

THE
RELATION OF FINANCE
TO
RATIONALISATION

by
Sir Josiah Stamp

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THE RELATION OF FINANCE TO RATIONALISATION

I

RATIONALISATION DEFINED FOR THE PURPOSES OF THIS LECTURE

AT the outset let us deal with the many misconceptions on the finance of rationalisation, which arise because of the habit of confusing a financial reorganisation upon the basis of which rationalisation becomes more feasible, with rationalisation itself. Some use the term for a scheme in which a number of units are merged together, or brought under one central control, but this, until something visible or objective is done, makes no difference of itself to costs, to technical efficiency or to economies of working. It may enable a reduction in the number of directors, managers or senior staffs to be made, but in itself it does not re-arrange the work in any less costly way. The term is used in the second place for the reconstruction of the framework of finance of a business, when the whole capital has to be written down to represent revised and reduced values. Schemes which do justice to the position and prospects of debenture holders, preference shareholders, and ordinary capital holders, and many sub-divisions of them, have to be devised for securing the approval of the Court and the several bodies of shareholders and creditors, and after this surgical operation in the ownership proportions and inter-

ests, the business goes merrily or sadly on. But nothing actually happened to it as an economic unit.

In the third place, rationalisation is often used to describe what happens when plant and machinery are modernised and re-established. This process has, however, been going on for generations without having any such grand name.

For our present purpose I should prefer to confine the idea of rationalisation, first to those re-arrangements and modernisation of plant which can be made as the result of mass production in straight or uniform lines, through bringing a number of separate, but like, production units together in one place, simplifying a complex output into fewer lines, or re-arranging existing physical units. But the introduction of new methods and devices which are rendered possible by greater size, and radical changes from manual to mechanised methods in *existing* large business units, necessary to enable them to compete with mergers or other new businesses, are also the features of mass production and straight-line production, and are ruling factors in large scale enterprise.

So rationalisation is more than scientific management, such, and involves a pooling of business and a physical re-arrangement of it, with regulated production, prices and sales, and with an attempt to reduce and adjust premises to the scope and kinds of production. It is thus different from mere pooling arrangements with quotas or price fixing.

I would also include in the term rationalisation all the financial operations which are a condition precedent or essential to these physical changes.

II

THE SEVERAL KINDS OF BIG BUSINESS

RATIONALISATION is, of course, associated with business on a large scale. It is important to remember that the treatment of a big business cannot be dissociated from the way it has *become* big. First, there are those that have grown from small beginnings under one direction, such as Liptons or Levers; second, those that are big because they are an amalgamation of smaller units hitherto under separate control, such as Nobel's—now Imperial Chemical Industries—L.M.S. Railway and the Wall-Paper Combine; and third, there are those that are big from their initial construction, such as Ford's works at Dagenham. The last is born great, the first has achieved greatness, but the merger has greatness thrust upon it. Each of these presents the problem of rationalisation. The finance in the third case is extremely difficult to get except under the most highly accredited management, and but for Ford's famous record abroad and the existing market for his cars, the project of raising such a large sum of money for such enormous works would have been quite impracticable. But when once raised, it has a very definite characteristic, inasmuch as it is all expended in new construction, and represents a very active demand for new production goods. It is new capital in every sense of the word, and there is no waste whatever if it at once embodies all the latest forms of machinery, scientific management and lay-out. The only waste that we have then to consider socially is the capital in other concerns

that is rendered obsolete, which was capable of producing the same goods, whether they were produced at as low a price or not. This is part of the general problem of obsolescence and progress. In the case of new agglomeration, bringing a large number of businesses into one, there is not *necessarily* any new capital at all. In the first instance shareholders of the original concerns merely become shareholders in the larger one by exchange of shares, or if some of the businesses are purchased for cash and new cash is raised by public subscription, it is quite possible for there to be no addition to the total capital of the country at all. "A" who subscribes may sell other debentures or war loan to provide the cash. The new company "B" pays over to the vendors of the business "C," and "C," having this free money to invest, comes into the market and takes up the very war loan or debentures that "A" relinquished. There is only a shifting of ownership of existing assets and no actual new savings are required, despite some important financial operations. In the case of the business that has *grown* big, if it merely changes hands from a family ownership to wider public shareholding, much the same reasoning applies. The process may certainly set up some new "strains," so to speak, in the demand for particular types of capital holding, reducing the interest yielded or required for some, and increasing that for others. It may thereby influence the way in which the future capital market works.

The finance of rationalisation, therefore, has not necessarily a great deal to do with financial amalgamations and reconstructions, although most accountancy books on the subject treat of the *technicalities* of holding companies and mergers as though they were the main factor. When the big business has entered into the field where rationalisation is considered desirable and possible, i.e. under a unitary

direction or control, it is then that the financial problem arises, whether there have been financial reconstructions or not.

As a general rule, the more complete the financial identification of the interests which come together, the better the prospects for complete physical rationalisation. Where Boards remain distinct, or only partly identical in character, and where shareholdings are not wholly the same in each case, or even where particular debentures remain intact secured on particular premises or works, there are obstacles to complete unity of policy. The legal doctrine of the independent legal unit, whose interests must not be sacrificed to those of another, with almost complete identity of ownership, does not completely disappear even when there are no "minority" shareholders at all! This question of identity of control may be studied in the case of the Cables and Wireless merger. But the Shipbuilders' scheme for rationalisation of shipyards shows that it is possible to get a high degree of common action without any merging of ownership at all. Here outside money is raised to rationalise the industry by acquiring obsolete and redundant shipyards and disposing of them, the interest and repayment of this capital being provided by a royalty on all the new tonnage built. This experiment must be watched with great interest as an instructive development in a new direction.

III

THE FINANCING OF BUSINESS—OLD AND NEW

THERE is a great contrast between the method by which the units of large manufacturing industry were financed in the nineteenth century, and the methods and sources that are now open to units of the same size. The majority of progressive single unit factories for textiles, engineering, and most collieries were not financed out of public savings at all. Profits grew rapidly and the sums withdrawn from business by their private owners for personal consumption were kept down to very modest dimensions. The large marginal surplus of profit was automatically "turned in." Strong local banking units, with personal knowledge and freedom from hard and fast centralised rules, and insistence on external physical collateral, came to the assistance of many of these units from time to time, and helped them over difficult periods of financing, or gave them a start. To-day a far smaller proportion of industry is in private hands, even taking into account the private limited companies. The margin of profit above costs is less generous, though more effective in fluid competition, and the proportion of that profit distributed for consumption purposes in dividends and drawings is probably greater, while the inroads of heavy taxation also serve to reduce the *quantum* available for reinvestment and extension. Obsolescence causes the turnover in plant to be much more rapid, and the annual provision to be made for it on proper lines is greater. Altogether the amount available for free extension is much

restricted. If to-day to be successful the business needs to be four or six times the size of one of these single units of former times, it is consequently out of the possibility of ownership of a few private hands and dependent upon a wider range of stockholders. If these shareholders, through their boards, desire to make extensions and improvements the units are too big for *privately* subscribed capital and yet tend to be too small to have a public drawing power on a relatively distant money market like London, at any rate, for ordinary capital at risk. Rationalisation on a large scale tends to be able to raise its money only upon the conditions of debentures and cumulative preference shares. We have had no real experience for the past twenty years of the financing of industry as such, so far as the taking of real industrial risks is concerned, for I do not count the optimism of the 1919-20 boom as any sufficient indication of a permanent tendency. If debenture capital is to be kept within reasonable proportions of the physical security, and preference capital requirements confined within an irreducible cover of profits, as I have already indicated, then a substantial sum is wanted for the equity of the business or the marginal capital at risk. No one yet knows what would be the effect of a succession of flotations in the London, Liverpool or Bradford money markets of large-scale textile enterprise appealing for *ordinary* capital for large new factories and extensions. Successful appeals must now be made to a large extent by established concerns, and they are much more likely to do it by putting secure money, such as debentures, in front of existing equities and profit margins, than they are by sharing the balance of profits or promising new profit margins. Nevertheless, the true dynamic of industry in its extensions and originality, must rest upon the equities and the risk-taking capital. Unless there is a free and courageous market for this, all the businesses will

play for safety or stability and for most of the things which are tendencies towards stagnation, in rings, trade understandings, and price fixing. We thus see that the growth of a profitable unit of manufacture to a size beyond the scope of local and private capital, is an important social phenomenon, with important new consequences unless we are sure that we have provided a source of capital in all respects as courageous and mobile as the original. Now the small investor in London is hardly able to pronounce judgment upon a prospectus for ordinary capital for businesses run by names, in Lancashire and Yorkshire, which are practically unknown to him, however well they may be recognised and esteemed in their own localities. If the business is an established one and the appeal is for debenture or preference capital, the machinery of the issuing house, the Chartered Accountant's certificate and the lawyer's protection will give him a prospectus carrying its own assurances. He will know how many times an average of profits over a period of years covers the charge for debenture interest or preference capital. He will have independent valuations of plant and property, and he will have the credit of the issuing house also involved. But some development will be needed to carry this into the field of the ordinary capital for the small investor. These tendencies will tend to consolidate existing successful business and make the rise of completely new units comparatively rare.

IV

THE FINANCE OF "RE-ARRANGEMENT" —SELF-PROVISION

A CERTAIN amount of rationalisation is merely re-arrangement, and does not necessarily involve large outlay. A number of separate units may have been providing many different types of product from each unit, and by focussing the whole supply to meet a particular demand, by manufacture in one place, the economies of "straight-line" production can be achieved, and perhaps this may sometimes be possible by the mere changing over of machinery. Localisation and concentration of particular manufacture is the commonest feature of rationalisation. It occurred, for example, in the Wall-paper combine which has now particular factories responsible for particular types and classes. These transfers of manufacture are, however, rarely so simple, for in order to get the full benefit of straight-line manufacture, the machines probably have to be somewhat more uniform than this kind of haphazard growth in different places would make likely. Such transfers may involve structural changes and re-arrangements of the layout of the receiving factory. Reduction of the number of lines, by eliminating close variants and unnecessarily detailed differences, in itself varies the requirements of plant, throwing some machines spare, and making new demands for others. The first type of rationalisation, the re-arrangement of lines of supply, nearly always involves some changes in layout and modifications in machinery,

which again involve new expenditure. A good illustration was when the Sporting Cartridge manufacture of Curtis's and Harvey, Eleys and Kynochs, were first of all concentrated in Edmonton and Witton, and finally in Witton. Other instances are the closing of railway works in the smaller centres such as Stoke or Inverness.

A second feature of rationalisation is the introduction of new methods of performing old functions, where the existence of a single large quantity of work to be done makes possible or profitable methods and devices which were not economic so long as the stream of production was divided. In other words, there are labour-saving devices which are not profitable for adoption by separate units on a small scale, but which become practicable when these units are concentrated. This is especially the case in office work, with calculating machines, sorting and addressing devices, and specialised kinds of typewriters. One of these machines in each of ten small establishments would be hardly justified if employed only a tenth of its time, but one for all of them, when concentrated, becomes an economic proposition.

But concentration and uniformity enable stores and purchases to be obtained in quantities on better terms, to be simplified and standardised, and also to be far less in the aggregate than when held separately, for then only one margin for contingencies and for delays in delivery is required instead of many. Now this will often produce free capital instead of demanding new capital, and much finance for active rationalisation may be actually internally provided in this way, through internally freeing circulating capital. In Nobel's combine, from 1919 to 1926, apart from the effect of the fall in prices on the capital required to deal with an equal physical output, the capital locked up in the quantity of stores was reduced by several millions. In the London, Midland and Scottish Railway the value of

stores came down by 27 per cent. in five years, and released over £2 millions of working capital. Wagon sheet stock was reduced by one-sixth; the different items purchased by 35 per cent.; felt pads under railway "chairs" on the line from some hundreds to 45, coach trimmings 150 to 5, varnishes 28 to 8, brushes 24 to 4, oil lamps 186 to 52.

In the same way, less circulating capital may be held up in finished stocks and transport charges, while, in my experience, even the pooling of bank balances through one central account has freed a certain amount of capital for general use. The closing of factories, and sale of surplus machinery and land, may often provide cash for other rationalising operations. But they do not solve the accountancy problems which arise in dealing with the disposal of assets below cost, and which are certainly "financial" in a high degree.

V

RATIONALISATION OF PERSONAL FUNCTIONS

ON the human side, rationalisation includes the specialisation of particular people on particular functions, which were formerly everybody's business. There becomes room for individual officers whose sole work is the study of personnel, the conducting of entrance examinations, welfare work, specialisation of all kinds, in whole-time tasks. Instead of twenty factory managements sending out questions to twenty different firms of lawyers, the combine will almost certainly have its whole-time legal staff and save both money and time in the process. Special departments for publicity and advertising, for economic research and statistics, for transport organisers, for taxation questions, for the study of office requisites, for medical officers, for scientific research of all kinds, are the natural consequence of size and self-sufficiency. But these personal readjustments do not involve much finance, whereas the plant and machinery under this heading are certainly a very important factor.

VI

THE CHOICE OF METHODS

UNDER the third line of rationalisation comes the choice of the best means. So long as the units are operating on a small scale, the ways of doing particular things vary very widely, from inadequate, but long-tried methods, to the most recent and the most speculative and it is unduly expensive to change them. The management of each place will probably be wedded to its own method, and can probably quote experiments and experience from which its choice has been made. But under a combine it soon becomes absurd for all these different methods to be perpetuated, especially when an actual break up of existing conditions is necessary in any case, and a careful detailed investigation is necessary to determine in the end the one which should be chosen. The scrapping of old methods and the adoption of the new nearly always demands a certain additional financial outlay not only in obtaining the new when chosen, but in the process of choice.

Another problem in rationalisation, especially when uniform production is on a large scale, is to determine with greater accuracy when transfers from manual to machine methods can economically be made, or where transfers from simple machines operated on the older lines, to new machines with up-to-date drive, etc., or feed, can usefully be effected. These are so important in their financial aspects that I will deal with them separately later.

VII

THE CLOSING OF WORKS

Most important of all in rationalisation is the suppression of whole physical units of production, when the total output required is far less than the total capacity, and those that are working at higher costs must be closed so that actual output and potential output of the effective units are brought much closer together. This sounds simple to enunciate, but it is very complicated in practice. How do we know that one factory, given the same task as another, is less efficient? In many cases where the margin of difference is not obvious to the eye, determination can only be safely arrived at by very exact systems of costing. These have to be devised and agreed—a painful psychological process—and they have to be operated for a sufficient period, to cut out seasonal variation and give a stable “time basis” of comparison. Even then, if any glaring discrepancy in a particular process is shown, it may be possible to correct or reduce some of the factors quickly, by reorganisation or new machinery, and it would not be fair to assume that the factory should be closed, merely upon the *first* results of strictly comparable costing. When, however, the effect of such new expenditure has been determined and it is seen that such a change is still not likely to correct the whole difference of costs, a decision can be reached. But closing the factory involves many actual out-of-pocket expenses, such as the pensioning or compensating of staff, and the compensation for rent and other charges.

VIII

THE ACCOUNTANCY PROBLEMS

THE actual writing off of values from accounts raises the most important issues. No new combine cares for the process of writing down its capital at the outset because of these adjustments. Although one factory may be abandoned and deprived of part of its book value, the concentration of manufacture in another does not permit of its value in the balance sheet being written up accordingly. It is an accountancy conservatism, that such a thing is "not done." This "one-way traffic" of adjustment of figures is thus a great drag on readjustment of finance prior to rationalisation. If the gain of concentration by the new and lower marginal cost would not, over a reasonable period of time, compensate for these expenses of disturbance and cessation, then it would be difficult to carry them out; but it might obviously be possible to borrow the money for making the change, and then pay off the loan by spreading a charge in addition to the new costs of the product until the expense has been wiped out. In the case, however, of the writing off of the whole difference between the cost of a factory and its plant, and the scrap values that they realise, we are faced with a problem of first-class magnitude which lies at the root of the problem of rationalisation. Strictly, if the community are going to have the benefit of much lower economic costs as a determinative element in price in the future, they ought to stand the racket of the expense of bringing it about in the meantime and the amortisation of

these capital losses over a period of years may well be a true and legitimate cost before the price is arrived at or profit determined. From an economic point of view, how far is it possible to do this? If the concern has become a monopoly, the public can well go on paying the old and original price without being particularly conscious of the process, and inasmuch as, by hypothesis, all the new costs under rationalisation are much reduced, there is an extra margin (between new cost and old price) out of which the amortisation fund may be provided. When this has once been done and the provision made, then the public can be given the benefit of the lower cost in lower prices, and, if the demand is not too inelastic, the concern will secure its advantages in wider sales at these prices.

It is possible also for a similar process to take place, without a complete monopoly, where the industry is under the shelter of a tariff. If, however, new concerns exist at home or abroad, built in the latest style and without any obsolescence to overcome, and are putting their goods on the market at prices appropriate to their new costs, then the old and rationalised concern may not be able to maintain a fund of extra annual profit out of which to write off the lost capital. This lost capital of rationalisation is, of course, really lost long before it is recognised or written off. It involves very often altering the status of debentures and bank loans, and it is the desire of the holders to carry these on,—waiting for something to turn up—or the inability to face up to writing them off or making new arrangements for them, that holds up rationalisation much more than the difficulty of raising new cash capital for improvements. But new capital cannot be raised, except in priority to these other charges, unless the existing capital itself is readjusted and “rationalised.”

It is not absolutely necessary for a complete margin

of superiority in costs at *existing* prices to exist before obsolete units are dealt with. In the Shipbuilders' scheme I have referred to they make themselves liable for a small royalty on their tonnage output, which provides a fund to pay interest and repay the finance raised. Here the final incidence is almost certainly upon the community in the price of tonnage, with the prospect of reduced costs ultimately—the most orderly and economic of all methods so far devised.

IX

THE INFLUENCE OF THE PRICE LEVEL

THE question whether it pays to substitute more mechanised for less mechanised methods has no absolute answer. It varies obviously with the required quantities of production or output. But it also varies with the relation between the general price level and the general wage level. If at a particular point there is a balance between the sum of the labour costs and the capital costs of new methods against the larger labour costs of the old, this may not remain constant. For if wage levels remain high while general prices fall, the equation may be completely altered. Thus on a Railway, the annual cost of allowing interest and sinking fund for the cost of a new device may be £500 in capital expense and the working thereof £500 in wages, or £1,000 per annum in all. If the present expenditure in wages is £950 per annum, the scheme shows no margin of profit, and is not given effect to. But suppose in five years' time the machinery can be obtained for a third less, the future expenses will become £830 and, assuming no change in wages, with the present expenses of £950, the change over is worth making. Of course, the case is not always quite so simple, because the new work may not be the same as the old, and the workers may object to having a change of duties. Or again, there may be obligations of a financial character towards redundant staff. But in general, the ratio between the fall in price levels and the fall in wage levels is an important factor in the *speed* of rationalisation.

It has, doubtless, much to do with the obvious over-rationalisation in Germany, and this may be studied in Mr. Meakin's book, the *New Industrial Revolution*, when it may be seen that several false factors entered into the scope and speed of machinery substitution in German industry.

X

A BANKING PARADOX—CHEAP MONEY IN INDUSTRY

I MUST refer again to a further influence at work which makes consolidation profitable, and that is in the relative difficulty of the smaller unit in obtaining the capital to reconstitute its productive equipment. The Macmillan Committee Report referred to a distinct gap in the British financial machinery in the absence of institutions for financing business, lying between the method of temporary banking overdrafts, and the full service and equipment of public prospectuses for large well-known concerns. This position has been still further accentuated recently by the discovery we have made, on the advent of cheap money, that the banking system cannot afford to pass on really cheap money to ordinary businesses, and that these businesses are little better off with the Bank Rate at 2 per cent. than they would be with the Bank Rate at 4 or 5. This is due to the fact that the banking overhead expenses form a relatively incompressible sum which must be carried somewhere, and if the income of the banks in the non-industrial uses of their funds, the money market and investments, is automatically reduced, the burden falls to be sustained by the non-reduction of the third main source of income, the net difference between business advances and deposits where they retain some power to regulate it. It might even mean that the more the cheap money policy forced down the automatic yield from the two sources, the

higher would the yield on the third have to be to pay the expenses. It seems, therefore, that the average small unit will find it difficult to get finance for rationalisation either cheaply or at all. But inasmuch as the agglomeration of such units may be big enough to command public company finance in London, at any rate, on the debenture and preference capital side, the only hope for rationalisation in the small-unit industries is a further merging on a considerable scale. At the present moment there is, however, very much of a vicious circle in this finance. In the Iron and Steel Industry we have been told that really good regional rationalisation is not possible without considerable new capital; that the raising of new capital is well nigh unthinkable without tariff protection; that tariff protection would be a fatal step, and merely stereotype existing deficiencies and obsolete methods if there is no effective rationalisation. This circle may now have been broken by the promise of a tariff, and we may expect some effort to be made to raise capital for rationalisation. In other industries it may also be said that rationalisation is dependent upon new capital, and that new capital often cannot really be obtained until some measure of rationalisation has been agreed.

XI

SUMMARY OF FOREGOING

WE have seen that effective rationalisation, if it is to overcome all difficulties, requires (1) the obtaining of new cash resources for new equipment, (2) the provision of surplus values and profits adequate to provide for writing down assets displaced, and that these are two very distinct problems. With regard to the raising of cash resources, in many cases rationalisation itself will provide much of what is wanted through economies in stocks, etc., and realisation of properties. But where outside cash is required, it does not necessarily come from new capital savings if businesses are merely changing hands in order to enable them to be more effectively controlled or merged.

The actual demands of new capital in the sense of new savings for the provision of new equipment are really rather small relatively—certainly small, compared with the accountancy resources in the way of enhanced values, which are necessary to protect or provide for specific diminishing values in the balance sheets. The Lancashire Cotton Corporation has raised some £2 millions, but only a relatively small proportion has gone into new capital spending—the rest, after achieving certain balance sheet adjustments, “goes round” the community in a circle. Even in this field, however, of the provision of new savings, British industry at the moment, prior to rationalisation, is so unattractive in the staple industries that the investor will need a good deal of new encouragement to take the equity

risks, and industrial revival will have to be some way upon its course before this inertia is overcome. Our existing financial framework is not very favourable towards assisting it in the present public psychology.

XII

SOCIAL EFFECTS OF A FINANCIAL CHARACTER

WE have referred so far to the internal demands of business and the investment market. It may be well to glance for a moment at the larger distribution of financial results in economic society. Let us take the *simplest* case where rationalisation involves no capital expense and produces an article which is not wanted in larger quantities at any lower price. Let us say that the community has bought a million items for a million pounds, and now they can be made with half the labour and cost £500,000, and that half the number of workers are now out of work. The community in general have £500,000 worth of new purchasing power in hand, gross, but, inasmuch as the unemployed have to be maintained through unemployment insurance and relief payments, their taxation will rise and absorb some two-thirds of this purchasing power. The extent to which the community is benefited by rationalisation is limited to the difference between the old wage level and the new relief level of the unemployed. This balance of purchasing power not so used may stimulate further demand in other directions, but it is not demonstrable how much additional labour in those directions will be created and whether a part of the unemployed will be absorbed. In times of active trading and invention and capital investments, no doubt the process will proceed until all the unemployed thus created are re-absorbed in producing commodities to be met by the

released purchasing power. That is not the immediate static result. We have taken an unduly simplified case. In the real world the process of rationalisation will demand a new capital supply and this will employ a *proportion* of those who would otherwise have been unemployed. Again, at the reduced prices an increased quantity of the commodities may be taken off, and this also will employ another section. There will thus be two net deductions from the gross number of potential unemployed. It still means, however, that the whole of the purchasing power set free to the community by rationalisation may not be immediately utilised in such a way as to re-employ all the men, and much of it must be taken up in keeping them during their idleness. A too rapid rationalisation, therefore, from the point of view of the community, defeats itself as a net addition to human welfare and riches, and the tempo of adjustment is all-important in this problem of Invention and Progress. Moreover, this is not merely a question of the tempo of creation of new demand and wants, but also of the tempo of *adjustability*. In a community which, for humanitarian reasons, every natural impetus to radical change is warded off, by insurance categories, trade union rules, etc., almost the only adjusting mechanism left is the slow effect of the recruitment of industries in new proportions by young people who are new entrants.

This subject of Rationalisation, and its inevitable engine, finance, may seem a very strange one to deal with in an audience of women, but I believe that there is so much confusion of thought between the financial operations attaching to rationalisation and rationalisation itself, and so little appreciation of the real financial resources behind the operation, that all of us interested in social problems ought to clarify our ideas upon the subject. After all there is no

financial problem that is not a social problem and no social problem to-day that is not a human problem, while there is no human problem that is not a women's problem, and that is all the apology that I can give.