THE THEORY OF BUSINESS ENTERPRISES PART 3: CAPITAL AND CREDIT

In Chapter 5 Veblen takes up the use of credit. He defines credit as any money obtained from third parties to run a business, including the owner's capital, but excluding profits. He disregards the form in which the capital is contributed: equity, preferred stock, debt whether collateralized or not, all are credit. That's because the business has to pay for the use of the money one way or another. Of course, structure matters in bankruptcy, because debt gets a preference over equity, and the order of payment is set by the documents of the capital structure. Veblen says that in economic downturns, bankruptcy takes hold, and the creditors determine the ownership of the material means of production and redistribute them in their best interests.

Veblen distinguishes the newer credit economy from the money economy described by the earlier economic thinkers, including Adam Smith.

> It has been the habit of economists and others to speak of "capital" as a stock of the material means by which industry is carried on, — industrial equipment, raw materials, and means of subsistence. This view is carried over from the situation in which business and industry stood at the time of Adam Smith and of the generation before Adam Smith, from whose scheme of life and of thought he drew the commonplace materials and conceptions with which his speculations were occupied. It further carries over the point of view occupied by Adam Smith and the generation to whom he addressed his speculations. That is to say, the received theoretical formulations

> regarding business capital and its relations to industry proceed on the circumstances that prevailed in the days of the "money economy," before credit and the modern corporation methods became of first-class consequence in economic affairs. They canvass these matters from the point of view of the material welfare of the community at large, as seen from the standpoint of the utilitarian philosophy. In this system of social philosophy the welfare of the community at large is accepted as the central and tone-giving interest, about which a comprehensive, harmonious order of nature circles and gravitates. These early speculations on business traffic turn about the bearing of this traffic upon the wealth of nations, particularly as the wealth of nations would stand in a "natural" scheme of things, in which all things should work together for the welfare of mankind. Chapter 6.

In Adam Smith's time, and the generation after him, production occurred in a "money economy". The earlier economists examined this from the standpoint of natural law and later utilitarianism. I understand the first part, about natural law. That appears in a number of French thinkers and British as well, and perhaps is part of the thinking of Smith, as Veblen asserts. The idea is roughly that factory owners would benefit from an engaged working class, and all would want to improve things in their communities because that would benefit them and because it was the natural order of things. Veblen adds the notion of the utilitarian philosophy which I assume is a reference to Jeremy Bentham, although that name does not appear in the book. The connection isn't obvious to me.

By the early 1900s the money economy was replaced by a "credit economy". Veblen seems to be saying that the ideas of the money economy were imported into the credit economy, including the ideas of natural law and utilitarianism. He does not elaborate on this idea at this point, turning to a discussion of the general forms of business organization.

Chapter 7, The Theory of Modern Welfare, is primarily a discussion of the business cycle. Financing costs, including interest on debt, preferred stock dividends, and a normal rate of profit, are more or less fixed. Prices decline because of competition as new entrants use more efficient machines and processes, while facing the same or lower financing costs. When prices decline, the more heavily burdened businesses fail, causing a downward spiral in prices for suppliers and their suppliers. It takes an external shock such as a war to restore the previous price levels. And, as noted, the creditors get to decide how to redistribute the capital equipment and factories of the bankrupt companies. From this he concludes that the natural condition of the capitalist economy is chronic depression.

He concludes his discussion of the business cycle by arguing that the economy will sink unless prices can be maintained by oligopolies and monopolies operated through trusts. That's not a complete solution, though, unless almost all competition can be eliminated.

> The great coalitions and the business manoeuvres connected with them have the effect of adding to the large fortunes of the greater business men; which adds to the large incomes that cannot be spent in consumptive expenditures; which accelerates the increase of investments; which brings competition if there is a chance for it; which tends to bring on depression, in the manner already indicated.

That doesn't include workers, though. They are hung out to dry in this setting. Or as Veblen puts it: “there remains the competitive friction between the combined business capital and the combined workmen.”

Veblen begins Chapter 7 with this interesting observation. In a money economy, the welfare of the community, apart from issues of war and peace, “turned on the ease and certainty with which enough of the means of life could be supplied.”

> Under the old regime the question was whether the community’s work was adequate to supply the community’s needs; under the new regime that question is not seriously entertained.

This fleshes out the section quoted above about natural law. With this measuring principle, under the natural law, “…all things should work together for the welfare of mankind”. It makes a nice contrast with the credit economy which disregards the welfare of the community and concentrates all its efforts on the frantic search for profits.

It seems to me that the structures and theories Veblen identifies have grown into the structures of business today, but observing them in their earliest stages is helpful in thinking about alternatives. Veblen’s point that the costs of financing are included in the price reminds us of something we rarely think about. The price we pay for goods in a credit economy includes the amount necessary to pay off banks, bondholders, preferred stockholders and so on, and to produce profits to pay off shareholders and managers. The profits have to be great enough to persuade the businessman to stay in the business. At each step in the process, the ultimate consumer pays for capital.

At the same time, Veblen points out that competition will force profits to zero over time through efficiency gains, mismanagement, or other mechanisms, usually with disastrous consequences. Theoretically the US has an antitrust policy which pushes back against monopoly, but that has mostly fallen into oblivion. As a result, we preach competition but operate in an oligopoly at best, and in many areas, in an effective monopoly. That means that capital is being paid more than necessary to produce sufficient goods and services for the community.

There is effectively no limit on the amounts that the monopolist can collect. We see this in operation in the pharmaceutical industry. Pfizer, for example, raises the prices regularly on drugs in which it has a monopoly or an oligopoly. See also this discussion of an interview Pfizer CEO Ian Read did with Forbes. The pricing strategy for new drugs is to maximize profits, not to provide for the needs of the community. The explanation is that a business valued by capitalization of future earnings, like Pfizer, must show increases in earnings every year, or the stock price will stabilize or perhaps fall, and perhaps even the interest rates charged by lenders will rise. That should make us ask why we think this is a good plan for something as important as medicine. But we don’t ask that question. Instead, our politicians protect businesses with favorable trade treaties and other accommodations, and raise prices to consumers for drugs.

Suppose the goal of manufacturing drugs is to produce sufficient quantities to meet the needs of the community, and to pay the owner of a plant a reasonable living wage, as Veblen says was the case in Adam Smith’s time. This business model was used by actual non-profit hospitals like the one my Dad worked at, a Catholic hospital built and operated with cash raised from the community. In that setting, there is no need to raise prices beyond inflation and depreciation (shorthand for new and replacement equipment and plant, training and so on). Any new entrant would face the same situation, so there is no advantage to be obtained in the near term from introduction of new capital. The business of creating new drugs can be pushed off to venture capital, as is mostly the case already, so there is no need to provide for R&D. There would be no need in this setting to pay dividends, and the need for interest payments would also be reduced. There would be other savings as well.

I leave as an exercise for the reader working out methods for forcing this outcome. I assume there must be some problem with this analysis, and leave that open as well.