Chapter from Shann Turnbull's book: Democratising the Wealth of Nations
Company Directors Association of Australia Limited, Sydney, 1975

10 Wealth from production

The classical method of accumulating wealth was from income created by the employment of labour for the production of goods and services.The traditional concern of economists and political philosophers has been for the employment of people, rather than the employment of machines, structures and other productive assets.Production was dependent upon employment and wealth was dependent upon income.Historically, human labour contributed the principal source of both energy and skill in the production of goods and services.The development and accumulation of machine power and skill in the production process is a relatively recent development over the past two centuries.

Before the industrial revolution, the availability of ownership value was not only inhibited by the lack of productive assets, but also by the primitive legal rules of ownership. Major assets, such as land and buildings, were owned by the sovereign, the church or the local lord. Unless wealth was due to an inheritance, changes in fixed assets were more likely to be accomplished by social force or by political fiat. The concept of a capital market, with ownership transfers negotiated between willing sellers and willing buyers, grew out of changes in ownership of trading ventures and their means of transport.

Trading ventures and activities concerned with the production and exchange of goods and services still provide the principal field of study for economists.They have left the theory and practice of obtaining wealth, from the transformation and exchange of assets and liabilities, to businessmen and financiers.This leaves a very major difficulty for economists in understanding the practical operations and management of asset-rich societies.

One problem, arising from governments limiting their interest to only the income layer of the economic cake, is that the analysis of both fiscal and monetary policies is restricted to their effects in this top layer. Not only is the bottom layer neglected, but its intimate interaction with the income layer through cash flows is ignored. The exchange of assets and liabilities in advanced industrial societies can generate cash flows of the same order of magnitude as those produced by the National income. Thus, economic policy prescriptions that ignore these bottom-layers cash flows are unlikely to work according to plan.

Because of the lack of information and analysis of the bottom layer of the cake, modern economic analysis is most likely to work best in those societies where this layer is not very large.This situation exists in undeveloped societies, socialistic and communistic societies, where this layer has been truncated or eliminated.In such societies there is only one way to accumulate wealth — from not spending all one's income.This process the economists call savings, which they then define to equal investment.These words create conceptual problems, and they inhibit the understanding and development of a most important alternative method for generating investment in procreative assets.One of the most vital practical arguments for a private-ownership economy is that this alternative method, for financing the construction of viable assets to produce even greater leisure and freedom, is made possible.

The problem with associating investment with the word savings is that it implies to most people that investments in assets can only result from savings from income **already received**.This is consistent with the practical experience of most individuals.It is the only way to acquire assets in primitive and socialistic societies.In societies with a developed commercial and investment banking system, an alternative mechanism and interpretation of the traditional definition of savings and investment is possible.That is, investment equals savings expected in the future from income **yet to be received**.

The alternative method of financing the construction or purchase of procreative assets from future savings, rather than from historical savings, eliminates the factor of availability of funds being a restriction for economic growth. This alternative or roundabout method for financing economic growth is generally ignored when economic aid or development is planned. Such an oversight is encouraged by most basic economic texts, which at best, may explain only in a footnote this valuable alternative for financing economic development. This alternative is unique to private-property market economies and is not available in socialistic and primitive societies.

The principle of financing investments today from future savings is familiar to all home owners who purchase their house on terms. Indeed, many people value such a system of payment since it forces them to save to accumulate a real asset for the security in their old age. However, this example does not directly increase productivity or increase leisure time. This is because it is the owner who has to generate the income to produce the future savings, rather than the income being generated by the asset itself. An example of the latter situation is the taxi or truck driver, who purchases his vehicle on a time-purchase basis. The asset is working for the owner and pays for itself. If the owner hired a driver, he could pay off his vehicle without working himself. Buying a house has the opposite result – it forces the owner to work to pay for it. So the truck or taxi can work for its owner, while the owner must work for his home.

The truck or other machine that generates cash flow to pay for its cost (including the interest of the time payments) is of course what we have called a viable or procreative asset. The aggregate effects of these assets on a national economy, in creating more material goods and/or or more leisure per capita, have been discussed in Chapter 2. Increasing the accumulated value or stock of viable assets per capita has also an important effect on the supply of money in the economy. Viable assets will return a greater cash flow than their cost plus interest charges for the funds invested, thus they will allow any expansion in credit created for their purchase to be paid off from their own return cash flow. Since cash flow returns are received in excess of that required for viability, the total credit available in the banking system could be reduced or contracted. The aggregate contraction of credit is deflationary and hardens the currency. This result is, of course, consistent with viable assets increasing productivity. Productivity increases provide a way to reduce employment and produce more leisure. If a country has excessive employment, then these pressures could be further reduced by importing more productive assets on credit. The alternative method of capital creation givers new options in economic management, that are so astutely utilised by the Japanese.

Assets that do not, in themselves, generate sufficient cash flow returns to be viable would need an outside cash flow from their owner to repay their purchase cost and interest.Such outside cash contributions is of the nature of a subsidy and consumes the owner's cash flows.We could then call assets that result in non-viable cash-flows returns as consumption assets, and those that provide

viable cash flows returns as productive assets.Consumption assets may still produce goods and services, but the cash flows returned to their owners would not be sufficient to repay their costs with interest.Ownership of consumption assets requires a subsidy from the owner, in the form of a cost.This cost might only be the lost opportunity to earn interest.By using our previous example, houses would be called consumption assets and trucks or taxies would be production assets.

The practical problem of obtaining a loan to purchase a procreative asset is that there is no guarantee for expectations of its viability being realised. If a loan is obtained to buy a machine that does not meet the test of viability, then the owner will have to obtain cash from other sources to repay his lender. Besides the scrap value of the machine, the lender will look to the borrower's other assets and income, if any, and to his personal income-earning ability to make good any shortfalls. These shortfalls, which could be met over a time period by the borrower's personal exertion income, may not be large in relation to the total value of some machines, factories and enterprises. The value of a loan, which an individual may be able to borrow to purchase an asset that is expected to be viable, is likely to be limited to about the same order of magnitude as the value of his home.

A country can finance large-scale projects because of expectations of their viability allowing repayment of the expansion in credit required for their construction.This method for large-scale finance requires a special sort of commercial and investment banking system.The development of such a system in the late 19th century meant that the United States was able to change from a net importer of capital to a net exporter of capital.The United States followed the English in this regard.Japan and Germany have also now developed this alternative facility to a substantial degree.

Each country has different method and emphases in its approach to achieve the same objective.The common feature is a close relationship between commercial banks and productive enterprises, either directly or indirectly through investment banks of one type or another.The role of the intermediaries is to convert the loans from commercial banks, with their contractual obligations for repayments, into equity finance for which there are no contractual obligations.This process requires professional speculators who have the ability to average risks both over broad sectors of the economy and over a period of time.A well-developed stock market can be of considerable assistance.

Most advanced market economies have not, however, developed this alternative mechanism for financing major viable assets on a significant scale.One inhibiting factor is the need to develop the necessary financial infrastructure and skills.The need for these structures and skills could be very much reduced and simplified by using the Employee Share Ownership Plan (ESOP) developed by Louis Kelso.

The Kelso Plan provides a new means for financing procreative assets out of their future cash flows in countries with poorly developed financial systems.It could achieve this without the necessity for either investment banks or stock markets, through the presence of such facilities would be of considerable assistance.These facilities would develop, on their own accord from the general adoption of ESOPs.The Kelso Plan is now being introduced in the United States with government encouragement, and complements an already highly developed financial system.Besides providing the United States and its corporations with a new source of finance, ESOPs are being encouraged as a basis for sharing the bottom layer of the economic cake more equitably.This should make ESOPs popular for democratising the wealth of nations in other parts of the world.

The need for sharing income-producing assets on a democratic basis may be appealing on political and social grounds, but is can also make good, practical economic sense.It puts money in the hands of many more consumers.Unless consumers obtain money to purchase the goods and services created by assets, there will be little incentive for producers to replace or build productive assets.The incentive to invest in these assets is thus the expected demand made by consumers for the goods and services they produce.Investment in productive assets will rise and fall with the expected levels of consumption.The classical economic belief that increased investment requires less consumption is inconsistent with both the businessman's motives and modern methods of financing new investments.

This belief, which is valid in primitive and socialist societies, persists today.It is used as serious rationale for not sharing the income cake more equitably.The argument is that economic growth would be slowed down by the greater sharing of income, since this would produce greater consumption and to less investment.In actual fact, the opposite occurs in societies that have developed the alternative method for financing new investment.The alternative is based on the expectation of future consumption and cash flows.

Postscript

Since writing the book in 1975 I have coined the term „degenerate" assets to describe what this chapter describes as a „consumption" assets. This allows the term consumption asset to be reserved for that class of degenerate assets, which reflects the standard of living such as houses, cars, white goods and other consumer durables. These concepts are developed and defined in my 1992 paper „New strategies for structuring society from a cash flow paradigm" available from the web page of the COG library at http://cog.kent.edu/lib/turnbull1/turnbull1.html

Shann Turnbull, Sydney, October 26th, 1999.