

3 FUNCTION OF SAVINGS IN THE FINANCING OF CAPITAL FORMATION

Capital goods are not intended immediately to satisfy any consumer need or desire. They are a form of wealth intended to be used ultimately to *produce* wealth that can be enjoyed by humans—consumer goods and services. It is quite clear, therefore, that the production of capital goods would detract from, rather than contribute to, the purpose for which they were intended unless the wealth which capital produces is in fact a *net* contribution to the output of humanly consumable wealth.

If in a particular enterprise, for example, more wealth is used in producing the capital goods than these goods in turn produce in the form of consumer goods, the net effect of each instance of such capital formation would be to decrease the total output of consumable wealth. Thus, capital formation fails in its purpose unless the wealth produced by the newly formed capital fully equals the cost of the capital goods involved, *and in addition* provides an attractive surplus of wealth beyond. It is the net wealth to be pro-

duced by capital that is the motive behind the formation of new capital goods.

From the very nature of capital goods, therefore, it is clear that they would not come into being unless it were expected that through their employment more consumable wealth would be produced than would be laid out in creating the capital goods themselves. *The intent of those who organize the formation of capital is always that the cost of capital goods shall be defrayed from the wealth to be produced by the newly formed capital goods themselves.* Where this expectation is not fulfilled, it is due to the miscalculation of the future by the entrepreneurs—*entrepreneurial error*. Such error may be caused by miscalculation of the forces of supply or demand, failure to estimate competition, engineering errors, incompetent management, unexpected technological change, etc. Among those experienced in business affairs or in rendering advice to entrepreneurs, every precaution is taken to minimize entrepreneurial error.

Let us now consider what useful purpose is served by savings—previously accumulated capital—in this process of new capital formation. Perhaps an example will throw some light on the matter. Suppose we take the case of promoters or entrepreneurs who believe that they can produce an interesting amount of wealth through the establishment of a lumber mill in a particular location. We say that they expect to make a “profit,” but it is clear that the essence of their expectation is that the wealth to be created through the new mill will not only “pay off” those who take part in constructing it, and reimburse the costs of labor and supplies and raw materials required to operate it, but will yield an attractive excess that will be shared by the owners of the new mill.

Various things are required to bring about the existence of the new mill. Land must be acquired, machinery and equipment must be purchased or built, the operating and administrative staffs of the business must be employed, sources of timber must be acquired or contracted for, transportation facilities acquired or hired, etc. Of

the many different persons whose direct contributions must be induced to bring about the construction of an operating mill, each will fall into one of two classes. Either he is one who expects to be immediately compensated for his contribution (as in the case of workmen who participate in the building of the mill, or suppliers who merely sell materials, supplies or equipment) or he is an investor, *i.e.*, a contributor of something to the project who expects in return an ownership interest. The great majority of those who have anything to do with the enterprise will be men whose current contribution, whether in the form of labor or goods or supplies, must be currently compensated. They either cannot, or are not invited, or do not wish, to become owners of the mill, and their contribution is for immediate compensation.

But who compensates them? The mill is not yet a going concern; it is not yet producing wealth, and even when its production commences, it may be required to operate for years before it will have produced an excess of wealth (a net profit) sufficient to fully defray its costs of formation. The answer, of course, is that the investors shoulder this task. The investors' capital accumulations or savings are put at risk in one way or another to compensate those who take part in bringing about new capital formation and who do so for an immediate payment. We have already touched upon the mechanics of finance through which this comes about. One result is that savings—previous income invested directly or indirectly in capital goods—are used as a source of payment to all who must be compensated for their participation in new capital formation prior to the time when newly formed capital begins to produce wealth in sufficient quantities to reverse the flow of funds. Another result is that those who put their capital or savings at risk generally become the *owners* of the newly formed capital.

So far we have dealt only with the familiar aspects of the function of savings in the financing of capital formation. But a perplexing question now presents itself.

We have seen that capital instruments of whatever nature are designed and intended to produce wealth. They will not come into being unless those who are responsible are satisfied that they will produce wealth equivalent to their cost of production (the aggregate of the market value of the newly formed capital), and a surplus of wealth beyond. This surplus, the net wealth to be produced by capital, is indeed the real reason behind the process of new capital formation.

Why, in our conventional methods of financing new capital formation, is it necessary to depend upon the risking of existing capital (savings) in order to bring into existence newly formed capital that will, in the great majority of instances, produce far more wealth than sufficient to defray its costs of formation? Why is it not adequate to so design the legal structures of our businesses that the wealth produced by newly formed capital instruments will first be applied to reimburse those who have participated in their formation, or, what is the same thing, to reimburse banks which have extended credit for this purpose? Such an arrangement would subordinate the rights of the owners of newly formed capital to the claims of those who have assisted them in bringing such capital instruments into existence, yet would protect the new owners in their receipt of the net wealth to be produced by their newly formed capital.

The answer to this question, of course, is that our conventional methods of financing new capital formation, which involves compensating workers and suppliers who produce the capital instruments from the savings of the prospective new owners, *eliminate entirely* for these workers and suppliers all risk of entrepreneurial error and insure their receipt of compensation for their contributions toward such construction. Or, what is the same thing, banks or other immediate advancers of funds to workmen, suppliers, etc., are insured against loss by existing capital furnished as “security” in one form or another.

In fact, many of our forms of corporate finance involve what might be termed *double insurance*. For example, where the owners of savings invest in the common stock of a corporation, and the corporation employs a contractor to build a mill, both the newly invested savings, which become assets of the corporation for which its stock is issued, as well as the wealth to be produced by the newly constructed mill, are subject to the claims of the contractor for payment for the mill. The same is true if a corporation with assets or earning power sufficient to convince lenders that it can repay debt borrows funds to build a new mill. Both its existing assets (savings made by the business from the standpoint of the corporation's stockholders), and its newly acquired assets, as well as wealth thereafter produced by its increased capital assets, are subject to the legal claims of the contractor for compensation.

Today, therefore, our techniques of financing capital formation are such that two things are insisted upon:

(1) *Convincing evidence that the newly formed capital will produce sufficient wealth, in addition to its own costs of production, to warrant going forward with the project.* This is true whether the new capital to be brought into existence involves the expansion of an existing business or the creation of a new one. This we may call evidence of economic feasibility, evidence that the newly formed capital will produce not only sufficient wealth to reimburse those who have participated in its production, but also to satisfy reasonable expectations of an excess beyond—a net output of wealth.

(2) *A committing of existing savings or capital toward the reimbursement of the workers, materialmen, vendors of land, suppliers of machinery and equipment, suppliers of legal and accounting services, and others who participate in the formation of new capital.* Thus, these persons who are currently, or almost currently, compensated for their contributions toward new capital formation are insured against the risk of entrepreneurial error, or risk of error in determining economic feasibility. The physical process of new capital formation is one requiring the co-

operation of many persons in addition to those who anticipate becoming the owners of the newly formed capital. The functional use of the savings or capital of the prospective new owners is to insure the immediate compensation of these co-operators and protect them from the risk of entrepreneurial error.

Apparently the close connection, regarded as necessary under accepted financing methods, between savings or existing wealth and new capital formation exists for the reason that resort to such savings is the *only* method devised or generally acceptable today for insuring against the risk of entrepreneurial error in the process of new capital formation.

New capital formation requires either that the workers, suppliers of materials, owners of land, suppliers of professional services, and others whose economic contributions are necessary, shall await their reimbursement until the newly formed capital produces sufficient wealth to pay them, or that others shall do the waiting and assume the risk of entrepreneurial error. Since these "co-operators" whose services or goods are needed to produce the newly formed capital are ordinarily unable or unwilling to defer receipt of payment for their contributions toward production and to assume the risk of possible non-payment through entrepreneurial error of the promoters or managers of the firm, the owners of existing capital or savings become the advancers of funds and the insurers in this situation. In the course of so doing, and as a reward for so doing, they become the owners of the newly formed capital.