to the seller.

In the second place, the register of stockholders is usually closed for a short period – not exceeding a fortnight – during which time interest and dividend warrants are prepared. If, in fact, because the transfer deed could not be lodged in time payment is made direct to a seller who had sold his stock *cum interest*, then the buying client's broker is entitled to claim such payment from the seller's broker.

It was said earlier in this chapter that the major function of the Stock Exchange is to provide a market for stocks and shares already created and that in some cases it is directly concerned with the task of finding initial subscribers. This latter function relates to the operation known as *placing*. Instead of a new issue of stock being offered to the public by way of published prospectus or offer for sale, it may be subscribed for by one or more firms of stockbrokers partly for distribution among their own clients and partly for general distribution through those jobbers who are expected to deal in the stock.

At one time, *placing* was specially favoured as a method of issue by those who wanted to raise capital, since, although the Stock Exchange authorities insisted on the circulation of certain information regarding the issue in question, the requirements were not so comprehensive as in the case of public prospectuses. In 1947, largely as a result of action by the Stock Exchange Council, the requirements as regards published information were put on the same level as for prospectuses.

Placings had sometimes been subject to censure for the following reason. If the new issue of stock was likely to be popular, and so command a premium over its issue price, there was always a risk that as soon as dealings commenced the benefits might go to a privileged few instead of the opportunity being available to a wider circle of investors.

The expenses of issue in connection with a placing may, however, be considerably less sometimes than in the case of a public issue by prospectus or offer for sale. The amount of stock taken up is immediately equated to the amount offered; all the immense clerical work involved sometimes in dealing with oversubscriptions, scaling down of allotments, and partial return of application money is avoided. Thus provided any special privileges are not abused the method of placing may have considerable advantages, particularly when the size of issue is relatively small.

INTRODUCTION TO PUBLIC FINANCE

I Introductory

The importance of this subject requires no emphasis. Its intrusion into the daily lives of all of us is only too apparent. It is perhaps one of the ironies of the time that the frustration, the annoyance, and the resentment caused by the current high levels of taxation do not prompt a more determined effort to restrict the encroachment of public finance on the private purse. It must be admitted that the most probable reason for this lack of vigour is that the majority feel unable to appreciate fully what is involved.

The nation's finances have become so complicated, the purposes which they are deemed to serve have enlarged to such an extent, that it is not surprising that the experts themselves are confused. Several praiseworthy attempts have been made to educate and elucidate by means of Government White Papers, etc., and no doubt this process will continue.

The impact and influence of government finance is no new thing. The tax-gatherer in Biblical days seems to have caused about as much annoyance then as the receipt of the buff envelope does to-day. The political consequences of taxation since Elizabethan times have been far-reaching. Even as far back as the days of Edward I statutes were made forbidding the Crown to levy taxes without the consent of Parliament. Charles I chose to ignore these when he levied ship-money in time of peace. After the benefit of every doubt had been given and only when it became apparent that the King intended to flaunt the authority of Parliament did John Hampden make his famous stand and precipitate the clash which started the Civil War.

In the next century the revolt of the American Colonies and the War of Independence were to a great extent prompted by the imposition of taxes by the Government of George III. The taxes imposed under the Stamp Act, the Sugar Act, and the Tea Tax were all vigorously resisted. Not only was it considered unfair that taxes should be paid by those who could not rely on receiving full benefits in return, but there arose a passionate acceptance of the dictum that there should be 'no taxation without representation'.

Wars are great consumers of public money. The Napoleonic wars saw the introduction of income tax in 1799. It was confined to wartime purposes and did not become a permanent feature of public finance until reintroduced by Peel in 1842. The years of comparative peace which lasted for nearly a century following the battle of Waterloo imposed obligations by way of contribution to public funds which by modern standards seemed fantastically small; yet they were scrutinized and debated with no less fervour than in the case of the larger impositions of modern times.

There is often an abject fatalism about the payment of taxes of any kind. It is considered an unavoidable evil which the citizen feels powerless to influence in any material way. It may therefore serve more purposes than the purely instructive one to examine first the fundamental aim of public finance in its broadest aspect.

2 Purposes of Public Finance

Leaving aside for the moment the question of the extent of government intervention in the life of a community, and assuming that everything that could possibly be undertaken by private enterprise in a modern state were undertaken in that way, there would still remain several matters which by their very nature could only be administered by the state: legislation, justice, defence, police, and highways (though these are often made the responsibility of local authorities), diplomatic and consular services, etc. For these absolute essentials money would have to be raised by some form of levy on the community. In such circumstances the payment of taxes could then be described correctly by the dictum that a person should pay the minimum amount necessary in order to safeguard his property and rights and the enjoyment of the remainder of his income.

In addition to these essential functions of government there are certain services which it is customary for the state or a local authority to operate in whole or in part. These include the post office, education, and social security services such as health, pensions, family allowances, unemployment relief, disability benefits, etc. These services may be financed by general taxation levied on the whole community, or by contributions which bear some direct relationship to the benefits expected, or by a combination of each.

Most nations are burdened with a national debt and many have ministries or public departments concerned with the promotion

and safeguarding of industry, commerce, agriculture, and overseas trade. The service of the national debt must, of course, be provided for out of general taxation. The departments of trade and agriculture, although concerned at times with sectional interests, are responsible to the community as a whole and look to the general revenues of the country to pay for their cost of administration.

There remain to be considered now the finances relating to the industries and services in the actual ownership of the state. In some countries this may be a matter of negligible proportion: in others a matter of prime importance. The first thing to note here is that state ownership of industry, and of services such as the post office, vests in the state assets which are themselves directly capable of producing revenue. The cost of acquisition will, it is true, have placed on the administering body an obligation to pay interest on the debt involved, but the national finances will be concerned only with the extent to which the annual service of the debt falls short of or exceeds the revenues of the nationalized undertaking – in other words, with its net profit or loss.

In former times the fundamental conception of public finance was for the state to determine the nature and extent of the services it thought proper to administer and decide then on the best method of raising the necessary revenue. The modern conception extends far beyond this. Public finance is now no longer concerned solely with the raising of revenue, but provides as well a method by which the income of the community can be redistributed and the economic development of the nation influenced.

It is perhaps of interest to give in abbreviated form the four main principles of taxation as stated nearly two centuries ago by Adam Smith:

(a) Subjects ought to contribute as nearly as possible in proportion to their respective abilities.

(b) The tax payable should be certain, not arbitrary, readily calculable, and easily understood.

(c) The tax should be levied at the time and in the manner most convenient to the contributor.

(d) The cost of collection should be reduced to a minimum.

Although applicable to an age that is past, there is still much that is sound in these principles. In modern times many new criteria have crept in; not only the ability of the tax-payer to pay, but his basic needs, his family status, the manner of the spending of his

income, etc.; and the ugly phrase 'political expediency' cannot unfortunately be excluded.

3 Revenue and Expenditure Account

The revenue and expenditure accounts of the national exchequer are made up annually to the 31st March. A weekly statement is published showing cash receipts into and cash payments out of the exchequer. Chief public interest is, however, centred in the Chancellor of the Exchequer's annual budget and in his proposals for any changes in taxation. As might be expected, the constitutional machinery for dealing with the nation's finances is a somewhat involved process and it is only proposed to mention here some of the fundamental points.

On money matters the House of Commons is supreme. The House of Lords cannot effectively reject or amend a money bill. At the beginning of each parliamentary session the House of Commons sets up two financial committees, the Committee of Supply, and the Committee of Ways and Means, each comprising all members of the whole House and sitting under a chairman instead of the Speaker. One of the purposes of the former committee is to vote the supply of sums of money for the services, departments of state, and others; the main purpose of the latter is to provide the ways and means of obtaining the necessary money.

All the revenue and the proceeds of loans and other public receipts have to be paid to an account known as the Consolidated Fund. Permanent authority exists for the payment out of this account of what is known as the Consolidated Fund services. These include national debt charges (interest, maturities, and sinking funds), the King's civil list, the salaries and pensions of the judges, and certain other items; and are thus removed from the arena of annual parliamentary debate.

Other outgoing payments, e.g. the *supply* services in respect of each ministry and department, receive their votes from the Committee of Supply and legislative sanction for the payment out of the Consolidated Fund is by means of an Appropriation Act. The Comptroller General of H.M.'s Exchequer and Auditor General of Public Accounts is responsible to Parliament for seeing that no payments are made out of the Consolidated Fund which exceed in total the sums voted by Parliament. Thus, while it is hardly true to say that Parliament actually controls the allocation to and the

spending of money by each ministry and department, there is certainly opportunity for questioning and debate. Furthermore, the Public Accounts Committee – a small non-party committee set up by Parliament – stands ready to report on any cases of irregularity or flagrant extravagance, its reports being laid before Parliament.

The authority for the raising of revenue is the Finance Act which is passed each year by the end of the summer. This has the effect of confirming or reimposing (as the case may be) existing taxes and duties; it also gives legislative sanction to new taxation proposals made by the Chancellor of the Exchequer in his budget speech.

4 The Budget

Before the close of every financial year (31st March) each ministry and department prepares estimates of its requirements for the ensuing year. These estimates are scrutinized carefully by the Treasury and opportunity is given for each to be debated by the House of Commons sitting as Committee of Supply. Estimates are also prepared for the Consolidated Fund services. The Chancellor of the Exchequer is then possessed of estimates of all anticipated expenditure during the ensuing financial year. He is provided also with estimates of revenue on the basis of existing taxation, with estimates of income to be expected from miscellaneous sources, and with estimates of the effect of any alterations in taxation which he may have in mind.

He is then in a position to present his budget. He reviews the finances of the nation, compares the estimated revenue on one side (based on existing taxation) with the estimates of expenditure on the other, and states his proposals for alterations in taxation. These proposals are submitted to the House (sitting as Committee of Ways and Means) and are usually passed on the same day. This method of giving immediate effect to new taxation proposals has obvious advantages. If they had to await the subsequent passing of the Finance Bill before being imposed the opportunities for anticipation would be enormous – particularly in such cases as beer and tobacco duty, purchase tax, etc.

The Finance Bill is presented shortly after budget day and in its passage through the House is subject to debate and amendment. The actual drafting of taxation laws is a difficult and complicated matter and minor amendments are frequently agreed to during the

debates, most being for the purpose of removing ambiguities and facilitating administration.

It will be noted that the procedure in the case of Great Britain is to determine first the size of the expenditure and then to find sufficient revenue to provide the necessary money. It is worth while contemplating the effect of proceeding the other way round; to determine first what revenue the country could reasonably expect to raise and then to scale down the requirements of the spending departments (other than the Consolidated Fund services) if these exceeded the expected revenue.

It might be thought that the British system would lead to excessive demands on the exchequer. The defence against this risk is the time-honoured and effective system of Treasury control. All estimates, requests for votes of supply, and the actual spending of money appropriated to each ministry and department, are scrutinized closely by the Treasury. This safeguard is considered so adequate that estimates and votes of supply are invariably approved by the committee and the subsequent Appropriation Acts automatically sanction the full amount of money needed. On the other hand, in the U.S.A. the Appropriation Committees there conduct thorough investigations into departmental estimates and a scaling down through refusal to appropriate the full amount requested is by no means exceptional.

The revenue and expenditure accounts of the national exchequer represent cash transactions. The annual balance, the surplus or deficit, is in no sense a profit or loss account. No value is placed – or indeed can be placed – on the nation's liabilities or assets at the beginning and at the end of each financial year. What can be done, however, by a critical examiner is to earmark any non-recurring items which may be included in the revenue and expenditure accounts; what is left after excluding such items may then give a much more realistic measure of the state of the national exchequer.

5 Revenue Items

As was stated earlier in the chapter the original purpose of taxation was to raise revenue. Other purposes have since intervened, including the deliberate aim of redistributing personal incomes (to achieve greater equality), the safeguarding of industry, and the promotion of economic policy; these have all grown in importance relative to the original purpose. The two departments responsible for the collection of the major items of ordinary

revenue are the Board of Inland Revenue, and the Board of Customs and Excise.

(a) *Inland Revenue*

The principal personal taxes are income tax, surtax, and estate and legacy duties (often referred to simply as death duties). Income tax is based on a *standard* rate, combined with offsetting allowances dependent upon marital and family status. *Reduced* rates apply to lower ranges of income. There are also provisions whereby earned income is taxed rather differently from unearned income. Surtax is levied on incomes in excess of a certain figure and different slices of income are taxed at steadily increasing rates. The combined personal taxes payable in the form of income tax and surtax fall within the category of *progressive* taxes; that is to say, the percentage of income payable in taxes increases with the size of the income. As a consequence recipients of large incomes pay in combined taxation a high percentage of their income. On the other hand, incomes below a certain level are completely free of assessment to tax.

Death duties are a tax on capital. The rates vary according to the size of the estate; they also are progressive taxes. The receipts from death duties are treated as revenue items in the exchequer accounts, although payment of the duties is frequently made possible only through the sale of capital assets.

For many years companies and other business associations operating for profit paid income tax at the same standard rate as that applicable to personal incomes. This is justified more as a matter of convenience and long practice than of pure logic. In time of war, when exceptional industrial activity brings an expansion in the profits of many companies, a special tax has been imposed to offset excessive profits. Although the excess profits tax imposed during the second world war has been removed, there are now signs that some form of taxation in addition to income tax is likely to become a permanent feature of company taxation. Not only is this required as a contribution to the national exchequer, but it may be used for other purposes as well. For instance, it is considered (at the time of writing) to be in the national interest that generally speaking a substantial proportion of a company's earnings should be ploughed back into the business. In order to encourage this, a distributed profits tax was imposed in 1947 which levied tax at a higher rate on money passing through to the

stockholder than on any balance of profits retained in the business.

The Board of Inland Revenue is responsible also for collecting the stamp duties. The most important one of these is the *ad valorem* duty payable on deeds relating to the transfer of stocks, shares, property, etc.

(b) *Customs and Excise*

Customs duties are levied on certain goods entering the country from overseas, the most important contributors being tobacco and petroleum. Excise duties are levied on goods and services consumed within the country, the more important contributors being beer, spirits, entertainment, and purchase tax. Some customs duties are imposed for protective tariff purposes, as distinct from revenue purposes, but although Great Britain formally abandoned free trade in 1932 the amount of duties collected for protective tariff purposes has been relatively small.

For many years those who held the office of Chancellor of the Exchequer have had every reason to thank consumers of tobacco and beer. Prior to 1939 the guiding principle in regard to these duties was simply to charge what the traffic would bear. For example, in 1932 an increase in the rate of beer duty decreased consumption of beer to such an extent that the total duty paid (even at the higher rate) was diminished; so the rate of duty was accordingly lowered at the next convenient opportunity.

After 1945 the primary objective of certain customs and excise duties underwent a material change. They came to be used as a deliberate means of influencing expenditure. Tobacco, most of which had to be imported from U.S.A. and paid for in dollars, was a case in point. In April 1947 the rate of duty was substantially increased for the express purpose of reducing consumption, thus placing economic motives in the forefront.

The purchase tax was introduced in 1940 partly for revenue purposes, but also in order to reduce the amount of money spent on 'consumer' goods, particularly the so-called luxury or non-utility goods. Motor-vehicle duties are collected by county councils and are paid over direct to the exchequer. Formerly these duties were hypothecated to the Road Fund.

(c) *Direct and Indirect Taxes*

There is a very definite and important distinction between direct taxes and indirect taxes. The former include income tax,

surtax, death duties, and company taxes; the latter include customs and excise duties, and purchase tax. Direct taxes are levied on money received. Indirect taxes relate to money spent. Consequently a person pays indirect taxes chiefly according to how he chooses to spend his money. But his direct taxes are fixed precisely according to the amount of his income or capital. At this stage an important negative indirect tax should be mentioned, namely food subsidies. These were introduced in 1940 for the express purpose of limiting the rise in the cost of living due to increased food prices. The amount payable in respect of food subsidies passes through the national exchequer accounts as a vote of supply to the Ministry of Food. Although originally a wartime measure, food subsidies were accepted before long as a semi-permanent feature of national finance. Any reduction in subsidies unmatched by a fall in the price of food would be viewed by the public in the same light as an increase in indirect taxation.

Authorities on taxation have discussed and argued extensively on the relative merits of direct and indirect taxation. When taxes were lower than they have been since 1939, those who preferred direct to indirect taxation were in the majority. Direct taxation at a high level, however, may have a very damaging effect on the incentive to effort. The spendable reward may be out of all proportion to the extra effort required. Indirect taxes, especially if not uniform, leave the individual with considerable freedom of choice as to payment and are not nearly so restraining on incentive: indeed, they may well stimulate extra effort. It is largely for these reasons that some people favour the lightening of direct taxation even at the expense of an increase in indirect taxation (not excluding a reduction in food subsidies).

6 Extra-Budgetary Funds

This is a name given to a number of funds which although under the control of government departments do not form an integral part of the Consolidated Fund. They include among others the group of funds administered by the Minister of National Insurance, i.e. unemployment, health insurance, pensions, industrial injuries, family allowances, and others. Contributions to such funds are made partly by insured persons, partly by employers, and partly by grants from the exchequer.

The unemployment fund may accumulate very substantial sums of money during periods when unemployment is low. The health

insurance and pension funds also accumulate large sums of money in order to meet future liabilities. The assets of the funds under the direction of the Minister of National Insurance are either lent to the exchequer or invested in British Government securities. The management of the investments is in the hands of the National Debt Commissioners, who are responsible to the Treasury. It will be realized therefore, that, although the exchequer makes annual grants authorized by votes of supply to these special purposes funds, the funds themselves are in turn investors in government funds.

Depositors in Post Office and Trustee Savings Banks know that they are lending their money to the Government, but they do not perhaps appreciate that the procedure is indirect rather than direct. The assets of the savings banks are invested in the names of the National Debt Commissioners in British Government securities, some of which are specially issued for such purpose. If, therefore, a marked reduction in the amount of deposits with the savings banks were to take place – say, for example, because depositors preferred to invest in National Savings Certificates – then some of the government securities held for the savings banks would have to be redeemed or, if no such provision existed, they might perhaps have to be sold on the Stock Exchange. Alternatively an increase in deposits would require the subscription to, or the purchase of, additional government securities.

The National Debt Commissioners are responsible also for the investing of moneys held by sinking funds and by other funds under public control. The sum total of the assets of the so-called extra-budgetary funds is substantial and, if the funds of the savings banks, the Bank of England Issue Department, and the Exchange Equalization Account (see below) are included, the aggregate may at times exceed 15% of the total national debt. The amount of precise information relating to these funds is, however, limited. To the student of public finance they resemble a rather complicated series of internal book-keeping entries. Since the liability for all such funds is the ultimate responsibility of the Government, he might think that simplification would be achieved by amalgamation with the Consolidated Fund. Administrative and accounting reasons, however, decide otherwise, and the important thing to remember is that the separation of these funds places the Treasury authorities on both sides of the fence. They are not only responsible for the issue of government securities, but are investors

on a substantial scale in their own securities. The implications of this will be considered more fully in chapters 14 and 15.

7 Exchange Equalization Account

This account was established in 1932 under the control of the Treasury for the purpose of checking undue fluctuations in the value of sterling in terms of gold and foreign currencies. Between 1932 and 1939, when many currencies were divorced from a fixed gold value, the main purpose of the account was achieved. After 1939 it became the sole holder of the nation's stock of gold. The account was empowered to invest not only in British Government securities, but also in securities and assets expressed in the currency of any country, its general purpose being to safeguard the exchange value of the pound and to facilitate the means of making payments abroad. Two practical consequences of the transference of the nation's gold from the Issue Department of the Bank of England to the Exchange Equalization Account are (a) the placing of the note issue entirely on a fiduciary basis, and (b) the ease with which a veil of secrecy can be placed over the amount of the gold thus held.

8 The National Debt

Before discussing the subject of the national debt with its many ramifications it might be appropriate to consider first the other side of the picture – the national assets. It may perhaps be a surprise to many to learn that, apart from the nationalized industries (which have, of course, to meet the service of their respective compensation stocks) and the Post Office, the British Government owns relatively little in the way of income-producing assets. The most noteworthy assets are shareholdings in the Suez Canal and in the Anglo-Iranian Oil Company, but however impressive these may appear in themselves they represent only a minute fraction of the national debt. The real asset of the nation and the guarantee of its being able to honour the service of the national debt is the productive capacity of its citizens (aided, of course, by machinery and capital equipment). To the extent, however, that part of the debt is due to overseas holders, ability to meet it depends in part upon the transfer of appropriate sums of money into overseas currencies.

It has been the policy of the British Treasury in time of peace to borrow internally. Two world wars, however, forced the

country to incur debts abroad, but these debts were for the greater part inter-governmental debts and not loans subscribed for and held by citizens of overseas countries. Nevertheless, the greater part of the national debt is still held internally.

From the national point of view payment of interest on the internal debt (so long as it is held mostly by British residents) is largely a question of fiscal organization. Money is collected from the community by way of taxation and is then paid over to the holders of government securities. In an appraisal of the national economy such money is included in the term *transfer items*. No part of the nation's wealth need be mortgaged for the payment of the services of the internal national debt. But it would be wrong to say that the amount of the internal debt has no effect on the wealth of the nation. If its service contributes to a high level of taxation, then that causes annoyance, frustration, and lack of incentive to greater effort.

A yardstick used sometimes to measure the weight of debt is to express its amount as so much per head of the population. A far better measure, however, is to express the annual interest requirements as a percentage of the total income of the community. In this connection, the Chancellor of the Exchequer in his budget speech in 1943 stated that, in spite of the substantial growth since 1939 in the national debt, the interest charge expressed as a percentage of the national income was approximately the same as that existing not only after the first world war, but also after the Napoleonic wars. Between 1943 and 1948 the interest charge increased further, but when expressed as a percentage of the national income the increase was of the order of from 5% in 1943 to 6% in 1948.

Unlike internal debt, external debt is a real charge on the wealth of the community. It is not a simple transfer item. Not only have taxes to be gathered in order to pay the service of the debt, but the remittance of the money overseas is in the long run only possible to the extent that goods and services can be exported. It is largely for the reasons mentioned here and in the preceding paragraph that responsible opinion is now probably reconciled to the inevitability of little reduction ever being made in the present large figure of internal debt, but would aim strenuously at the elimination as soon as possible of the burden of external debt.

A detailed statement of the British national debt is contained in the Finance Accounts of the United Kingdom. These are made

up to 31st March and published a few weeks later. Many of the funded and unfunded debt securities have already been referred to in chapter V. In addition to (a) stocks quoted on the Stock Exchange, (b) securities where the maximum holding is limited and which are specially designed to meet the needs of small investors, (c) Treasury bills and Treasury deposit receipts, there are two other methods of government finance which should be mentioned.

The Treasury borrows money by means of what is known as 'Temporary Advances on Credit of Ways and Means'. It obtains these advances not only from various public departments, but also from the Bank of England. In the latter case the advances are in the nature of overdraft facilities and may be repaid at a day's notice. The amount borrowed in this way fluctuates considerably from day to day. The other method is by way of Tax Reserve Certificates. These were introduced in 1942, when it was realized that considerable sums of money were being retained on current or deposit accounts and earmarked for payment of taxes due in the future. The increase in deposits thus caused was considered undesirable, so the Treasury were prepared to issue Tax Reserve Certificates which carried a relatively attractive rate of interest. These certificates could be subscribed for by certain categories of taxpayers, but only to the extent of their outstanding liability for tax.

The whole field of government borrowing extends from day-to-day loans at one extreme to funded debt securities at the other. The rates of interest payable on new borrowing vary not only according to the date of the borrowing, but also according to the nature of the security. There has been a tendency for many years, however, for the rates to vary directly with the term of the debt; the shorter the term, the lower the rate of interest. Every year the sums of money involved in the redemption and replacement of debt are enormous and are usually spread over almost every form of government borrowing. The question may well be asked: What influences the Treasury in its choice of method of borrowing? Are there any overriding principles? Is it better to borrow for shorter terms at lower rates of interest than for longer terms or in perpetuity at higher rates?

If cheapness of borrowing were the sole criterion, then the Treasury could achieve this purpose by issuing as large an amount of bank notes as possible. The bank-note issue – now that it is entirely on a fiduciary basis – is equivalent to borrowing at a nil

rate of interest. It is true that the note issue is backed by government securities some of which are interest bearing, but, as the profits of the Issue Department of the Bank of England belong to the exchequer, the interest paid is returned later by way of profit (less, of course, the expenses of the Issue Department). It is only necessary to contemplate the effect of excessive borrowing by way of bank-note issue (the most direct road to uncontrolled inflation) to realize that cheapness of borrowing is only one factor in the situation.

The Treasury is, in fact, considerably restricted in its choice of borrowing by the supply of money available for investment in different types of government security. The amount of money available for investing in the group of securities especially suitable for small investors is naturally limited by the savings of such people. The demand for Treasury bills is dependent upon the resources of the banking community. They are seldom taken up by personal investors. Then the funded debt securities are only suitable for those institutions and individuals who can invest on a long-term basis.

The problem will be considered at greater length in chapters 13 and 14, but one or two further points can be made here. To achieve as low an average rate of interest as possible on the whole debt is, of course, the laudable objective of most Chancellors of the Exchequer. If, however, this is achieved by means of retiring long-term debt and adding to the floating debt the effect may well be inflationary, and this, if occurring at a time when other inflationary influences are at work, will almost certainly not be to the advantage of the country. The courses which are actually adopted in the management of the national debt can have an enormous influence on the economic welfare of the country.

The rate of interest on new borrowing is important to both Treasury and investor, but the capital value of marketable securities is of particular importance to the investor. When security prices are high he is more ready to spend capital and refrain from saving. This might have been a good thing from a national point of view during the world depression of the 1930's, but it was undoubtedly a bad thing during the years immediately following the ending of the second world war, when the country was faced with a reconstruction task which was bound to strain its resources to the full.

9 Local Government Finance

The finances of counties and county boroughs mirror many of the features of central government finance: in other respects there are some fundamental differences. Local authorities have been accustomed to provide services for their residents in the form of public health, education, poor relief, housing, highways, and police. Many owned and operated public services in the form of transport, electricity, and gas, until these were acquired by the state. But local authorities are, of course, not responsible for such matters as defence, foreign affairs, trade, and overseas departments.

The methods of raising revenue are bound to be entirely different as between local authority and central authority. The latter may tax its citizens without reference to where they live, but the former can only raise revenue by reference to place of residence. In fact, it has to go further and recognize that the collection of revenue can be most effectively enforced by levying what is, in fact, a charge on the physical properties lying within its boundaries. Local authorities have for many years administered national services for which provision has been made under Acts of Parliament. The financial cost of these was met partly by grants from the national exchequer. Thus local authority revenue is obtained partly by local contribution and partly from funds fed by national taxation.

Dealing first with the former – the local contribution – this is provided in the form of local rates. A rateable value is placed on every property. This is a hypothetical rent and is intended to represent the fair rent which would be charged by the owner to a tenant. The revenue requirements of the local authority are then related to the total rateable values on property lying within its jurisdiction, and rates are levied on a basis sufficient to provide the necessary sum. The rates are assessed in the form of shillings and pence in the pound. Thus if it is necessary to provide for an income of £125,000 per annum and the rateable value is £200,000, then rates equivalent to 12s. 6d. in the £ will achieve the purpose.

Although every property has a normal rateable value affixed to it, many industrial undertakings are *derated* under the Rating and Valuation (Apportionment) Act, 1928, and pay only one quarter of the normal rates. Unoccupied residential property in England (though not in Scotland) is entirely relieved of rating liability, as long as it remains unoccupied. Agricultural properties are exempt from rating liability.

Owing to the system of collecting revenue by local rates it was almost inevitable that the prosperity or adversity of an authority would be reflected in the level of rates charged. A prosperous county borough such as Bournemouth could pay its way in 1946/7 with rates of 10s. in the £, while some Welsh boroughs which were saddled with a legacy of great distress during the period 1919-1939 had to levy nearly three times as much. For many years it had been felt that local government finance needed a complete overhaul and this was done in the Local Government Act, 1948.

There are three important financial provisions of this Act. First, the inequalities in the level of rates as between one authority and another are to a certain extent ironed out. Exchequer equalization grants are made to counties and county boroughs in cases where their rateable value is less than the standard rateable value, which is really an average rateable value for the whole country with certain adjustments according to population, children under school age, and road mileage. On the other hand, where rateable values are in excess of the standard, the local authority is not required to contribute to the equalization funds.

Second, the grants made by the exchequer were formerly based on sums equal to the amounts required for specific services such as health, education, etc., together with sums by way of *block* grants to provide general financial assistance according to the respective needs of each local authority. These rather casually estimated block grants were superseded under the Act by the equalization grants mentioned above. The finances of the local authorities were further relieved as a result of the assumption by central authorities of liabilities in connection with the health services and poor law relief. As a consequence local authorities now have more precise knowledge than formerly of what they may expect to receive from the national exchequer.

Third, the central government took over from local authorities the responsibility for the valuation of property. The purpose was to achieve greater uniformity throughout the country. In so far as this involves the revision of existing valuation lists the change over will take some time to achieve.

Local authorities have been empowered under various statutes to raise loans for certain defined purposes, such as schools, housing, highways, police, and for many services normally provided by them. The loans must be secured indifferently on all the revenues of the borrowing authority. The usual procedure, prior to 1939,

was for the larger-sized authorities to make a public issue of a redeemable or irredeemable stock which could be dealt in on the Stock Exchange. For authorities whose requirements were hardly large enough to justify a public issue of stock; money could be borrowed from the Public Works Loan Board.

Under the Local Authorities Loans Act, 1945, however, borrowing by means of issue of stock by individual authorities was virtually limited to the replacing or refunding of existing securities. Otherwise the sole source of new finance was the Public Works Loan Board, which, itself obtaining advances from the exchequer, re-lent to local authorities at rates of interest varying according to the length of time for which the money was borrowed.

CHAPTER 9
THE NATIONAL ECONOMY

Introductory

This chapter is concerned with matters relating to the national economy. Let it be said at the outset that the task of statistical compilation alone is now a colossal one, quite apart from the questions of making a correct diagnosis and of trying both to encourage what is right and to remedy what is wrong. Within the space of the year ended 31st March 1948, four important White Papers all relating to the economic state of Great Britain were published; these contained in the aggregate no fewer than 159 closely printed pages. All four were the subject of debates in Parliament.

In addition to these publications the Central Statistical Office began in 1946 to publish a Monthly Digest of Statistics. This contains an extensive record of information relating to manpower, production, trade, and finance. Apart from a few important omissions for reasons of secrecy a student of national economy could certainly not complain of any lack of material. His complaint would more likely to be that he could not see the wood for the trees. In order to obtain a correct interpretation the expert has to give much time and study. The novice may well be excused therefore for re-echoing the question posed last century by Jeremy Bentham: 'What is the use of it?'

The broad overriding purpose is, or should be, to help in the creation, sustenance, and growth of national wealth. The mere compilation and study of statistics relating to the national economy do not by themselves create new wealth – indeed, the energy taken up in the process is actually a detraction from it – but they can play a useful part in guiding the various factors of production (land, labour, and capital) into the ways where they can contribute most to the national wealth, and in pointing to causes of avoidable waste. Adequate information is required by members of the Government to help them in framing their economic policy. It is required also for purposes of public education, without which no government could pursue successfully a policy which was unpopular.

It is not proposed to examine in detail the statistical tables con-

tained in the many Government White Papers, but rather to consider the main features of some of the more essential ones. A White Paper giving figures relating to national income and expenditure has been published each year since 1940 at about the same time as the budget. In the early months of 1947 and again in 1948 an Economic Survey for the current calendar year was published. There are indications that these two publications may continue annually in future. It is likely, too, that additional White Papers dealing with some particular facet of the economic problem (such as, for example, the balance of payments) may be prepared and published at times when a particular problem is critical or when the Government desire to draw special attention to it. Much of the statistical material in these White Papers is interdependent and inappropriate for isolated consideration. Perhaps the most important sections of the national economy which require examination and study are the following:

- (1) Home production of goods and services.
- (2) Balance of payments overseas.
- (3) Private income and expenditure.
- (4) National income and expenditure.
- (5) The generation of savings for capital investment.
- (6) The revenue, borrowing and expenditure of public authorities.

These will all be considered in turn.

I Home Production of Goods and Services

Productivity is the basic criterion of a country's wealth; measured not only by quantity, but by quality and according to its composition. The Monthly Digest of Statistics gives a useful array of fact and estimate. The principal components of production are (a) manpower, (b) raw and semi-finished materials, (c) land, buildings, and machinery, (d) food, fuel, and power.

(a) As regards manpower, estimates are given for the population grouped according to age and sex; this resembles a continuous census. Classification is also made according to occupation. A study here will show the total number of persons employed in productive industry and in essential services, how many are unemployed, and the numbers engaged in the Armed Forces, central and local government services, police, and so on. Those engaged in manufacturing industries are further classified according to the

number working for the home market or for the export market. A nation will obviously have the best opportunity of attaining a satisfactory level of production if a high percentage of its population is engaged in productive industry and in the essential services. On the contrary a large number of unemployed, or an excessive number engaged in the Armed Forces or in government service, will be an impediment.

(b) Tables are given showing the production and imports of raw and semi-finished materials; also in many cases the quantity of stocks of such materials held in the country. The importance of a satisfactory level of stocks needs little emphasis. If they are generally too high in relation to current output a subsequent fall in output is probable: if too low, the output of the manufacturers using them may be impeded owing to the difficulty of obtaining an even flow of materials.

(c) Statistics relating to land, buildings, and machinery are fairly extensive. Farm land is analysed as follows: the acreage available for arable land or permanent grassland; the acreage under tillage for wheat, barley, oats, potatoes, and other crops; the numbers of each kind of livestock.

Particulars are given of new construction of dwelling-houses and also of factory construction. Machinery in the form of machine tools, electric generating plant, steam and oil engines, vehicles, textile machinery, etc., is listed. Where a satisfactory unit of measurement is available the physical quantity is tabulated; otherwise it is done according to monetary value.

(d) Food imports and home production of food are made known, but there is a reluctance to publish statistics relating to stocks of food during times when world supplies of food are short. As regards fuel and power, the indigenous source of greatest consequence is, obviously, coal. Statistics relating to manpower, production, consumption, and stocks in the coal industry are of prime concern and are usually scrutinized closely. Figures for manpower and tonnage are given, but it would be more helpful still if information could be obtained for the calorific value of coal output; thereby informing on quality as well as on quantity. Output of electric power is a function not only of the coal (or water power) used in generation, but also of the amount of generating plant installed. Similar considerations apply to gas.

Ample statistics are published regarding the activities of each

important trade and service. In addition a useful composite index is contained in the Index of Industrial Production calculated by the Central Statistical Office and tabulated in the Monthly Digest of Statistics. This index is a weighted average of the physical production of the basic industries and services.

A certain amount of the information given in the Monthly Digest is summarized in the Economic Survey, but the purposes of the two are different. The former is designed to serve as a statistical record in the same way as a patient's temperature or pulse-rate chart, but the latter aims at going much further. It extends to a diagnosis, to forecasts, to the preparation of plans, to the prescription of cures for any apparent ills, and to the task of public education in economic matters. One part of the Survey contains a review of the preceding period, pointing to any outstanding reasons for success or failure. The part devoted to planning takes the form of indicating objectives for the future output of certain industries. The objectives, or targets as they are called, are decided not only in the light of what is considered desirable, but also in the light of what stands a reasonable chance of attainment.

There are certain industries which are fundamental to the national economy and upon which most of all others depend; special attention must therefore be paid to them. These include coal, oil, steel, electric power, transport, and of course food. Output of coal now depends upon manpower, machinery, and management. The extent of the coal deposits will no doubt become a vital factor at some future date. The import of oil is dependent not so much upon world supplies (which potentially appear to be adequate) as upon the amount of foreign exchange available. Refined oil products such as petrol and its derivatives may be imported from abroad in their finished state, or crude oil may be imported for refining in Great Britain. In the latter case the refinery capacity at home will be a limiting factor. Steel, electric power, and transport are capital industries dependent primarily on the amount of capital Investment installed for such purposes; and this is influenced to a considerable extent by the level of savings.

Supplies of food are, of course, conditioned by output at home, by purchases overseas – and at all times by the caprices of nature. It will be realized therefore that any determining of objectives – even for the basic industries alone – must be founded upon many

imponderables. Nevertheless, in a highly complex and integrated economy such as exists in Great Britain, if maximum production is to be achieved and wastage eliminated, there must either be conscious and wise planning, or reliance on automatic regulators such as the laws of supply and demand. Some of the methods appropriate for use in trying to attain the objectives fixed by government planning will be considered in the next chapter.

2 Balance of Payments Overseas

Overseas payments and receipts arise from the following main causes: payments for imports; receipts from exports; payments and receipts in respect of *invisible* items of trade such as banking, shipping, and insurance services, tourist traffic, interest and dividends on investments; movements of capital money; lending and borrowing overseas on private or government account. The trade balance of a country is usually ascertained by comparing imports of goods with exports of goods and adding or deducting the invisible items of overseas trade. For example, for the year 1930 (a year specially selected to illustrate the importance of invisible items) Great Britain's balance of payments was estimated as follows (in £ millions):

	£
Retained imports	957
Exports of produce and manufactures	571
	<hr/>
Excess of imports	386
Invisible income from all sources	414
	<hr/>
Net balance	£ 28
	<hr/>

Thus, although there was a substantial excess of visible imports over visible exports, the final net balance was a *favourable* one owing to the greater excess of invisible items. The balance is ostensibly struck on the basis of an income account, but certain capital items intrude. For instance, no allowance is made for changes from year to year in the stocks of materials and manufactured goods retained at home. Too much therefore should not be read into the figures for any one year. But when viewed over a period of years a true picture should be seen of the state of the country's balance of payments.

For many decades prior to 1914 Great Britain's balance of payments overseas was very favourable. The large sums thus derived were invested abroad and so increased still further that part of the

invisible items which was represented by interest and dividends on overseas investments. Between 1919 and 1939 the net balance, though in either direction small, showed a tendency to deteriorate. For a short period immediately following 1945 the net balance on invisible account was adverse, but by 1948 it had again been restored to a 'favourable' basis, though still well below the pre-war level. *Vis-à-vis* the rest of the world Great Britain has actually become a debtor country, though, owing to a higher *rate* of income receivable from overseas investments compared with a lower rate paid out in respect of money owed, there is actually an *income* surplus on overseas investment account.

The problem of the balance of payments overseas is always far more critical to debtor countries than to creditor countries, but in the particular case of Great Britain, whose viability is absolutely dependent upon successful trade with overseas countries, it is hardly surprising that it leaped to the forefront of the list of pressing economic problems. Moreover, since the general nature of most of her imports is very different from the general nature of most of her exports, Great Britain is more than usually interested in what is known as *the terms of trade*; that is to say, the relationship between the world prices of the goods and raw materials which she must import and the prices of the manufactured goods which she succeeds in exporting.

The balance of trade as estimated above is only a true criterion of the actual state of affairs if the currencies of each country with whom Great Britain trades are freely exchangeable into those of others at the ruling rates of exchange. For example, if Great Britain had a favourable balance of payments of £10 million in her trade with Australia and an unfavourable balance of the same amount in her trade with the Argentine, then taking the two together British overseas trade would be in exact balance only if the £10 million worth of Australian pounds could be exchanged readily into £10 million of Argentine pesos. Prior to 1939 free unfettered exchange or *convertibility*, as it is called, of foreign currencies was usually sufficiently extensive to justify the assessment of the balance of payments on the basis of an overall balance.

The aftermath of the war, however, made it necessary for many countries to take steps to control the foreign exchanges of their currencies. The laws of supply and demand as applicable to exchange rates were no longer allowed full freedom. Rates of exchange were fixed in terms of gold and of foreign currencies,

but free interchange was restricted. Control took various forms, but the general principle was that the state decided the extent and conditions under which its citizens could acquire foreign currencies and, when acquired, the uses to which they could be put. Those currencies which were most in demand and which could therefore be most readily exchanged for others came to be known as *hard* currencies: those which were most tightly controlled being known as *soft* currencies. Thus it became desirable to subdivide the trade balance according to balances arising from *hard*, *soft*, and *neutral* currencies. So long as currencies are not freely convertible multilateral trade will be restricted and nations may be obliged to negotiate bilateral trade pacts and currency agreements.

Balances on overseas account can be settled in various ways: by the transfer of gold, by the creation or repayment of debt, by gifts, or by the transfer of capital assets. Thus a country which is unable for the time being to achieve a favourable balance of trade, as, for example, Great Britain in the years following 1945, will be able to bridge the gap only by using one or more of these methods. If her own resources and the ability to borrow both fail, then the unfavourable balance will be automatically closed through the sheer inability to finance imports beyond a certain level.

The Monthly Digest of Statistics gives extensive tables of imports and exports of visible items. The Economic Survey examines the problem in greater detail, introducing estimates of invisible items and giving particulars of readily available capital reserves in the way of gold and credit facilities (this latter applies to such items as borrowing facilities from the International Bank, the International Monetary Fund – see page 156 – European Recovery Programme funds, etc.). The Economic Survey also outlines the Government's plans for dealing with any expected unfavourable balance of payments.

While satisfactory estimates can be made of interest and dividends, either arising from sources overseas or paid to holders overseas, estimates of the corresponding capital assets are usually confined to monetary debts or balances; other capital assets in the form of property and share capital holdings cannot be easily measured.

3 Private Income and Expenditure

It is obvious that, if information is obtainable regarding the sources of the incomes of the whole community and the manner in which these are spent, a great deal can be learnt about the state

of the national economy. Such information is now available and has been set out annually in the White Papers on National Income and Expenditure of the United Kingdom. In a matter of such size and complexity it is not surprising that there should be more than one approach to the problem, nor that estimates must be employed where precise calculations are impossible. There are limitations, too, in the information obtainable. For example, it is only possible to include in the estimates the incomes and expenditures where money changes hands. Thus, a man who grows for his own use fruit and vegetables in his garden receives an income in kind, but there is obviously no convenient way of expressing this in terms of money. In a predominantly agricultural community income and expenditure in kind form an important part of the total, but in a highly diversified and industrialized country such as Great Britain an analysis of the income and expenditure actually received or paid for in terms of money gives a sufficiently accurate picture of the whole economy.

The two principal methods of approach to the study of a nation's income and expenditure are from (a) the personal or private point of view, and (b) from the point of view of the whole nation. The difference between the two methods arises from different ways of dealing with the incidence of public finance. It is proposed to deal in this section with the former.

Personal income is derived from two main sources, *income from work and property*, and from *transfer incomes*. The former comprises rent, interest, and profits (including interest on the national debt, since from a personal point of view this represents ownership of property); wages and salaries; pay and allowances of the Armed Forces. Transfer incomes comprise social security payments such as pensions, family allowances, national insurance benefits, national health service, national assistance, etc. Miscellaneous transfer incomes include such items as war gratuities, trainees' wages and lodging allowances, state scholarships, etc. The totals of personal incomes when compared from year to year and analysed according to source give illuminating information regarding the national economy.

Personal outlay is divided into three principal groups: *cost of consumer goods and services*, *taxation*, *saving*. Taxation is, however, paid in two distinct ways: directly and indirectly. The personal cost of consumer goods and services includes indirect taxes, less subsidies. If indirect taxes and subsidies are eliminated what is left

is called the *national* cost of consumer goods and services, and this is a better measure of the true value received by the community. For, if the personal expenditure on consumer goods and services were to rise solely because of increased indirect taxes or reduced subsidies, no personal benefit would result. The third main item of personal outlay, namely savings, is an item of great significance; it is the unspent part of personal income whether resulting from desire for thrift or inability to spend.

In addition to the items of personal income and outlay mentioned above there are others in a similar category, belonging to members of the community, yet not actually distributed to individuals. This *other private income before tax*, as it is called, consists of undistributed profits of joint stock companies, special company taxes such as profits tax, and other direct tax payments and tax adjustments. When these are added to the figures for personal income, and personal outlay, the resulting totals are called *private income before tax* and *private outlay*. The table on page 136 compiled on the basis of notional figures (expressed in £ millions) will serve as an illustration.

The way is now open for further analysis of each side of the account. As regards income, this is analysed in the White Papers according to the range of personal incomes before and after direct taxes. It is shown usually according to the ranges: under £250; £250 to £500; £500 to £1,000, and so on. A study of the distribution of personal incomes before tax is instructive. For example, it can be calculated that the percentage contributed by the £250 to £500 group in 1938 was 13%; in 1946 it was 24%. Further tables are given showing the distribution of personal income after deducting income tax and surtax, i.e. according to the amount at the disposal of the individual; this gives the best picture of income distribution.

Analyses of the sources of personal income according to occupation and type of property owned are more difficult to compile, but starting in 1947 the personal income from wages was divided into important groups of industries and services. If comparison is made from year to year it must be remembered that such figures represent the money income of wage-earners and do not necessarily form reliable indices of physical production.

On the expenditure side the analysis of perhaps the greatest interest is that of the expenditure on consumer goods and services. Although the total cost includes indirect taxes, *less* subsidies, from

ESTIMATES OF PRIVATE INCOME AND OUTLAY

PERSONAL INCOME

<i>Income from work and property</i>	£	<i>Consumption</i>	£
Rent, interest, and profits	3,000	National cost of consumer goods and services	6,500
Wages and salaries	5,600	Indirect taxes less subsidies	1,300
Pay and allowances of the Armed Forces	400	<i>Direct tax liabilities</i>	
<i>Transfer incomes</i>		Payments of income tax and surtax	1,000
Social security payments	500	Payments of death duties	200
Miscellaneous transfer incomes	300	Employees' national insurance contributions	150
		Miscellaneous	50
		<i>Saving</i>	
		Personal saving	600
Personal income before tax	9,800	Personal outlay	9,800

OTHER PRIVATE INCOME

Other private income before tax	900	<i>Direct tax liabilities</i>	
		Payments of excess profits and profits tax	400
		Other direct tax payments	300
		Additions to tax reserves	—100
		<i>Saving</i>	
		Undistributed profits	300
Other private income before tax	900	Other private outlay	900

PRIVATE INCOME

Private income before tax	£10,700	Private outlay	£10,700
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the personal point of view, it is expenditure at market value which really matters. A person buying a packet of cigarettes reckons the cost at what he pays over the counter and does not make a separate calculation of the amount he contributes to the exchequer. Very useful and extensive tables are available showing the expenditure on goods and services. The principal items include food, alcoholic beverages, tobacco, rent, fuel and light, clothing, travel, etc. It is perhaps only when these tables are studied that one realizes the extent to which retail prices are influenced by the levels of taxation or subsidies. For instance, consumption of tobacco in 1947 was £690 million compared with £177 million in 1938. It is obvious

that much of this increase must have been due to increased retail prices brought about by higher tobacco duty. In order therefore to provide a better comparison, the tables for personal expenditure are recalculated according to a fixed level of retail prices. For several years the 1938 level of prices was used. On this basis tobacco consumption in 1947 would have been £207 million and thus more comparable in value with the £177 million spent in 1938.

4 National Income and Expenditure

The component items of *national income* appear to be quite similar to those used in the compilation of *personal income*, but there are some very important differences. Interest on the national debt and all transfer incomes are incomes only when in the hands of the personal recipients; they do not form part of the national product and must therefore be excluded from the *national income*. On the other hand, income arising from government ownership of property or from government trading is certainly part of the national product, though not forming part of the *personal income*. Therefore *national income* may be derived from *personal income* by deducting (a) national debt interest and (b) transfer incomes, and adding (c) income from government ownership and trading. The resulting total is known as the *net national income at factor cost* and represents the income received by the active factors of production of goods and services of all kinds.

National expenditure is divided into three principal groups: *national cost of personal consumption, government expenditure, net capital formation*.

The net national income at factor cost is derived from profits struck after providing for depreciation and maintenance. The amounts set aside for depreciation and maintenance should in theory be just sufficient to keep property, plant, and machinery in a condition where there is neither deterioration nor improvement. In fact, there will usually be conscious striving after improvement; the more which is set aside for depreciation and maintenance the greater will be the opportunity for improvement. It is therefore well worth while taking into consideration the actual amounts thus set aside. When the amounts set aside for depreciation and maintenance are added to the net national income the resulting total is called the *gross national product* (or *gross national income at factor cost*). On the expenditure side of the account the amounts set aside

for depreciation and maintenance are added to the *net capital formation* to give the *gross capital formation*.

An important item which was submerged in the personal income and expenditure accounts must appear now separately in the national tables. That is the balance of overseas payments. Any borrowing overseas – which will arise as a rule through excess of imports over exports – will augment the items of personal outlay. Therefore *net borrowing abroad and sales of assets to foreigners* must be added to the gross national product in order to obtain a figure for the *total resources available for use at home*. The following table compiled on the basis of notional figures (expressed in £ millions) will serve as a further illustration:

GROSS NATIONAL PRODUCT AND
BORROWING FROM ABROAD

	£		£
National income (at factor cost) of the United Kingdom	9,500	National cost of:	
Provision for depreciation and maintenance	900	Personal consumption	6,500
	900	Government	2,300
Gross national product	10,400	Gross capital formation at home	2 000
Borrowing from abroad and sale of assets to foreigners	400		
Total resources available for use at home	£10,800	Total resources used at home	£10,800

The net national income at factor cost, and the gross national product are excellent indices of the national economy. If they increase from year to year, provided always that the increase is not brought about only because of a rise in the cost of living or by an increase in the population, then an advance is really being achieved. Such a conclusion would not necessarily apply to an increase in the figures for national resources available for use at home, as the increase might be caused primarily through additional borrowing overseas. Similarly a valid comparison year by year of figures for private income before tax could be made extremely difficult if there were substantial alterations in the amounts of transfer incomes.

One of the most important analyses of national expenditure is the analysis of the national cost of consumer goods and services. A comparison with the analysis of personal expenditure on goods and services *at market prices* throws into vivid relief the effect of

indirect taxes and subsidies. For example, the national cost in 1947 of expenditure on tobacco was £169 million, personal expenditure being £690 million. On the other hand, personal expenditure on food was £1,995 million, but owing to the incidence of subsidies the national cost was £2,241 million.

5 The Generation of Savings for Capital Investment

It is hardly necessary to emphasize the important part that saving and Investment play in the national economy. That is true of any industrial country, but particularly so in the case of Great Britain, where capital equipment can be such a vital factor in the production of national wealth.

Investment in new buildings, plant, machinery, etc. – capital formation as it is called – is limited by the amount saved out of the total national resources: unless we borrow abroad. The principal sources of saving are: personal savings; undistributed profits of companies; budget surplus, and surpluses arising from national insurance funds and local authorities.

Personal savings arise from conscious saving through thrift; they also arise through inability to spend because of rationing and other forms of control. If a person's net income can provide a satisfactory standard of living with a margin to spare, then saving becomes almost automatic. If not, then saving is difficult and may only be achieved by lowering the level of personal consumption. The percentage of personal disposable income which is saved is an important index in the national economy. In 1938 it was 3.5%; it rose to 16.1% in 1944 and fell later to 5.7% in 1947.

Undistributed profits of companies comprise sums placed to reserves and sums added to the balances of profit and loss accounts carried forward. There are several factors which influence the total. At one time the capital requirements of the industry and ordinary business prudence were the sole ones. More recently new ones have appeared. For instance, when profits tax is levied at a higher rate on the amount distributed by way of dividend than on the amount retained in the business, then a direct incentive is given to distribute less than might normally be thought fit. Any restraint on the rate of dividend payable, such as, for example, dividend limitation (by request or by virtue of law), has also a direct bearing on the balance retained. Further, capital expenditure for special purposes may be stimulated by tax rebates and if

so may well encourage the provision of the necessary money by saving rather than by raising fresh capital.

The most important source of saving through the medium of public funds is, of course, a budget surplus. It might be asked how this can contribute to the general formation of capital unless invested in capital projects on government account. The answer is that the excess of income over expenditure causes a consequential retiral of government debt, thus placing money in the hands of the former owners of that amount of debt; and so money is released for subscription to new investments through the normal channels. In addition to a budget surplus, contribution to national savings may come from other public funds, such as, for example, local authority accounts, and the national insurance funds.

These are the three main sources from which savings are generated for the purpose of capital formation. But the resources available at home may be augmented by loans from abroad and the sale of assets overseas. To such extent this is really equivalent to an addition to capital formation at home at the expense of a decrease in capital assets overseas.

It is now possible to examine the tables relating to the combined capital account which are found usually both in the White Papers on National Income and Expenditure and in the Economic Surveys. The figures may be shown net or gross according to whether depreciation and maintenance allowances are omitted or included. The following table compiled on the basis of notional figures (expressed in £ millions) will serve as an illustration.

COMBINED CAPITAL ACCOUNT

SAVING			£				£
Private saving						Gross capital formation at	
(a) Personal	.	600				home	2,200
(b) Others*	.	200	800				
		—				<i>less</i>	
Saving of public						Borrowing from abroad and	
authorities	.		400			sale of assets to foreigners	300
Sums set aside for de-							—
preciation and main-							1,900
tenance	.		700				—
			—				
Savings and other sums						Gross capital formation	£1,900
set aside.	.		£1,900				

* Made up of undistributed profits, and adjustments for tax reserves.

The size and trend of the sums shown as being saved and available for capital formation provide an excellent pointer to the trend

of national income in the future. Indeed, unless new discoveries are made or national resources are put to more effective use, unless the population increases or the output per working person expands, the only way the national income can grow is through the process of saving and capital formation.

6 The Revenue, Borrowing and Expenditure of Public Authorities

The exchequer receipts and expenditure which are published in the Finance Accounts of the United Kingdom, and the estimates which form the basis of the budget resolutions, are grouped according to the departments raising the revenue or spending the money. The White Papers on National Income and Expenditure analyse the exchequer accounts differently and in a way which gives a clearer picture of the effect on the national economy. In the revenue account income is shown according to three main groups: direct taxes, indirect taxes, income from property. The last item is shown after deducting interest on the national debt and the net figure is thus a negative quantity. A comparison of the amounts raised by direct taxes (including death duties) and by indirect taxes is of interest. The figures reflect not only fiscal policy, but economic policy as well.

On the expenditure side the main subdivisions are current expenditure and saving (i.e. surplus). Current expenditure is analysed in moderate detail, but two useful and informative groupings can be made. The first is the expenditure on goods and services (in the form of wages and salaries and cost of materials) and the second is the transfer payments of all kinds. It will be remembered that transfer payments are not included in estimates of the national income; so government expenditure on goods and services gives a proper picture of the amount of the national output devoted to central government purposes.

It would be of additional interest if the expenditure on goods and services could be subdivided further according to the fundamental services of government such as legislation, justice, defence, police, diplomatic services, etc. – and those which are concerned primarily with the redistribution of income by means of social security services, rationing, controls, etc. The former do not add directly to the nation's output, but they are indispensable. Many of the latter, however, are by themselves non-productive and can only increase the nation's output to the extent that the services

they render to the community stimulate output to a greater extent than the amount which they themselves consume.

The most important item in the capital account is the surplus or deficit on current (revenue) account, i.e. saving or dis-saving. This is equated with figures for the raising or repaying of government debt and with any alterations in the physical assets owned by the Government.

Similar figures for revenue and capital account are given for local authorities and also for the national insurance funds. A study of these will show how much of the central government's contributions to them are spent on goods and services and how much on transfer payments.

In conclusion, it should be emphasized that the comprehensive study of the national economy is a comparatively new science and at the time of writing is still in the process of evolution. New series of statistical information may well replace in future the present pattern. All that it is possible to attempt in this chapter is to draw attention to some of the fundamental aspects of the problem.

BACKGROUND TO THE DEVELOPMENT OF ECONOMIC THOUGHT

I Introductory

Economic thought is such a wide expression that for the purpose of this chapter it is necessary to apply some limiting definition. In chapter 3 it was shown how an industrial community lives and thrives on the production, exchange, and consumption of goods and services; how the factors of production – land and natural resources, labour, capital equipment – play their respective parts; how they are impelled by motive forces which are varied and liable to change from time to time; how all factors of production are directly or indirectly dependent upon work.

Men and women work for various reasons: to provide themselves and their families with the necessities of life; to win the joy which comes from good husbandry, craftsmanship, and creative art; to attain the benefits of what is colloquially known as a ‘high standard of living’; to perform what they believe to be their civic duty. The predominating motives of each person depend largely on their individual minds, but *collectively* there is little room for difference of opinion. The common purpose is to safeguard and where possible to increase the wealth of the community.

Wealth in its economic sense relates to the satisfaction of material wants. But man does not live by bread alone. Thus in any striving by a nation after material wealth great care must be taken that the progress towards that goal marches in step with – or at any rate does not march counter to – the wider ideal of national well-being, a state which embraces not only material wealth, but freedom, happiness, and regard for the future. Economic thought will be defined here as the study of the means to that end.

In a subject of this nature it is usually wise to avoid making sweeping statements. But for the sake of seeing things in a proper perspective there is one sweeping statement which ought to be made regarding the development of economic thought during the past two centuries. It is this. During the greater part of the nineteenth century the primary motive was the production of wealth: how it was distributed was often a secondary consideration. In the

present century the distribution of wealth is being viewed by the majority as the primary problem; the production of wealth being taken – too much so – for granted. Preoccupation with production brought in its train great inequalities in the distribution of wealth: but overemphasis on distribution hinders the actual production of wealth. Indeed, it will never be easy to achieve a nice balance in the demands of each. But in spite of such inequalities, and in spite of the conditions of poverty under which many people lived, during the nineteenth century wealth was created, wealth on an immense scale, wealth beyond the dreams of former generations. It was this very fact of immense production of wealth which enabled people in the present century to concern themselves so fully with the distribution of wealth and with the alleviation of hardship.

There are two principal aspects of economic thought: the one passive and the other active. The former is concerned with study and teaching, with seeking the reasons why certain events happen, with associating definite series of results with certain sets of circumstances in order to decide whether such connections are merely accidental or so logical as to be likely to occur again in the future. The latter, the active aspect of economic thought, is concerned with methods of deliberate intervention aimed at influencing results by altering the circumstances. This ultra-theoretical description may help to explain the two extremes of economic thought represented by *laissez-faire* at one end and far-reaching state control at the other. The following may serve as a practical illustration.

If better-quality and cheaper sugar can be grown abroad than at home and if there is world-wide free trade in sugar, then it requires no effort of economic thought to deduce that as long as such conditions endure and under conditions of *laissez-faire* farmers at home will not grow sugar. But suppose the view were taken that the national welfare was not safeguarded by such complete reliance on the ability to import sugar from abroad, then economic thought would have to manifest itself in an active manner. The Government would have to induce farmers to grow sugar either by granting them a subsidy or by imposing a duty on imported sugar. Obviously any necessary action is the prerogative of the Government. Not only do they have the necessary power, but they are responsible to the community as a whole.

The actual form which controlling action may take in general may be confined to purely fiscal measures such as taxation, cus-

toms and excise, subsidies, etc., or it may extend in varying degree to control over men, money, and materials. Control may, however, be exercised also by bodies representing the interests most directly concerned and whose constituent members are ready to accept their ruling. For example, trade associations (of manufacturers) might take effective action to establish higher selling prices for their products and consequently obtain a larger margin of profit (probably on a reduced turnover) than would otherwise be the case. Trade unions are often able to achieve higher wages and shorter hours for their members than would be the case in a free labour market. Both of these are forms of monopoly and are sometimes known as restrictive practices. But any consequential gain to certain sections of the community at the expense of others is always liable to be countered by remedial action on the part of the Government.

Turning now to the factual background of economic thought, its development will be examined chronologically rather than by referring in turn to different aspects of the problem. It is necessary for the sake of completeness here to go over some of the ground already covered in chapter 2.

2 1776-1846. (Declaration of Independence to the Repeal of the Corn Laws)

This period saw the transformation of Great Britain from a pastoral to an industrial community. The Declaration of Independence had been signed and the United States of America was born. The allegiance to the British flag of large parts of Canada, India, and Australia had made Britain a great Imperial power and brought her both benefits and obligations.

The population of the country showed a remarkable increase throughout the period. As well as the political and military consequences of the Napoleonic wars the economic consequences were far-reaching. Economic thought was influenced by the writings of Adam Smith, Malthus, Ricardo, and others. It was an era when the doctrine of *laissez-faire* was virtually unchallenged. The essence of good government was to interfere as little as possible with business, and as a consequence government and business worked in harmony. Economic thought was guided by economic laws, especially by the laws of supply and demand. In his book on the Wealth of Nations, Adam Smith developed the theory that the productivity of labour improved greatly when it was divided into

separate or specialized jobs, especially so when applied to manufactures. It was observed that greater productivity ensued when craftsmen who formerly made a complete product were replaced by labourers concerned only with component parts or with attending to separate processes while others finished or assembled. Over a wide range of industries division of labour on these lines lowered the degree of skill which was required.

The motive forces impelling men to work were the profit motive at one end and the struggle for existence at the other. The manufacturer did not hesitate – indeed, he conceived it his right – to buy in the cheapest market and to sell in the dearest. This doctrine applied to the hiring of labour as well as to the purchase and sale of goods and services.

The studies and essays on population by Malthus had a great influence on social and economic thought in the first half of the nineteenth century. The notable increase in the population which began around 1760 was due not so much to a rise in the birth-rate, but to a marked fall in the death-rate. Malthus set out to prove that the population was increasing far faster than the growth of the means of subsistence. He foresaw therefore nothing but poverty for the vast majority of mankind. Indeed, he formed the opinion that the population would continue to increase up to the limits of the means of bare subsistence and would only be prevented from increasing beyond that stage by war, famine, and pestilence. The gloomy forebodings of Malthus appeared to be only too true to many of his contemporaries and successors. They were manifest not only in cheap labour, but in the economic thought of the time, which found difficulty in drawing any other conclusions.

In the present egalitarian era it is difficult to understand how in the early days of the Industrial Revolution public conscience tolerated and how, without more violent protests, the majority of workers endured the conditions in urban England, which by modern standards were appalling. In addition to the fact that many economists of the time accepted such conditions as inevitable, there were other factors at work. The nation was ruled by owners of land and property; labour was not enfranchised. Not only were the rulers of England seeing the growth abroad of a new nation dedicated to the declaration that all men are created equal, but the French Revolution with its cry of Liberty, Equality, and Fraternity was extremely alarming to them. Whenever great revolutionary upheavals take place in countries with whom Great

Britain normally has social or economic contacts her traditional rôle is one of intense reaction at first; later, when the excesses of revolutionary fervour subside, she is then ready to assimilate whatever may be good in the new succeeding régime. Thus during the Napoleonic wars all organized attempts by labour to better its position were ruthlessly suppressed. The Reform Acts came later.

Turning to another sphere, that of religious opinion; this, although greatly influenced by the Evangelicals, who fought so hard for the abolition of the slave trade, was not yet very seriously concerned with the state of poverty in the new industries and towns nor with the maldistribution of wealth. Such a state of affairs was thought by many to be pre-ordained and man was considered powerless to alter it; indeed – so it was preached – abject poverty had its compensation in spiritual advantage.

The basis of economic thought in the era under review here was mostly passive. It is true that the Government imposed taxes, levied customs and excise duties, protected home agriculture, but the reasons were not primarily economic. They were dictated by the circumstances of the time and by the persuasion of the ruling interests.

3 1846-1914. (The Repeal of the Corn Laws to the Outbreak of War)

This was the era during the greater part of which Great Britain sailed on the floodtide of industrial supremacy. The advocates of free trade under the leadership of Cobden and Bright had won the day. Free trade was accepted not merely for theoretical reasons, but because it brought enormous practical advantages. Great Britain was first in the field in industrialization. Everything seemed to be in her favour. She had plentiful supplies of cheap coal and iron ore; labour was abundantly cheap; adequate communications could be built when and where required. Cheap food was available in increasing quantities from the newly farmed prairies of North America, Australia, and the Argentine – and British ships carried the trade. The social and economic consequences of the decline of home agriculture were deplored by the minority who suffered directly, but their protesting voices were ineffectual compared with the approval of the more numerous manufacturing interests.

It was not until near the end of the century that advocates of

tariff reform were heard, the most persistent of them being Joseph Chamberlain. The suggestion was not so much that free trade *per se* was necessarily failing in its purpose as that the results of both the German Customs Union and the tariff policy of the United States of America (which appeared to benefit these two nations) could not fail to provoke serious thought and concern. Would not a similar policy bring like advantages to the countries of the British Empire and particularly to colonial producers in early stages of development? The debate on tariff reform continued on and off for several decades and it was not until 1932 that free trade was formally abandoned (for a variety of reasons which are outlined on page 153).

Throughout the second half of the nineteenth century a steady improvement took place in the condition of the workers. There were several reasons. Many associations for mutual help were formed: trade unions, friendly societies, co-operative societies, and others. These were all growing and gaining in experience. The dissenting churches attracted large numbers of their adherents from the working population. Education was on the move. Emigration played an important part, and provided both a means of escape and a source of opportunity for large numbers of the population.

Political and economic thought was beginning to move away from its earlier severity. Robert Owen had shown in his New Lanark mills that good working conditions and co-operation between employer and employee could achieve results of more lasting benefit than strict adherence to the doctrine of high profits and low wages. John Stuart Mill, Jeremy Bentham, and others were exploring the problem of the distribution, as distinct from the production, of wealth, and paved the way for the founders of the Fabian Society in 1883. G. M. Trevelyan, writing of Mill in *English Social History* (page 558), says: 'Mill's doctrine was semi-socialistic. He urged the better distribution of wealth by direct taxation, particularly taxes on inheritance; the bettering of conditions of life by social legislation enforced by an effective bureaucracy, national and local; a complete system of manhood and womanhood suffrage not only for Parliament, but for bodies entrusted with local government. In Mill's thought, democracy and bureaucracy were to work together, and it is largely on these lines that the social fabric of modern England has in fact been constructed, even after Mill himself and his philosophy had passed out of fashion.'

During this period of great industrial expansion two factors of considerable importance were (*a*) the means by which capital was provided, and (*b*) the monetary and currency systems. The industrial expansion could not have taken place without capital formation on a vast scale and this was only possible if savings were available. The inequitable distribution of wealth was itself a factor which facilitated saving on an ample scale. The majority who lived on a level of bare subsistence had no chance to save, but the incomes of the wealthy landowners and manufacturers were often so large that there was no alternative to their saving on a substantial scale. Taxation was low and thrift was fashionable. As regards forms of proprietorship, while many preferred direct ownership, either solely or in partnership, the principal form of large-scale enterprise was the joint stock company, especially the limited liability company.

Trade and industry cannot thrive without a sound currency and an adequate banking system. Great Britain was well served in both these respects. The basis of the currency was gold – gold coins and bank notes backed by gold. Terms such as non-convertibility (into other currencies), hard currencies, soft currencies, exchange control, etc., would have been quite meaningless in those days. International traders were not constantly wondering whether some currencies were more likely to change in value than others or whether free exchange from one to the other was likely to be impeded. Except in times of war, the question of where and in what currency balances should be held revolved mostly around the question of where they would earn the highest rate of interest and where the most helpful banking services could be obtained. Any attempt to tamper with the operation of the Gold Standard would have been considered economic heresy of the gravest order.

Although a gold basis for sterling and for other currencies brought great advantages in the way of stability, the system depended upon an adequate supply of newly won gold. It will never be known whether, or to what extent, industrial expansion was, in fact, restrained by an inadequate supply of gold. However, the discoveries of gold in California in 1849 and in the Witwatersrand at the close of the century were certainly followed by big advances in world trade.

During the course of this long era (1846-1914) the changes in economic thought which took place were evolutionary rather than

revolutionary in character. This is not altogether surprising. It was mostly a time of peace and prosperity, with wealth being produced on a vast scale, and there appeared to be nothing seriously wrong with the prevailing economic philosophy. Indeed, few people then worried much about the economic state of the whole nation. They too busy getting on with their own particular jobs.

The first steps in the retreat from *laissez-faire* were, however, being taken. Government intervention in the way of Factory Acts and the regulation of rates on public services such as railways, gas, electricity, water, etc., seem trifling by present standards, yet at the time of their inception these events seemed of great significance.

4 1914-1939. (War, Peace, and the Shadow of War)

Economic thought has, of course, an entirely different significance in time of war, especially so during a struggle for national survival. When war ended in 1918 most people tried to revert as soon as possible to the economic beliefs and business practices of 1913. (This was perhaps influenced by the fact that 1913 happened to be a particularly prosperous year). Most of the controls imposed during the war were therefore removed as speedily as possible. The pent-up demand for many of the goods and services denied during the war caused a trade boom accompanied by a rapid rise in prices. Instead of rationing in order to ensure an equitable distribution, the goods in shortest supply usually went to the highest bidder. The boom was shortlived and the subsequent recession prompted the passing in 1920 of the first extensive Unemployment Insurance Act.

The Gold Standard had been in suspense during the war and its restoration seemed indispensable to the regaining by London of its former prestige as a great international money centre. Moreover, nothing short of pre-war parity was considered sufficient and this was achieved in 1925.

It was not long before many thoughtful people began to realize that there was something seriously wrong with British economy. Unemployment was at a distressingly high level, especially in the basic industries such as coal, textiles, shipbuilding, iron and steel. Export markets were being lost for a variety of reasons. New competitors were appearing. British costs were in many cases too high. But while many observed the economic illness there were divergent opinions as to the causes; consequently little effective action was taken to prescribe a cure.

On the other side of the Atlantic the U.S.A. was enjoying a prosperity unparalleled in her history and in the three years 1927-1929 a considerable revival in world trade brought some consolation to Great Britain. Yet even at the peak in 1929 the volume of British overseas trade never regained the 1913 level, nor did unemployment fall below 1,200,000 persons.

In October 1929 Wall Street crashed and American lending abroad stopped abruptly. Since the U.S.A. had replaced Great Britain as the leading world creditor country which was both ready and able to invest abroad, such cessation had a tremendous effect on world economy. The recession in trade had by 1931-32 reached the state of a world depression the like of which had never before been experienced or anticipated. Unemployment figures in Great Britain reached 2,700,000 in 1932, but in the U.S.A. the figure rose to the staggering total of over 11,000,000 persons. There was obviously something fundamentally wrong with the mechanism of world economy. Either the earlier doctrines which had helped to foster the growth of trade were not being properly followed, or the changing circumstances required something radically different.

While a co-ordinated but unsuccessful attempt to deal with the problem on an international basis was made at a World Economic Conference in 1933, the urgency of the disaster was so impelling that most Governments took separate action to combat the distress; the actions varying with the political character of the different nations. Russia continued her policy of state control and economic isolation. The political and economic dictatorship of the Nazis attained full power in Germany and economic thought was subordinated to military designs. In Italy a somewhat similar state of affairs persisted.

In March 1933 Mr Roosevelt delivered his first inaugural address. It was devoted almost entirely to the economic situation. The new President attacked the recent excessive speculation which had been fostered by indiscriminate use of bank credit. He drew attention to the surrounding distress which was not caused by 'failure of substance'. 'Plenty is at our doorstep but a generous use of it languishes in the very sight of the supply.' He did not suggest a passive approach to the emergency; he called for action. 'Our greatest primary task is to put people to work. . . . It can be accomplished in part by direct recruiting by the Government itself, treating the task as we would treat the emergency of a war,

but at the same time through this employment accomplishing greatly needed projects to stimulate and reorganise the use of our great national resources. . . . It can be helped by national planning for and supervision of all forms of transportation and of communications and other utilities which have a definite public character. There are many ways in which it can be helped, but it can never be helped by merely talking about it. We must act; we must act quickly.'

Thereafter followed the policies known as the 'New Deal'. These proceeded often by trial and error and met with both success and failure. Their fundamental aim was to stimulate expansion – to prime the pump – and to achieve a more equitable distribution of purchasing power. Was the 'greatest primary task' accomplished? Unemployment certainly declined, yet it was not until 1941 that the numbers fell below 6,000,000 persons! In spite of the active intervention of the state in economic affairs it cannot be said that a wholly satisfactory solution was obtained.

In Great Britain the years 1930-1932 must surely be looked upon as forming a landmark in the development of her economic thought. London had been struggling to fulfil the functions of a great international money centre with all too slender resources of working capital in the form of gold and foreign currencies. When her balance of trade moved from a favourable to an unfavourable state confidence in sterling was shaken and money deposited by foreigners was withdrawn. The resulting outflow of gold assumed alarming proportions and the Gold Standard had to be suspended.

Almost on the morrow of this apparent disaster people began to realize that an opportunity had arisen which might well ease many of the former difficulties. Sterling was allowed to find its own level, its former overvaluation in terms of other currencies was eliminated, and, as confidence was restored, foreign balances returned to London. Moreover, large hoards of gold, which during the earlier period when sterling was mistrusted had been acquired by Eastern countries, in particular by India, were disgorged under the stimulus of the higher sterling price of gold. This caused a welcome and quite unexpected addition to the supply of gold held by the Bank of England. As a result the internal credit basis was expanded, yields on Government securities declined, and the way was paved for the successful conversion of 5% War Loan 1929/47 into a 3½% loan. The era of cheap money which followed stimulated those industries where expansion was most sensitive to

reductions in the rate of interest charged by borrowers. Housing was particularly important in this connection.

During much of the period 1919-1939 the terms of trade were favourable to Great Britain. The cost of imported food and raw materials in relation to the price of exported manufactures had declined. This factor helped to shield Great Britain from the full blast of the world depression of 1930-1933. It also helped her during the subsequent recovery. Because she was such a large buyer of raw materials (which could not be sold readily elsewhere) the sterling cost of imports increased only slightly after sterling had been devalued in 1931; the cost in terms of gold actually declined.

After decades of controversy free trade was formally abandoned in 1932. Historians tell how bad potato harvests in Ireland precipitated the Repeal of the Corn Laws in 1846. In 1932 there were a variety of reasons for the imposition of protective tariffs: the intransigence of the protagonists of high-tariff policy in the U.S.A.; the undermining of the textile and other industries by cheap labour in India and Japan; the need for the revenue that could be obtained from import duties. The pattern of British and Empire tariffs was cast in the Empire trade agreements signed at Ottawa and a substantial increase in trade with the Dominions and the Colonies ensued.

Great Britain won a fair share in the recovery of world trade which began in 1933. The terms of trade remained in her favour and she still retained considerable resources from which invisible exports were derived. At the same time the shadow of war was growing larger and the need to rearm brought increased demands on her productive resources. The profits of industry were in many cases not unsatisfactory, yet unemployment in the 1930's never fell below 1,500,000 persons.

During the closing years of the inter-war period the thoughts of people were increasingly preoccupied with the threat of war. But apart from this, the demon that had for many years haunted most minds was the fear of unemployment, especially in what was then only too aptly described as the Distressed Areas. National well-being could never be assured unless the demon of unemployment could be conquered. Apart from personal tragedy and social evil, the wastage of such a large part of the productive resources of the nation was deplorable.

There were, of course, plenty of alibis for those responsible, but

it was by no means clear exactly who was responsible. A tremendous amount of thought, study, and research was undertaken by economists, and of these the one who had the most profound influence on economic thought was undoubtedly John Maynard Keynes. The era was one when the savings of the nation were substantially in excess of the amount being spent on new capital equipment (described on page 40 as voluntary Investment), the balance (involuntary Investment) being applied in adding further to stocks of commodities and materials. If voluntary Investment could rise to the level of savings, then the problem of unemployment, it was said, would be well on the way to solution. But the amount of money spent on new capital equipment was influenced almost entirely then by the opportunity for profit, so that from a practical point of view the shortfall could only be made good by (a) increasing the prospect of profit, or (b) by the Government guaranteeing the success of doubtful projects, or (c) by the Government going into business on its own account.

It was along the lines of (a) and (b) that action was actually taken. The prevailing opinion in Government and business circles clung to the belief that government undertaking of capital projects either merely supplanted those which would otherwise have been undertaken by private business or reduced the total resources available for private capital formation. Opinion was not yet ready to accept the new thesis that such action would *add* to the total of new Investment.

Fair progress was, in fact, made in the direction of increasing the expectation of profit. The pursuit of a cheap-money policy played a useful part and protective tariffs also helped. In the aggregate, however, the measures adopted were not adequate, though one should not be too critical of what was done. Public opinion was not yet ready for large-scale action by the Government and in comparison with other free nations Britain's unemployment statistics did not look too bad.

It was said earlier in this chapter that although the active aspect of economic thought was usually manifest in government action it could also be carried out by bodies representing sectional interests. The latter was particularly the case in Great Britain during the inter-war period. In the era before 1914 when any particular trade or industry encountered difficult times the sequence of events was usually as follows. The lower margin of profit – or perhaps the occurrence of losses – meant that the industry could not afford the

ruling level of wages. Labour was either diverted to other industries or was obliged to accept lower wages. The deduction in wages together with an impelling urge to lower costs by means of greater efficiency in manufacture ultimately brought down selling prices. The capacity of the entire industry might also be reduced as a result of the inefficient firms being forced out of business. Lower output reduced supply and lower prices stimulated demand; in the end profitability was restored – for the efficient survivors! It was the theory of the survival of the fittest; it was ruthless, but it worked. And as long as the many survived and only the few went to the wall protests against the system were not of much avail.

But after the depression of 1921, when several industries were faced with the possibility of unbridled competition weeding out a large instead of only a small proportion of the total, events took an entirely different course. Trade associations, cartels, monopolies, price rings, and so on became the order of the day. The objective was nearly always the same: the acceptance of the inevitability of demand being lower than the industry's capacity, and the centralization of orders for the purpose of parcelling them out on a quota basis. As a result immediate profits were ensured where losses might otherwise have been incurred, but the false sense of security thus acquired reduced or removed the stimulus to take the only really effective long-term cure; which was to eliminate all waste and to promote efficiency.

A similar policy was followed by the trade unions. Many improvements which were suggested in the hope of bringing long-term benefits, but which in the early stages of use might result in temporary redundancy of labour, were vigorously opposed. The plea for shorter working hours was not usually an indication of an industry's prosperity or of its ability to operate on such terms, but arose from a desire to have a larger number of employees engaged than was warranted by the actual circumstances.

The restrictive practices of both employer and employee did much to retard the modernization of industry. Here again it is easy to be unjustly critical. Such policies of mutual self-help may have been in the long run economically disastrous, but at least they were ethically acceptable and for the greater part politically unopposed.

5 The Second World War and After

It was to the credit of the nation that during the second world

war so much study and forethought was directed to seeking solutions for many of the social, economic, and monetary problems which were likely to arise when the war was over.

In the realm of public finance much had been learnt in the previous few years about the technique of Treasury control over credit and borrowing. The amount of money which had to be borrowed for the purposes of war was colossal, yet it was obtained at low rates of interest. By restricting the ability to spend, partly through high taxation and partly through rationing, by means of foreign-exchange controls, and by the control of the issue of capital, direct conscription of savings was avoided. During the first world war the Government could only ensure subscription to its loans by offering attractive rates of interest. Some then feared that failure to raise sufficient money would jeopardize the successful prosecution of the war. In the second world war it was correctly understood that manpower and physical production – not money – determined the limits of the capacity to wage war. Indeed, the ease with which money could be borrowed at low rates of interest might well encourage the temptation to overborrow in time of peace.

International currency problems during the war were dealt with inside the larger framework of inter-allied war finance. But all the same, monetary experts were busy with the formulation of plans for post-war use. These were aimed at solving two outstanding problems: how to deal with the disequilibrium in international trade which was bound to occur during the first few years of peace; and how to provide a more competent system of currency exchange. After lengthy discussion the agreements drawn up at the Bretton Woods conference were signed.

The International Bank for Reconstruction and Development was constituted with the aims, *inter alia*, 'to assist in the reconstruction and development of territories of members by facilitating the investment of capital for production purposes, including the restoration of economies destroyed or disrupted by war'. The requirements were subsequently found to be so greatly in excess of probable resources that in the immediate post-war period most of the relief and reconstruction money was supplied by agencies such as U.N.R.R.A., by credits from the U.S.A., and by the European Recovery Programme.

At the same time the International Monetary Fund was constituted with the aims, *inter alia*, 'to promote international monetary co-operation . . . to facilitate the expansion and balanced growth of

international trade . . . to promote exchange stability'. Currencies of member countries had to have a par value in terms of gold, but limited facilities were provided for changing the par value. It was hoped thereby to retain the benefits of the earlier form of gold standard while at the same time removing some of the disadvantages. One of the principal objectives was to restore a working system of multilateral trade, a wish very dear to American opinion, and to thwart a return to the form of bilateral trade pacts which had become so prevalent in the 1930's.

In 1942 Sir William Beveridge completed his report to the Government on the subject of Social Insurance and Allied Services.¹ The terms of reference required 'a comprehensive survey of existing schemes of social insurance and allied services'. The report received wide publicity not so much by reason of the recommendations relating to unification and administration, but because the envisaged scheme of comprehensive social security had as one of its objectives an attack upon the evils of Want, Disease, Ignorance, Squalor, and Idleness. It is not surprising that many popular misconceptions soon arose regarding the proposals. The high-sounding aims caught the imagination of the public. The benefits were magnified: the contributions were minimized. Those who pointed out that the scheme was a scheme concerned with the redistribution of the national income and not with the creation of new wealth were considered by not a few to be reactionary.

There is little doubt that public opinion would have insisted sooner or later on a comprehensive scheme of social security and economic opinion was certainly not against it. But the contribution which it could make in the long run to the national wealth would depend a lot upon the public being able to understand correctly what was involved. At best it would provide a useful lubricant in the economic machine: at worst it might have the malefactions of grit in the works. Only by a surfeit of wisdom could it increase the driving power.

Although industry during the war was preoccupied in making a maximum effort to fulfil whatever was required of it by the nation, opportunities for critical examination were afforded in certain cases. Government-sponsored committees reported on the coal and cotton industries with particular reference to the comparative performances in Great Britain and the U.S.A. The findings were

¹ Cmd. 6404.

far from encouraging. The production per man-hour – P.M.H. – at home made unfavourable comparison with abroad. In Great Britain the very age of these two industries was now one of their principal weaknesses. Mines, factories, and machinery had in many cases served their useful life. Units were too small to achieve a sufficiently low cost of production and restrictive practices of both capital and labour had retarded progress. In another industry, the steel industry, costs of production were found to compare unfavourably with those in the newly constructed steel plants in the U.S.A., India, and Australia. It was estimated that modernization of these three industries alone – coal, cotton, and steel – would require expenditure on capital account of several hundreds of millions of pounds. There was no longer much doubt that, in order to bring these industries to the state of efficiency required by modern standards, capital expenditure on a large scale would be necessary.

On the other hand, the British faculty for being in the forefront of scientific progress was demonstrated by the part played by her inventors in the discovery and development of penicillin, radar, jet propulsion, etc., and in the wartime feats such as Pluto, Fido, and the Mulberry Harbours.

As regards the combating of unemployment there was little likelihood of this problem coming to the fore either during war-time or even during the immediate post-war period. There was general agreement that never again should conditions of unemployment such as existed during the two decades prior to 1939 be accepted as the result of economic conditions over which Governments could have no control. A White Paper entitled *Employment Policy*¹ was issued in 1944. The opening words were: 'The Government accept as one of their primary aims and responsibilities the maintenance of a high and stable level of employment after the war.' This policy emanating from a Government which was a coalition of all leading parties was another landmark in the development of economic thought.

There are two principal forms of unemployment: general and localized. The first is caused by general trade recession and by temporary unemployment brought about by delay in moving from one job to another or by seasonal reasons. The second is caused by depression in industries which are concentrated in special localities and where those thrown out of work cannot obtain re-employment

¹ Cmd. 6527.

without moving to different industries in other areas. The difficulties of retraining and rehousing are often so great that those thrown out of work prefer to remain unemployed in the hope of ultimate re-engagement by their former employers.

The White Paper on Employment Policy proposed to attack the problem of localized unemployment: by influencing the location of new enterprises in order to encourage diversification and discourage undue concentration; by encouraging the transfer of workers through the provision of houses to rent; and by providing training facilities for those willing to move from the declining to the expanding industries. In the field of action which had already been taken and which was directed at avoiding localized unemployment much was achieved by the Government Trading Estates. These were formed in 1936 and 1937 to attract industries to the Distressed Areas (now called Development Areas). Factories were built with money provided by the Government and were let to industrialists on very attractive terms. The building and letting of such factories continues and the movement has grown to one of substantial proportions.

The key to the attack on general unemployment, as proposed in the White Paper, was the influencing of the volume of both private and public capital expenditure in order to maintain the total at a satisfactory level. (This was in conformity with the view that pre-war unemployment was caused largely by the insufficiency of capital Investment.) The methods proposed included: a policy of cheap money with variations in interest rates when thought desirable; the encouragement of private enterprise to embark on capital expenditure, stimulated if necessary by tax reliefs; the undertaking of capital Investment schemes by public authorities. The unemployment which would be caused by any falling off in the amount spent on consumer goods and services was to be countered by schemes for increasing the purchasing power of the community. For example, contributions to social security funds might be reduced. Taxation also could be reduced even if this meant a budget deficit for a short period.

After fourteen years of Governments which had been either a coalition or had contained representatives of most parties, the return of the Labour Party in 1945 with a large majority introduced into economic affairs a more sharply divided political controversy. This resolved itself into debate on the degree of government control over the national economy. Was ownership of industry to be

public or private? What was to be the relative reward of capital and labour? In the years immediately following 1945 economic thought and action was determined partly by political doctrine and partly by the sheer necessity of coping with the several urgent problems which arose in rapid succession. It is, therefore, neither possible nor profitable at this point of time to try to examine closely the various forces at work. Yet while the whirlpools are confusing the undercurrents are more discernible.

Historians of the future may look upon the period 1919-1939 as the decisive stage in the retreat from the doctrine of *laissez-faire*. Was the endemic unemployment of that period and the decline of many basic industries caused by the very existence of this retreat or was it because it did not proceed further or fast enough? Had there been no change in economic thought the sequence of events would presumably have been something like the following. At the first onset of serious unemployment after the first world war a drastic reduction in wages would have been forced, accompanied no doubt by strikes and by a certain amount of civil strife. Costs of production would have been lowered to a point where demand revived. If redundancy had still persisted force of competition would have eliminated the inefficient. Labour and capital would have flowed to other industries where prospects of profit were greater. If such outlets did not exist, then they would have to be sought in other parts of the world. But for very many reasons the acute distress which would have been suffered – perhaps only temporarily – by part of the community would no longer have been tolerated; and so events took a different course.

In the international sphere any attempt to return to the doctrines of *laissez-faire* were made almost impossible from the start by the need to deal with vast sums of war debts and reparations. Any smooth working of international trade requires that those countries with favourable balance of trade should invest these balances overseas. But during the two decades 1919-1939 the nation with the largest export surplus, namely the U.S.A., did not do this regularly, but instead acquired on balance an unduly large proportion of the world's supply of gold. This in itself would not have prevented the ultimate redistribution of gold and a free flow of world trade had it not been for the sterilization of the gold influx and the withholding of it from the American monetary system. This prevented a rise in American prices and the ultimate return to equilibrium which would otherwise have occurred had the rules and customs in force prior to 1914 been in operation.

Thus it may be said that after 1919 the adherence in Great Britain to the doctrines of *laissez-faire* as known in the era before 1914 was no longer politically feasible or ethically acceptable. Furthermore, any normal functioning of *laissez-faire*, had it been attempted, would probably have been frustrated by the policies of other nations.

One of the advantages of *laissez-faire* was that economic forces were self-regulating and had a tendency always to achieve equilibrium. The trend of these forces was frequently predictable and business men had a chance of planning ahead. The retreat from *laissez-faire* was directed in the first place towards reducing the distress which was the lot of the unfortunate, the inefficient, and the unsuccessful. But it was not long before governments found themselves responsible for dealing also with whatever appeared to be the most pressing economic problems of the day. Just as every action is said to have its own reaction, so every problem in the long run brings its own solution. The most pressing economic problems since 1919 have included unemployment, regulation of credit, provision of housing, the balance of overseas payments, etc. Unfortunately measures aimed exclusively at the solution of any one particular problem have a habit of creating in the process some entirely fresh problems. No doubt this will be so in future as it has been in the past.

If it has not yet found a really satisfactory solution, economic thought has at any rate recognized the changed circumstances. The successor to *laissez-faire*, democratic planning as it is called - itself a contradiction in terms - must somehow find a workable synthesis between its two conflicting elements: democracy, meaning in its widest sense personal, political, and economic freedom; and state planning, involving a surrender of part of that freedom for the purpose of protecting the needy and of promoting the general welfare of all members of the community. But never, to the benefit of the nation, can there be a retreat from the most fundamental economic truth of all ages - namely, that the basic source of all well-being is the character, ideas, industry, and skill of men and women.

CHAPTER II
SOME BASIC PRINCIPLES
OF INVESTMENT

The Essential Questions

In the past two chapters the word Investment has been used most frequently in its national economic sense meaning capital formation; Investment in the sense of new construction for capital purposes; the economic counterpart to saving. In this chapter it relates solely to the investment of money by persons or by associations of persons, whether done by way of application to new issues or by purchases on a Stock Exchange or by negotiation.

The *principles*, referred to in the title of this chapter, relate to those which should govern the *choice* of investments by investors and apply to the problems of retention and sale as well as purchase. There are countless theories about investing money, but it is intended to avoid the realms of speculative thought and to concentrate as far as possible on principles; principles meaning fundamental truths as the basis of reasoning.

The first basic principle – and this is not peculiar to the study of investment – is to ask the right questions. This is not a useless platitude; it is an indispensable condition of success. The questions most fundamental to the study of investment problems are:

- (1) What is the purpose of the investor?
- (2) What is the precise nature of the investment under consideration?
- (3) What is the past record and present financial standing of the debtor or proprietary interest?
- (4) What is the purpose for which money was borrowed or capital raised?
- (5) What is the quality of the persons principally involved?
- (6) What are the future prospects?
- (7) Will the investment be readily realizable?
- (8) Is the price of the investment suitable?

As a rule it will be found that the answers to the first four can be found if the facts can be ascertained. The answers to the last four, however, are largely matters of opinion. Therefore the principles of

investment hinge partly on fact and partly on opinion; on judgment applied to knowledge; in other words, on wisdom. There is no short cut to success.

I What is the Purpose of the Investor?

This is essentially the problem of equating the requirements of the investor with the suitability of the investment. The requirements of different investors may vary greatly. They may be determined by the urgency of absolute need, or they may have the latitude enjoyed by those whose wants are satisfied. More often than not the actual requirements will lie somewhere between these two extremes. They may be capable of precise definition, but usually there will be some uncertainty. The problem will be easiest when the requirements can be met by choosing from a wide range of investments. It will be most difficult when full achievement is hardly possible or when it is a question of selecting the investments which, though falling short of complete fulfilment of purpose, yet come nearest to attaining what is required.

Both sides of the equation are seldom static for long. One or other or both may change and if necessary the investments should then be altered to conform to the new circumstances. One very important thing to note is that it is the *requirements* of the investor which should make the pace. Theirs is the body which has to be clothed. What, then, are the measurements?

Perhaps the best way of examining this point is by a series of illustrations. Take first a very simple example. A trust is formed to provide a sum of £500 per annum in perpetuity. The donor is prepared to make over whatever capital sum will ensure the fulfilment of his bequest. The requirements are definite, so the trustees must seek a perpetual investment where the security of income is unimpeachable. Since income in perpetuity is the aim, fluctuations in market price are of no real concern. There are, however, two very important points to watch. An investment may have all the appearances of a perpetuity under conditions ruling at the time of purchase; but circumstances may alter and bring into operation a contingency, originally seen as a remote one, yet one in which redemption could actually be made. Such an investment would not be ideal for the purpose in hand. $2\frac{1}{2}\%$ Consols could be cited as an example. So long as the price remains well under par the possibility of the Government exercising its option to redeem must be considered a remote one. But conditions *might* change

and the stock is not a true perpetuity. Then the question of nationalization should not be lost sight of. Some debenture stocks of British railway companies were designated *perpetual* stocks, but that did not prevent their conversion into redeemable transport stock when nationalization took place; and in almost every such case a considerable loss in income was suffered.

Turning now to another illustration, that of a trust formed to provide a certain sum of money at the expiry of a fixed period of time, the primary purpose of the trustees would in this case be the safety of the capital. Income would be a secondary consideration. The trustees should therefore select investments which are definitely redeemable at the time when they are due to pay out.

More usually, however, trusts are formed to provide income for one or more persons for a defined period of time, with the capital reverting to others at some later date. Trustees should therefore have regard to both capital and income when selecting the investments. It so happens, however, that attempts to earn a high rate of income frequently impair the safety of the capital. Similarly attempts to augment the capital or even to place undue emphasis on maintaining it intact may diminish the income. The trustees may therefore find that such dual purpose results in a conflict of interests between those of the life tenant and those of the reversioner. Unless therefore the object of the trust is more precisely defined in the deed creating the trust, the trustees may find themselves called upon to decide on wider matters than purely investment ones.

Turning now to personal investors, as distinct from trustees, they invest for many different reasons and purposes: to accumulate capital in order to buy a home; to supplement earned income; to provide an income on retirement; to provide for their dependants. In such cases the investments should be selected to fulfil as far as possible the ultimate purpose. One of the purposes common to most personal investors is that at some future time the income and perhaps part if not all of the capital should be spent; much will depend therefore upon the price level (of goods and services) at that future time. This does not apply to cases where the purpose of investment is to provide for the redemption of a debt.

Anyone who saved for the purpose of providing on retirement for a certain standard of living would have his objective frustrated if the income so obtained bought much less than expected. On the other hand, if it bought more than expected, because prices had

fallen, then an unnecessary sacrifice may have been made during the time of saving. For this reason the ideal for many investors would be the type of investment which could be expected to fluctuate in respect of both capital and income in conformity with variations in the price level. It is extremely difficult, however, to find such an investment. In theory investment in equities should serve as the most likely medium. This does, in fact, provide a key, but much skill is required in opening the door – and it seldom opens to the full extent!

The requirements of institutional investors are usually ascertainable within certain limits. The powers of investment will, of course, be defined in the memorandum and articles of association or in whatever is the appropriate deed of constitution. A company whose business is first and foremost the investment of money, for instance an investment trust company, may have either unrestricted powers of investment or restrictions may be placed on such things as the amount which may be invested in any one security or country or industry. The requirements will depend, too, upon the company's liabilities in the form of its loan and share capital. Suppose that these consist of redeemable debenture stock, preference, and ordinary stock; the primary purpose of the directors will then be to invest the assets of the company in such a way as will ensure the service of the debenture stock, pay the full preference dividend, and provide for a reasonable rate of dividend on the ordinary stock. If these requirements are easily attained, then the company will enjoy considerable freedom in the choice of its investments; otherwise its investment policy may be restrained.

Many companies engaged in manufacture, commerce, or trade have occasion to invest money. This may arise in several ways: money may be set aside out of profits in order to provide for replacement of property or plant at some future date or for the redemption of debt; the amount of circulating capital which is required may decline owing to a recession in trade, thus releasing money for investment; free reserves may be accumulated as a consequence of a conservative dividend policy; money may be accumulated for the purpose of providing a pension fund or provident fund for its employees. Whatever the source of the money available for investment it is the present and future needs of the company which should govern the choice of the investment.

Institutions such as banks, discount houses, building societies, etc., have rather specialized investment problems. Permanent

capital is relatively small in relation to the sums of money which are placed on deposit and repayable as a rule at short notice. Although the primary purpose of such businesses is not the investment of money in stock exchange securities, a very considerable proportion of their assets is, in fact, invested in this way. The amount of money available for such investment depends partly upon the level of deposits and partly upon the extent to which the assets cannot be employed fully in the basic purpose of the business. Here again investment principles demand that money be invested in such a way as to equate suitability with requirements.

In spite of much of the liabilities being in the form of short-term deposits, so long as there is every reason to believe that the total will remain above a certain figure and so long as some substantial part of that total is likely to be available for investment, it might be thought that investment could be made wherever the highest rate of interest was obtainable – even if that meant long-dated or irredeemable securities. But one of the primary motives for the deposit of money – sometimes at low rates of interest and without the support of any pledged security – is that complete confidence exists that it can always be withdrawn whenever required. If therefore the interests of the depositors were not safeguarded, and if it became known that assets were invested in securities liable to material fluctuations in price or not readily realizable whenever required, a rush to withdraw deposits would most probably ensue.

The principles of investment applicable to all forms of deposit banking have been built up as a result of years of experience. Consequently a series of codes and customs have evolved, changing when necessary with changing circumstances. The businesses of banks, discount houses, building societies, and others who finance their activities by accepting deposits depend greatly upon the preservation of confidence, and this is only possible if there is adherence to customary practices.

The investments of life assurance offices and pension funds have been omitted here, as the principles and problems relating to them will be dealt with in chapter 21. The question of the diversification of investments will also be considered there. It might be thought that the wise spreading of risks was an investment principle of unquestioned importance. So it may well be. But it is subsidiary to the main problem just considered.

2 What is the Precise Nature of the Investment under Consideration?

The first of the eight questions relates to an examination of the requirements of the investor, to the measurement of the body to be clothed, and to consideration of the type of clothing required. The next seven are all concerned with the examination of the investment in order to decide whether or not it is suitable for the purpose in hand.

The determination of the precise nature of any investment, whether a contractual obligation or a proprietary interest, should not usually cause much trouble. The primary authoritative sources of information include the prospectus, the trust deed in the case of a debenture stock, the mortgage, bond, or other form of contract, the memorandum and articles of association or whatever is the appropriate deed of constitution. Copies of some of these documents are not always readily obtainable and an exhaustive examination in every case would be impossible without a great waste of time. Fortunately in the case of investments quoted on a Stock Exchange the problem is simplified by the existence of the Stock Exchange Official Year Book, which contains a record of the essential features of each security. In most cases the information given there is adequate for the purpose in hand, but every now and then it is necessary to delve into the original sources of information. It is difficult to dogmatize about when this should be done (though in all cases of doubt the original sources should be examined). One should always be on the alert to discover any provision whereby the investment under examination can be made to undergo a material change in its status. For instance, can the amount of a debenture stock currently outstanding be increased at some future date, or can a new stock be issued ranking in priority to or *pari passu* with it and so weaken the value of the security? Can any stock acquired by sinking fund operations be reissued at a later date?

As regards preference and ordinary stocks, it is essential to examine their respective rights as to dividend and capital – and also their voting powers. If a preference stock is under consideration and if the price is substantially above the price to which it is entitled in a winding up, then particular attention should be paid to any factors which might have a bearing on the duration of the company's existence. If equity capital is being considered, are there any restraints on the permitted level of earnings or dividend,

such as, for example, existed in gas and electricity companies before nationalization took place? Is the equity shareholder liable to have his share in the equity diluted as the result of subscription to new capital issues on favourable terms by other parties?

3 What is the Past Record and Present Financial Standing of the Debtor or Proprietary Interest?

(a) In the case of *companies* the answer to this question is usually contained in the directors' reports, profit and loss accounts and balance sheets. The study and analysis of these will be considered more fully in the next chapter. The extent of the examination which should be necessary will depend greatly upon the nature of the investment. In cases where well-secured loans, mortgages, bonds, and debenture and preference stocks are under consideration, only a cursory glance may be necessary. Where any doubt exists about the ability to fulfil contractual obligations or to pay the full preference dividends, and in almost all cases where equities are under consideration, careful examination is essential. Of parallel importance is the chairman's speech at company meetings. A lot of useful information and opinion is frequently given on these occasions.

In cases where many months have elapsed since the publication of the last report there will be an unavoidable gap in the process of being informed on the current financial position. Such a gap may be bridged partly by inference. If the business in question is inherently stable little change need be anticipated. Since the experience of many companies will follow the general trend of their own particular trade, current statistics or other published information relating to that trade may prove useful; so, too, will the reports of other companies in the same trade. Any change in the rate of interim dividend would, of course, be noted.

(b) As regards loans, mortgages, and bonds – where a *personal debtor* is concerned – information as to the past record and present financial standing is not as a rule readily obtainable. In the case, however, of mortgages or bonds where a property or some other physical asset is pledged, a valuation of the property will often make the question less necessary.

(c) As far as stocks and loans of *government* and other *public authorities* are concerned, the problem can be dealt with more conveniently in later chapters.

4 What is the Purpose for which Money was Borrowed or Capital Raised?

In section (3) the simple question was: In what form is the investment? Here the question is simply: In what undertaking is one investing? It is perhaps something of a paradox that many a person will take infinite pains to be fully informed about some goods which he intends to buy in a shop and yet he may be only too ready to invest a much larger sum of money in an enterprise about whose business he may have only the vaguest idea. Quite apart from the added interest which full knowledge brings, it is essential – if a proper appraisal is to be made – to know what the money is really being used for. In general it is wise to discriminate between progressive purposes and defensive purposes. The former includes the financing of development and production undertaken in the expectation of profit. The latter relates to such purposes as to make good any insufficiency of capital, to finance the carrying of unsaleable stocks of merchandise, to pay pressing creditors, etc.: in all of these the predominant motive is the avoidance of loss.

When an investment is being studied within a few years of its creation it will seldom be found that the investor's money has been diverted to different use than that originally intended. Nevertheless, one should be on the alert to detect any material change as well as being informed of the original purpose. It was pointed out in chapter 4 that, in the case of many companies, the memorandum of association gives very wide powers as to the type of business permitted. It is possible therefore for the directors of a company to change the fundamental nature of the business without requiring or inviting the consent of its members.

A company is obliged to state the nature of its business in any public prospectus; it is also obliged to publish accounts, but it is under no obligation to continue to make public the precise (apart from general) nature of the business undertaken. It is therefore not always easy to obtain the desired facts. It may even be necessary to study other sources of information such as trade journals, advertisements, catalogues, etc.

Names may be most misleading. It should not necessarily be assumed that, to take a hypothetical example, The Amalgamated Nut and Bolt Company is now actually making nuts and bolts. It may have done so in the past, but may have changed over since to the manufacture of welding processes. One should not be satisfied either with merely ascertaining the name of the trade or indus-

try carried on. Take *shipping*, for example; there is a tremendous difference between luxury liners, tramp cargo vessels, tankers, and the business of shipping agents and managers; yet all may be included in the general term, shipping. Property-owning companies, to cite another case, might be thought to form a fairly homogeneous group. Yet there is a world of difference between estates in an early stage of development and buildings let for long terms of years to tenants of undoubted financial strength.

5 What is the Quality of the Persons Principally Involved?

There can, of course, be no stereotyped method of approach to this problem, whose importance needs little emphasis. Many people would rather lend money without any security at all to a man of undoubted integrity than lend to one whom they could not trust, even if the latter loan were supported by legal documents and buttressed by amply pledged security. In the case of government and municipal obligations, personal qualities are usually submerged in national and civic characteristics, and financial ability to honour obligations may be indeed less important than the actual will to pay – or to avoid payment.

As regards public companies, the 'persons principally involved' are the directors, managers, technicians, and professional advisers. There are, of course, some businesses where the impact of personalities can make or mar more readily than others. It is in such cases that closest attention should be paid to this question. The investor should be very much on guard when considering companies where the prospects are dependent to any material extent upon one man. In others where the very nature of the business makes for stability, it is usually sufficient to satisfy oneself that there is nothing to their discredit.

If it is possible to generalize it will be on the following lines. Personal qualities and abilities will usually have some reflection in past records. These should therefore be examined in that light as well as for the financial information they contain. One should endeavour to ascertain whether men hold their posts of responsibility because of their particular aptitude and qualification for the job, or whether other reasons predominate, such as family relationship, friendship, or the refusal to retire if no longer fit. But it must be borne in mind that it is the team, the combination of personalities, which matters most. Attention should therefore be paid to balance. A board packed with technicians each of them brilliant

might nevertheless fail lamentably because they did not know how to sell their products.

The investor should also be satisfied that there is a proper identity of interests linking himself with those responsible for the direction of his company. This is particularly important in the case of family businesses where shares have been sold to the public. If the vendors continue as directors yet retain only a small financial interest and do not sign contracts to serve as managing directors, there is, *prima facie*, little identity of interest – at any rate compared with those companies whose directors retain a large financial interest and where they have agreed to serve for a number of years as managing directors.

6 What are the Future Prospects?

The question here seems to lead towards the realm of speculative thought which it was intended at the beginning of this chapter to avoid. When it is extended to read: 'What is the range of possibilities which one could reasonably contemplate in the not too remote future, and within that range, what in the light of past experience and present evidence is the most reasonable expectation?' then the question is often capable of a practical answer. In any case such an approach is an extremely profitable exercise in that it helps to indicate the degree of risk involved in the investment under consideration. For instance, no one would question the due fulfilment of the terms of a British Government security. Similarly in the case of many debenture stocks and preference stocks and shares in well-established and prosperous undertakings, the possibility of failure to meet contractual obligations or to satisfy full preferential rights may be extremely remote. On the other hand, in the case of debenture and preference stocks whose requirements are thinly covered by current earnings and generally speaking in the case of all equities, the range of future possibilities may be much wider and foresight is accordingly far more important.

The aim is, of course, to form some reasoned opinion of the level of profits likely to be earned during the ensuing few years. This is often a matter of forecasting demand and supply – if allowed to operate freely. If, however, these forces are in any way subject to control by government or other authorities, then the effect of such control must be considered. If that control is strong or unpredictable, then forecast cannot be anything better than a guess.

Fortunately there is often a considerable amount of published statistical information which contributes usefully to present evidence, and it is rare that circumstances are so completely new that the past record is no guide to the future.

The oil industry in the immediate post-war period may be cited by way of illustration. In 1945 the demand for oil was in excess of the supply. Forecasts were made by several authorities that demand would increase for many years to come. Apart from the expected expansion of industry throughout the world, there were other reasons. The supply of competitive fuels, especially coal, was declining and the cost of these was increasing. Over a large area of the world the tractor was replacing the horse. On the supply side, new discoveries of oil were certainly taking place, but, before these could enter full production, wells had to be sunk, pipe lines built, refineries constructed, and tanker fleets enlarged. All this would take several years to carry out, so that for some time to come demand could be expected to outstrip supply. On purely economic reasons therefore the oil industry could look forward to enjoying several years of prosperity. This was not guesswork; it was based on rational and logical arguments. But when it came to forecasting the part which domestic and international politics and fiscal measures would play one was back again in the realm of speculative thought.

Whenever past experience is used as a guide to the future it is essential to examine whether the surrounding circumstances are sufficiently similar. If they are dissimilar attempted comparisons may be extremely dangerous. For example, when forecasts were made that, after the end of the second world war, industrial activity and business profits in the U.S.A. would exceed those ruling in 1929, past experience might have led one to expect that prices of American equities would follow a similar pattern. But surrounding circumstances were utterly different. In 1929 the demand for equities was swollen by a wave of speculative borrowing. Years later speculation had been drastically curtailed and the potential demand for equities considerably reduced owing to high taxation of personal incomes and the almost complete absence of the European investor.

Any consideration of future prospects will always involve both knowledge and judgment. The field is so vast that he is a wise man who is never reluctant to seek expert advice.

7 Will the Investment be Readily Realizable?

The importance of this question depends almost entirely on the needs of the investor and on the nature of the security. It is impossible to suggest any generalized answer, but the question of marketability may be an extremely important one. If the purpose of the investment is a temporary one, then no investment which is not readily realizable when required should even be considered, however else it may fit the requirements. If the purpose is for permanent investment, then it must be remembered that nothing is suitable for permanent investment unless the needs of the investor and the suitability of the investment are properly equated – and remain so. Here one is faced then with the paradox that the more one strives to find a truly permanent solution the more one has to be on the alert to detect any later change in circumstances. A permanent solution is, however, seldom attainable, so the problem of realization cannot ever be dismissed as completely irrelevant.

8 Is the Price of the Investment Suitable?

If correct answers are obtained to the first four factual questions and if wise opinions emerge in answer to the next three, there is still left one of the most important questions of all. The problem of price and yield is indeed the most controversial factor in the whole study of investment.

In the case of loans, mortgages, and bonds where the value of the investment is normally represented by the face value of the debt, the *price* can only find practical expression in terms of the rate of interest. The suitable or appropriate rate of interest should depend both upon the rates currently ruling for risk-free investments (in this respect British Government securities provide the yardstick most frequently used) and upon the degree of risk (if any) incurred in the particular investment under examination.

Where the investment has a fluctuating market value – and this applies principally to those quoted on the Stock Exchanges – the question of choosing the best time to buy or to sell is often a factor of critical importance.

The movement of prices on the Stock Exchange is influenced by two main factors: one is the relationship between the requirements of investors and the supply of suitable investments; the other is the opinion which is formed by investors as a whole as to the value of particular investments. In the former case some seek investments just because they have money to invest, others are

obliged to realize investments because they need the money for some other purpose. In the latter case, that is to say where opinion is the main determinant of price, if an optimistic view is taken about the prospects of a company, then a special demand will be stimulated for its equity shares and so, other things being equal, cause a rise in price. The demand will not arise solely from those who happen to have money readily available. It will be swollen by money provided by the realization of other investments and perhaps by temporary borrowing. On the other hand, a pessimistic view will induce investors to sell with a view to putting their money to better use.

Thus whenever an answer is sought to the question as to whether the price of the investment is suitable these two factors must be borne in mind: the relationship between supply and demand; and opinion as to the merits of the investment in the present and in the future. There is, of course, no discernible dividing-line between the two, and they may often pull in opposite directions.

The following will serve as examples of the influence of supply and demand. In 1948, when the Argentine railways were bought out, investors received in cash over £150,000,000. As these railway securities were held mostly by permanent investors, the demand for investment in other securities was swollen by that large sum. The natural consequence was that reinvestment was only made possible by paying in many cases higher prices than would have otherwise been the case.

As an illustration in the other direction, the issue in 1947 of new ordinary capital to the value of nearly £30,000,000 by the Shell Transport and Trading Company Ltd. was responsible for a considerable fall in the price of its ordinary shares. Here the supply of shares was increased by a substantial amount and, as there was no new demand comparable in size, equilibrium could only be reached at a lower level of price.

From the demand and supply angle alone therefore one should have avoided buying at the time when the former Argentine railway holders were competing for reinvestment, and in the case of the Shell Transport and Trading Company the time of the issue of new shares offered a particularly favourable opportunity to buy.

The price relationship between different classes of investment will be dealt with in later chapters, in particular the prices and yields on British Government securities. However, it can be said now that the two fundamental indices of stock market performance

are (a) the yield on British funds, and (b) the level of equity shares.

Apart from the prices of individual equity shares a great deal of attention is given to what is known as the general trend. Just as trade booms and slumps are prone to occur with cyclical frequency, so, too, are equity shares as a group prone to move in cycles. It is usual for stock markets to anticipate by several months any change in the trend of trade. The duration of each cyclical rise and fall of equity prices varies considerably, but the more usual pattern is for the period of rise to last twice as long as the period of fall; the corollary being that the speed of the fall is usually twice as fast as the speed of the rise. The term colloquially given to the rising trend is *bull* market; to the falling trend, *bear* market.

It might be thought that the prevalence of such cyclical swings would greatly simplify the problem of choosing the best times to buy or to sell. To a limited extent it does, but there are two main difficulties to be faced. The first is to ascertain what is the basic trend: the bull market or bear market? If prices of a representative group of equities during the course of the cycle moved evenly upwards until reaching the peak and then proceeded to move evenly though at a steeper pace downwards the problem would be comparatively simple. But actually the normal pattern is anything but even. There are usually many fluctuations, some quite violent, which conceal the change of trend until well after the nadir or zenith has been passed; just as a person on an unknown shore has to watch the waves advancing and receding several times before he can tell whether the tide is on the ebb or the flow. Experience has shown that in the course of a complete cycle the times during which there is little room for doubt as to the major trend often last not much longer than the times during which opinion is sharply divided.

The other difficulty is this. Major trends, market cycles, trade cycles, etc., are reflected in the performance of representative *groups*, but not necessarily in the performance of each share in those groups. For instance, a chart of the performance of the average prices of a hundred representative equity shares might show a somewhat similar pattern in two successive cycles. They would no doubt start from different low points, reach different high points, take different lengths of time, but the general pattern would probably contain many similar features. But if the price performance of each individual unit were plotted it would be found that in many cases there was no similarity at all between the beha-

viour in one cycle and the behaviour in the other. For instance, at the time when the *group* had attained its peak in the earlier cycle the price of an *individual* share might be below the price touched at the time of the previous group low point – yet its price might rise again by the time the group as a whole reached its next low point. But in spite of any individual investment behaving very differently from the trend of the group as a whole, each is in some way, large or small, influenced by the general trend. Therefore *both* individual merits and general trend must always be taken into consideration.

9 General Considerations

It has been said that the first principle of investment is to know the right questions to ask. The answers to these will be found partly by ascertainment of fact and partly by the exercise of opinion. When that is done judgment must then play its part. The handling of investment problems certainly requires much technical skill, but to be really successful it requires something else as well. Courage, patience, forbearance: these moral qualities can be supremely important. So, too, is the ability always to recognize things as they are and not as what it was hoped they would be, even if this involves a complete reversal of previously formed opinion.

ANALYSIS OF COMPANY ACCOUNTS

I General Comments

The report of the directors, together with the profit and loss account and balance sheet, form the principal sources of information available to members about the financial state of affairs of their company. Every member of a public joint stock company is entitled to receive a copy of the directors' report and accounts, but many who are contemplating the purchase of a company's stock will quite naturally want to examine as well the financial history of the company. For this purpose the statistical services provided by Moody's Services and by the Exchange Telegraph Company are of great value. In addition to giving general information, each statistical card contains an analysis in tabular form of the principal items of the profit and loss accounts and balance sheets. It is perhaps an interesting commentary on the relative importance of these two accounts that as a rule the analysis of the profit and loss accounts extends over a much longer period than in the case of the balance sheets. The manner and pace of a company's growth (or decline) is usually thought to be more important than its actual size at any particular point of time.

Every public company is required to prepare and issue each year a directors' report, a profit and loss account and a balance sheet, and to hold a meeting of proprietors. The chairman's speech at this meeting is often very informative, though by reason of custom rather than of law. But the report, profit and loss account and balance sheet must conform to the requirements of the Companies Act and the accounts must be certified by duly appointed and qualified auditors.

But in spite of these circumscriptions a very considerable degree of latitude is often left to the directors as to the exact form of presentation and more important still as to the fixing of some of the actual figures in the accounts. There are indeed very few companies where the accounts can be drawn up according to a set of formulae which would allow of no modification whatsoever. Fortunately there is a deeply rooted propensity among most British companies to try to show things rather worse than they

really are; to understate strength and wherever possible to value assets on a conservative basis. But while partiality towards caution is commendable any deliberate concealment of fact is not. It was largely for these reasons that the Companies Act, 1948 introduced new regulations which required the disclosure of much fuller financial information than was formerly necessary.

The symbols used in all accounts are words and figures. Many words are common to the accounts of different types of business, so that a study of accounts is apt to be confined to the examination of the bare figures themselves. It will help therefore towards a proper understanding if in the process of examination a mental picture is formed at the same time of what the figures actually represent. Consider, for example, the item, 'fleet at cost less depreciation'; this might refer to one huge liner like the *Queen Mary*, or, under the identical phrase, it might refer to a dozen channel steamers, a few dozen tramp steamers, or a number of fishing vessels. Some special features of the accounts of particular types of businesses will be examined later in the chapter, but in the next four sections the main features common to the accounts of most types of company will be examined.

2 General Features of the Balance Sheet

A balance sheet is a statement of a company's affairs, of its liabilities and assets, at one particular point of time. The totals of both sides of the balance sheet are always shown to be equal, but this is as much an accounting convention as an unavoidable necessity. It may help towards a proper understanding of a balance sheet if at first the question is asked and answered. Why should they always be equal? A hypothetical illustration will be used and, in the construction of this balance sheet, the essential parts of both sides will be tabulated – but with one item missing so that the two sides will *not* be equal to one another. The illustration used would be appropriate to many manufacturing companies and a synopsis of the assets is shown as follows:

	ASSETS	£
<i>Fixed Assets</i>		
(a) Land, Buildings, Plant, Machinery, etc.		1,000,000
(b) Investments in Subsidiary and Associated Companies		300,000
<i>Current Assets</i>		
(c) Stock in Trade, Debtors, Miscellaneous Investments, Balance at Bankers and Cash in Hand		550,000
(d) Advances to Subsidiary and Associated Companies		100,000
		£1,950,000

Turning now to the liabilities, the illustration assumes that the company has been in existence for several years and that it has traded at a profit.

LIABILITIES

	£	£
	Authorized	Issued
<i>Share Capital</i>		
5% Cumulative Preference Stock	1,000,000	500,000
Ordinary Stock	1,000,000	500,000
4% Debenture Stock		250,000
Specific Reserves (e.g. Pension Fund)		50,000
<i>Current Liabilities</i>		
(e) Creditors, Taxation, Provision for Dividends		380,000
(f) Amounts due to Subsidiary and Associated Companies		70,000
		<hr/> <u>£1,750,000</u>

The difference between the two totals arises from the hypothesis that, since its formation, the company has made profits of £200,000 over and above the amounts paid out in dividends. This sum is virtually the property of the equity shareholders, to whom the directors may be said to be liable in respect of it (in addition, of course, to their liability to other creditors and to their obligation to account for the capital originally subscribed), the liability being looked after by the assets of the company. One might perhaps define the state of the company's affairs by saying that assets exceeded liabilities by £200,000, but the term liabilities would then have to be limited to the satisfaction of the amount of proprietors' capital which was originally subscribed. It is, however, more convenient to include the £200,000 in the liabilities side of the balance sheet, thus equating the two sides. For the moment the £200,000 will be designated *surplus*.

Suppose, however, that the hypothesis was different and that, instead of making profits, losses amounting to £100,000 had been incurred. In this event the liabilities would exceed the assets by £100,000. The shareholders' capital would be subjected to a *deficit* of that amount. If both sides are to be made equal the most convincing manner of presentation would be to deduct the deficit of £100,000 from the £500,000 ordinary capital originally subscribed. But if it were done this way it would be tantamount to *writing down* or *reducing* the capital. Now, the actual process of *reducing* capital has to conform strictly to the provisions of the Companies Act and it requires the confirmation of the Court. Therefore it is desirable to avoid – unless deliberately intended –

anything which might be construed as a reduction of capital. Thus if both sides of the balance sheet are to be equated there is no alternative but to show the deficit on the assets side. To distinguish it from other assets it is euphemistically referred to sometimes as an *intangible* asset. *Non-existent* would perhaps be a more correct description.

A system which allows the inclusion of intangible items among assets has often been criticized. It could be avoided if the law permitted the issue of shares of no par value. The capital originally subscribed could be increased or decreased as profits or losses were made. Such gain to accounting reality is, however, thought to be offset by disadvantages in other directions. In any case, the knowledge of how balance sheets are constructed will usually avoid any confusion which might arise from this convention of giving 'to airy nothing a local habitation and a name'.

Returning now to the precise manner of treating the surplus or deficit, the more normal way of showing the deficit is as an adverse balance of profit and loss account carried forward: in the case of a surplus, the balance will, of course, be a favourable balance. There are many ways of specifying a surplus on the liabilities side and the manner chosen is often dictated more by tradition and custom than by any verbal logic. If the £200,000 (in the illustration on pages 178 and 179) is confined to the balance of profit and loss account carried forward, no difficulty arises; but suppose it were in either of the following forms:

	(a)	(b)
	£	£
General Reserve	70,000	100,000
Contingencies Reserve	30,000	25,000
Dividend Equalization Reserve	60,000	—
Profit and Loss Balance	40,000	75,000
	<hr/>	<hr/>
	£200,000	£200,000
	<hr/>	<hr/>

Should any special significance be placed on the actual subdivision? Is (a) really any different from (b)? In order to seek an answer the horse must now be put in front of the cart. The surplus is actually derived by adding together the appropriate items on the liabilities side. In most cases companies segregate and identify the surplus items. In others it may be a question of having to decide for oneself what are the correct items to include. The general rule is to exclude all reserves or funds which are specifically allocated

to meet liabilities other than to the proprietors, or to meet any diminution in value of assets, and to include the rest. For instance, pension funds, funds for depreciation, maintenance, repairs, obsolescence, leasehold redemption, would all be excluded. The component items in the surplus arise not only from the accumulation of profits, but may be augmented as a consequence of the issue of additional capital at a premium or may be altered by the revaluation of part of the assets.

After having decided what items are to be included in the surplus the exact composition remains to be considered. Here the custom and tradition of each company play such a large part that it is neither wise nor easy to generalize. But the following may serve as a guide. A general reserve is usually the hard core of the surplus group. As a rule directors have a greater reluctance to transfer sums from general reserve than from other reserve accounts. Together with any share premium account (arising from issue of capital at a premium) the general reserve is the account out of which bonus issues of capital may be made (i.e. without payment by the shareholder). This process is known as the capitalization of reserves.

Contingencies reserves cover a multitude of purposes. They may have all the objects of a general reserve, yet their name suggests something more akin to an insurance fund. Moreover, directors who have set aside out of profits a large sum of money and who have allocated this sum to a contingencies fund are less likely to meet with criticism from stockholders on the grounds of withholding money from dividend distribution than had the allocation been made to general reserve.

The guide to the interpretation which should be placed on a dividend equalization fund is often found in past experience. If the same directors have failed in the past to draw on that fund to supplement dividends when the occasion arose, then in truth the fund differs little from a general reserve.

3 Profit and Loss Account

The fundamental principles of profit and loss were outlined in chapter I. Profit or loss is not simply a balance of income and expenditure. It is the difference between the full cost of production and the proceeds derived from the sale of the products, combined with any necessary adjustments arising from changes in the value of capital items between the beginning and the end of the account-

ing period. There are two principal types of capital assets employed in business: *fixed assets* in the form of land, buildings, plant, machinery, patents, trade marks, etc.; and *current assets* which include cash, debtors, marketable investments, stock in trade (being inventories of all kinds of materials used in the course of production from the primary state to the finished process).

The values of the first type, the fixed assets, are naturally liable to vary from year to year – often for reasons quite extraneous to the nature of the business undertaken – but no adjustment is made in the profit and loss account for random fluctuations in value. Allowance must be made, however, for changes due to wear and tear, ageing, and obsolescence. Therefore provision must be made out of profit and loss account for maintaining the fixed assets in a continuous state of efficiency and usefulness.

Entirely different principles apply to the value of the current assets. In the case of monetary debts little difficulty arises unless there is some risk of the debts not being paid in full. But the prices of materials used in the process of production and the prices of the final product change frequently and any changes in value here must be reckoned with in drawing up the profit and loss account. Indeed, in some trades fluctuations in the value of current assets may be of even greater significance than the normal margin of profit on trading. But violent fluctuations from year to year in profit and loss accounts are undesirable, so the usual procedure is to iron out as far as possible any ups and downs caused primarily by changes in inventory values. The only practical way of doing this is to refrain from taking into account the full extent of any increases in inventory values and so provide a buffer against any subsequent fall. But the desire to avoid fluctuations should never be used as an excuse to allow a deliberate overvaluation of inventories. A method of valuation often used in practice is ‘cost or market value, whichever is the lower’.

The broad outlines of a year’s trading account of a manufacturing company can be illustrated by the hypothetical example shown at the top of page 183.

The details of the trading account are seldom published in a company’s report and accounts. All that is usually shown is the residual figures for profit (or loss) on trading. But it is advisable to envisage as far as possible the form of the trading account and to consider such points as the likely ratio of profit to the proceeds arising from the sale of goods; i.e. the percentage which profit

TRADING ACCOUNT

DEBIT		£	CREDIT		£
1 Jan.	Inventories at lower of cost or market value	200,000	1 Jan.	Sale of goods to	2,000,000
1 Jan.	Cost of materials	600,000	31 Dec.	Other revenue	50,000
	Wages, salaries, to etc.	1,000,000	31 Dec.	Inventories at lower of cost or market value	250,000
31 Dec.	Fuel, rent, rates, selling expenses, etc.	75,000			
31 Dec.	Profit on trading carried to profit and loss account	425,000			
		<u>£2,300,000</u>			<u>£2,300,000</u>

bears to turnover. If the percentage is believed to be low, the trading risks may be considerable. If it is thought that inventories are large in relation to turnover, then any fluctuations in the values of inventory items will be of much greater significance than if they are small. It is perhaps appropriate to mention here that a matter of considerable importance to many of the companies concerned is the precise method by which the Finance Acts give effect to any changes in the rate of excise duty or purchase tax.

Continuing the hypothetical illustration, the profit and loss account would appear as follows:

PROFIT AND LOSS ACCOUNT

DEBIT		£	CREDIT		£
	Depreciation	100,000		Profit on trading	425,000
	Directors' fees	5,000		Interest and dividends received from subsidiary and associated companies	25,000
	Audit fees	1,000		Interest and dividends received on miscellaneous investments	10,000
	Interest on loans and debenture stocks	10,500			
	Net profit carried down	343,500			
		<u>£460,000</u>			<u>£460,000</u>

The net profit thus derived is available for allocation according to the provisions of the articles of association, the judgment of the directors, and the demands of the tax authorities.

Continuing the illustration:

FINANCE AND INVESTMENT
PROFIT AND LOSS ALLOCATION

DEBIT	£	CREDIT	£
Taxation	200,000	Net profit for the year	343,500
Transfer to general reserve	20,000	Balance brought forward from previous year	75,000
Transfer to contingencies reserve	5,000		
Preference dividends (less tax)	13,000		
Ordinary dividends (less tax)	65,000		
Balance to be carried forward, as per balance sheet	115,500		
	£418,500		£418,500

4 Consolidated Accounts

Many companies, indeed the majority of large British companies, have under their control one or more *subsidiary* companies. The control operates either by virtue of having the power to appoint or remove directors or through the ownership of more than one half of the equity capital. Such is the definition of a subsidiary company according to the Companies Act (see section 154). It must not be confused with an *associated* company. The latter is usually a form of business ally, perhaps party to some trade agreement, but is not under the control of the company with whom it is associated. It should be mentioned that sometimes directors refer to a subsidiary company as an associate or associated company purely for reasons of courtesy and to avoid drawing attention to the fact that the subsidiary is in law under the control of the parent company.

The financial relationship between parent (or holding) company and its subsidiary companies had been a subject of discussion among company reformers for many years prior to the passing of the 1948 Act. The scope for concealing information had been wide and a holding company was a favourite device of those who were specially anxious to conceal information. Since the passing of the 1948 Act it is obligatory to publish consolidated profit and loss accounts and consolidated balance sheets and as far as possible to synchronize the dates up to which the accounts of each company concerned are made. Provisions in the Act allow for exemptions in cases where consolidation might actually be misleading.

Consolidation is essentially a matter of amalgamating the

accounts of the parent company with those of its subsidiaries. On that score alone there should be little difficulty in construction or interpretation. But consolidation introduces two new factors. The first relates to the extent of the parent company's ownership of the subsidiaries. Unless all are owned to the extent of 100% the consolidated balance sheet will show among the liabilities the item 'interest of minority shareholders' (i.e. shares owned by holders other than the controlling company). A mere statement of the amount of the subscribed capital held by these minority shareholders would not necessarily meet the requirements. There must be included as well the proportionate share of the surplus (represented by reserves and balance of profit and loss account carried forward) of the subsidiaries. In a similar manner the consolidation of the profit and loss accounts must provide for the interests of any minority shareholders by making the appropriate subtraction.

The second factor concerns the relationship between the values placed on 'shareholdings of subsidiaries' in the balance sheet of the parent company and the values of the shareholdings as represented by the figures in the separate balance sheets of the individual subsidiaries. It is unusual for the values to be identical and unless this is the case a balancing item will appear as follows:

Difference between the value of the net assets appearing in the balance sheets of subsidiary companies and the value of the shares in and advances to those companies as shown in the balance sheet of the (parent) company.

5 Annual Service Cover and Earnings

So far attention has been confined to the general construction and interpretation of accounts. When an analysis of accounts is required for the express purpose of assessing the merits of an investment the following are some of the calculations which can most usefully be made: as regards prior securities such as debenture and preference stocks, the cover available for their annual requirements, and sometimes also the capital cover; as regards equities, the rate of earnings per share, and the net assets value per share. These points will be considered in greater detail later in this chapter and again in subsequent chapters, but it will be convenient to deal now with the basis of calculation of annual cover and earnings.

The following hypothetical case will serve as an example:

	£	Times Covered	Priority Percentage
Net profit (after all charges and expenses except British taxation) available for service of debenture stock	250,000		
Debenture interest (gross)	<u>50,000</u>	5	0-20
Available for taxation and share capital	200,000		
Company profits tax (on distributed and undistributed profits)	30,000	—	20-32
Dividend 5% first preference shares (gross)	50,000	1.9	32-52
Dividend 7% second preference shares (gross)	<u>7,000</u>	1.8	52-55
Dividend ordinary shares (gross) (10% on £500,000)	<u>50,000</u>	10%	55-75
Balance to 'surplus' accounts (subject to income tax)	<u>£63,000</u>	12.6%	75-100

There are two important points to bear in mind. The first relates to the general basis of calculating the cover. It is essential to avoid the fallacy of just comparing the requirements of the stock in question with the balance available for that stock. For example, by such method the amount available for the first preference shares would be £170,000 to meet £50,000, i.e. a cover of 3.4 times; in the case of the second preference shares, £120,000 to meet £7,000, i.e. a cover of 17.1 times. This produces the absurdity of the second preference dividend appearing to be better covered than the first. The correct method is to compare (a) the sum available, not just for the particular stock in question, but for all those which may rank in priority to it or *pari passu* with it, with (b) the aggregate requirements of the stock in question and of any ranking in priority to or *pari passu* with it. The use of a system of *priority percentages* should avoid any risk of making a fallacious calculation.

The second point relates to company taxation. If the only tax payable were income tax at the standard rate, there would be no complication except what might sometimes arise through the amount reserved for taxation in the accounts being only a close estimate rather than the exact amount ultimately payable. But if a company profits tax is payable in addition to normal income tax, and if the rate, at which this company tax is levied, depends upon the amount of profits actually *distributed* to shareholders, then precise calculations of cover and earnings is almost impossible.

However, the method employed in the above illustration will as a rule be found satisfactory for most practical purposes.

It will be realized that the actual cover and earnings depend not only on the actual level of earnings, but on the dividend policy as well. Thus, in the above illustration and on the assumption that a company tax is levied at a higher rate on distributed profits than on undistributed profits, the cover for the preference shares would be greater were a smaller dividend paid to the equity shareholders.

The earnings for the equity shares are shown as 22.6% (i.e. 10% dividend plus 12.6% to reserves or added to amount carried forward). If instead the entire earnings had been distributed to the shareholders, the profits tax would have been greater, say, £40,000, and the distributable earnings in that event would have been lower at 20.6% per share.

6 Financial Companies

It is proposed now to examine some features of balance sheets and profit and loss accounts which are peculiar to particular types of business. Financial companies such as banks, discount houses, investment trusts, etc., are primarily concerned with money or with things which can readily be expressed in terms of money. Fixed assets are as a rule confined to office premises. The bulk of the assets are in the form of investments, bills, loans, etc., and are capable of ready valuation; indeed, most are freely marketable. During the course of the year the composition of these assets may change considerably. It is important therefore to consider the extent to which profits or losses may be caused by such changes in the portfolio of assets as distinct from the normal process of regular trading.

For instance, the main assets of a discount company are bills and short-dated gilt-edged investments. The normal source of annual profit is the difference between the money paid out in the form of interest on loans and deposits and the yield earned on bills and investments, *less* expense of management. But discount companies often pursue an active investment policy and their investment portfolio is frequently changed. Profits or losses resulting from such changes enter into the profit or loss account, and it is not always possible to know whether these items are large or small in relation to the total. Fortunately the custom is to take steps to iron out any fluctuations caused by exceptional profits or losses – for

example, to write down the cost of new investments out of profits – and, if exceptional figures still emerge, to draw attention to the reasons in the directors' report or chairman's speech.

The business of an investment trust company is to invest money. The articles of association usually provide that only interest, dividends, and commissions are to be credited to profit and loss account. Profits or losses arising from the realization of investments are to be excluded from the revenue account – and are not subject to income tax. They concern only the balance sheet. Since most investments held by investment trust companies have a Stock Exchange quotation, a frequent procedure is to show not only the balance sheet figures (constructed as a rule on the basis of cost, less net surplus on realizations), but to disclose as well the valuation at market prices. Since the assets then carry a marketable or realizable value, it is a simple matter to estimate the worth of the equity stock in the event of liquidation. The following synopsis will serve as an example:

BALANCE SHEET

LIABILITIES	£	ASSETS	£
5% Preference Stock	600,000	Investments at cost less net surplus on realizations	1,580,000
Ordinary Stock	400,000	(Market Value	
General Reserve	50,000	£1,900,000)	
Profit and Loss Balance c/f	50,000	Current Assets	60,000
4½% Debenture Stock	500,000		
Current Liabilities	40,000		
	<u>£1,640,000</u>		<u>£1,640,000</u>

The balance sheet *surplus* is £100,000 (i.e. general reserve plus profit and loss balance carried forward); the appreciation in the value of the investment is £320,000, making a total of £420,000. If in the event of liquidation the debenture stock and the preference stock are entitled to par, the liquidation value, or break-up value, of the ordinary stock can be estimated at 205%, less the expenses of realization and liquidation.

Break-up values are frequently calculated and cited as useful yardsticks for measuring the worth of investment trust company equity stocks. If the company is really likely to go into liquidation in the near future such a yardstick is relevant and useful. If not, it can be most misleading. But as a measure of the assets worth of the equity stock in a going concern it can be of real value, provided certain adjustments are made. If the debenture and preference

stocks are entitled to fixed capital sums, say, par or 105% or 110%, in the event of liquidation it does not really matter what rate of interest or dividend they are entitled to. But to the equity shareholder *in a going concern* it matters very much indeed. If the rates are above the average yield on the company's investments the prior stocks will not, so to speak, 'pay for their keep'; if, on the other hand, the rates are below the average yield the equity stockholder should benefit from the existence of these prior stocks. As a rule this factor will be reflected in the market prices of the stocks. For instance, in the illustration taken above the 5% preference stock might be quoted at 125% and the 4½% debenture stock at 115%. The premiums on these two stocks over what they would receive in liquidation (if entitled only to par) is therefore £150,000 + £75,000 = £225,000, equivalent to 56¼% of the equity stock. Thus 205% less 56¼%, i.e. 148¾%, would be a reasonable assessment of the assets value of the equity stock of the company as a going concern, subject always to the assumption that the expenses of operating the company are equally matched by the benefits derived from expert direction and management.

Finance companies differ from investment trust companies in that although their assets consist almost entirely of investments (whether miscellaneous or concentrated in one or more particular trade) their profit and loss accounts include any profits or losses realized by the sale of investments. Earnings are therefore liable to fluctuate considerably from year to year, and when studying accounts it is important to bear in mind the source of the profits or losses.

Among the largest finance companies in existence are those which specialize in mining ventures. Some of these companies disclose how much of their profit and loss account is derived from interest, dividends, and commissions, and how much from profit or loss on realization. But where all items are lumped together it is difficult if not impossible to obtain a true insight into the actual position.

If the market values of the investments are disclosed it is possible to make calculations regarding the assets value similar to what was shown in the case of investment trust companies, but there is this important distinction. If the investments as a whole have a market value above their cost, the entire realization of them will involve the company in immediate liability to tax on realized profits; not so in the case of an investment trust company.

7 Heavy Industrial Companies

There are some accounting features of special interest in companies engaged in shipbuilding, heavy engineering, steel, manufacture of mining and oil equipment, etc. In all such cases their products take a considerable time to construct and many of the companies need substantial fixed capital assets which are often exposed to hard usage.

Where products are manufactured within a short space of time it is comparatively easy to compensate for any rise in manufacturing costs by the method of increasing selling prices. But when it normally takes several months if not years to complete an order, then the manufacturer is much more vulnerable to the consequences of any rise in costs. Indeed some companies will not accept orders for such things as ships, oil refineries, generating plant, hydro-electric schemes, etc., on a *contract* basis, i.e. the prices being agreed at the time of placing the order. The orders are arranged, either on a sliding-scale basis where the price to be paid will be adjusted upwards or downwards according to any change in the prices of wages and materials used, or on a basis of the ultimate cost plus an agreed percentage for profit (colloquially known as 'cost plus'). Unfortunately it is not always made known to shareholders what bases are used or whether the reckoning of profits (or losses) is held up until after the work has been completed or whether credit is taken as the work progresses. The profit and loss accounts of such companies should therefore be read in the light of whatever is known on these points. If nothing is disclosed it will be difficult to know what is the real position.

As regards fixed assets which are liable to heavy wear and tear or which have a limited life, the question of maintenance, depreciation, renewal, and obsolescence is especially important. It is by no means a problem of just making provision for writing off the balance-sheet values of worn-out assets. These may have cost £500,000, there may be a renewal reserve of £500,000, but if the cost of replacement has in the meantime risen to £1,000,000 the reserve will be anything but adequate for its specific purpose. Therefore, in the case of those companies whose principal fixed assets are due for renewal or modernization, especially after a time of rising prices, particular attention should be paid to the adequacy of the specific reserve funds held for such purposes.

8 Goodwill' Companies

There are many companies whose most important asset is the

ownership of certain trade-marks. For example, Players' cigarettes, Colman's mustard, Guinness's stout, Beecham's pills, etc., are such well-known brands that the right to trade under those names is extremely valuable – probably far more valuable than the fixed assets necessary to produce the goods. The possession of such trade-marks is frequently designated by the name *goodwill*. As a rule the value placed on popular trade-marks in company balance sheets is only a fraction of what they are really worth, chiefly because the goodwill has been built up gradually over a period of many years. Yet in some cases the figure may appear at nearer to its true worth, and the reason for this may well be because the trade-mark was purchased only after it had already become well known and had acquired a substantial value.

Consider now the case of two companies engaged in similar businesses owning trade-marks of equal worth: one with a capital of £500,000, but with no value placed on goodwill in its balance sheet; the other with capital of £2,000,000, but with goodwill in the form of trade-marks entered in its balance sheet at £1,500,000. How do these companies compare? The answer is that the precise values actually placed on goodwill in the balance sheets count for very little indeed. Trade-marks are only of value in so far as their ownership contributes to the making of profit. It is therefore to the profit and loss accounts that one has to look in order to obtain a proper comparison. If in the case of both companies the profits are, in fact, the same and the capital is all ordinary capital, one might expect dividends on the first company to be at about four times the rate applicable to the second company – and the market value of the total capital in each case might well be about the same.

Indeed, the true value of goodwill, whether arising from the ownership of trade-marks or from the benefits of efficiency in management, organization, or production, is nothing more than a sum representing so many years' purchase of the additional profits thus achieved. In this interpretation *goodwill* forms a big part of the market price of the equity shares of many successful companies.

9 Property Owning Companies

There are two principal forms of property ownership: freehold, which is absolute ownership; and leasehold, where the benefit of a lease is enjoyed for a number of years subject to the payment of rent. The second is a wasting asset which will become practically worthless when the lease expires. It is therefore absolutely essen-

tial for property companies to make provision out of profits for amortizing the cost of any leasehold property. Although many companies do not segregate their freehold and leasehold properties in the balance sheet, some rough idea can be formed of the relative importance of each if the amount set aside for leasehold redemption is disclosed.

As regards the profit and loss account, it frequently happens that the sum payable in respect of rents on leasehold property is not shown separately, but is included among general expenses and outgoings. The relative proportion of freehold and leasehold interests may be of great significance in assessing the cover for debenture and preference stocks. The following hypothetical example will serve as an illustration. Two companies have an identical capital structure: £250,000 4% debenture stock, £250,000 5% preference stock, and £250,000 ordinary stock. Company A owns nothing but freehold property and earns a profit of £50,000. Company B owns mostly leasehold property and earns a profit of £60,000, after making provision for amortizing the cost of leaseholds. The debenture stock of Company B would therefore appear to have the better interest cover. But fuller information might reveal the following (taxation being ignored for purposes of simplification):

COMPANY A		£	COMPANY B		£
Rents received		100,000	Rents received		300,000
<i>less</i>			<i>less</i>		
Rates and miscellaneous expenses		50,000	Rents payable	100,000	
			Rates and miscellaneous expenses	100,000	
			Leasehold amortization	40,000	
					240,000
					<u>Profit</u>
Profit		<u>£50,000</u>			<u>£60,000</u>

Now, if the rents received by each company declined by 20%, Company A would still be making a profit of £30,000 but Company B would make none at all. So, in fact, Company B is the more marginal and the apparently better cover of its debenture and preference stocks is illusory.

If there is any general moral about the study and analysis of company accounts it is this. It is not only an exercise in figures, but also an endeavour to obtain the true meaning of what lies behind the figures.

