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The Capitalization of Earning Capacity and T. Veblen's Theory of Loan Credit*

Yoichi Kawanami
Shimonoseki City University
kawanami@shimonoseki-cu.ac.jp

Abstract

This study clarifies the content of the capitalization of earning capacity and credit expansion based on T. Veblen's theory. The uniqueness of Veblen's theory arises from his observations of the peculiarities of the credit economy. Veblen noted that under a credit economy, monetary assets tend to diverge from physical assets. The capitalization of earning capacity forms the core of Veblen's theory on credit expansion and the growth of "corporate capital". The capitalization of earning capacity, which Veblen focused on, is also embedded in modern financial phenomena such as securitization and derivatives in the form of cash flow. This suggests that Veblen's theory holds validity as a perspective for analyzing modern finance.

Keywords

Veblen, Earning Capacity, Loan Credit, Capitalization, Credit Economy, Common Stock, Preferred Stock

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I. Introduction

1. Issues and Research Perspectives

Chapter 5, "The Use of Loan Credit" in Thorstein Veblen's *The Theory of Business Enterprise* offers a distinct analysis of credit and capital that differentiates it from the approaches of the British Classical School, the German Historical School, and the diverse strands of American economics at the time, including Neoclassical and Institutional perspectives. One notable aspect is Veblen's attention to the phenomenon in which the scale of monetary assets, such as borrowed capital and issued securities of enterprises, diverges significantly from that of tangible industrial equipment and other production assets.

This phenomenon was caused by the autonomous expansion of credit. In this context, credit includes not only bank credit between enterprises and banks but also massive fundraising through issuing various credit securities, such as preferred and common stocks and corporate bonds. However, in the sense of financing to establish larger monopolistic enterprises through mergers, the focus is more on fundraising through securities issuance. This expansion in loan credit has been highlighted as a unique phenomenon in situations such as merger movements.

In these scenarios, the elements generating differential profits are evaluated for their ability to enhance the earning capacity of the newly merged enterprise. In this context, capitalization refers to the issuance of securities corresponding to a value equivalent to the differential profits capitalized at the interest rate.[1] Veblen perceived this phenomenon of capitalization as realized through the collateralization of earning capacity. Marx, who analyzed credit and financial markets in 19th-century Britain, also held the perspective that credit and monetary assets expand and diverge from physical capital.

However, the discussion of credit expansion based on the collateralization of earning capacity is unique to Veblen. From the interwar period to the postwar era, situations arose in which earning capacity became the basis for bank loans.[2] Moreover, in the recent development of securitization and financial derivatives, cash flow has become the axis of product design. This suggests that Veblen's theory of loan credit expansion, based on the borrowing entity's earning capacity, is a precursor to analyzing modern financial phenomena. Thus, Veblen's work is expected to provide a theoretical perspective for analyzing the expansion of bank loans and prevalence of securitization during the 20th century.

Veblen observed the rise of monopolistic enterprises, particularly in the heavy and chemical industries, and their engagement in fierce competition in the United States during the late 19th and early 20th centuries. Corporate mergers and acquisition movements unfolded, and massive fundraising was conducted in the capital market for this purpose. Veblen focused on the phenomenon of the expansion of "corporate capital" amidst competition for "pecuniary profit".[3] By "corporate capital", he referred to the total operational capital of an enterprise, comprising both the enterprise’s own and borrowed capital. Veblen took particular interest in the function of credit and capitalization of earning capacity in expanding "corporate

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[1] 'Capitalization' in Seligman, E.R.A. (1930), pp.207-211.

[2] For more information concerning bank lending based on earning capacity, see the following literatures: Prochnow, H. V. (1949), p.38; Dewing, A. S. (1934), p.488. In addition, H. P. Minsky realized the importance of cash flow in securitization. cf., Minsky, H. P. (2008), pp.2-4.

[3] Cf. Veblen, T. (1994), Vol. II, p.20.

capital". The question is how Veblen understood the mechanisms of earning capacity capitalization and autonomous credit expansion.[4] This study aims to clarify the content of earnings capacity capitalization and credit expansion based on Veblen's discussion.

To clarify the significance of setting this issue, I would like to provide additional explanations based on my own unique perspective on why focusing on Veblen is important. This clarification leads to a clearer viewpoint for approaching phenomena that have emerged since the 20th century.

As detailed in the main discussion, Veblen explained the expansion of loan credit, a prominent feature of monopoly capitalism during his time, by focusing on the capitalization of putative earning capacity and the issuance of securities secured by it. When discussing this issue, he paid attention to earning capacity as the ability of a business to generate regular differential profits expected in the future. At a concrete level, this corresponds to the cash flow of enterprises.

On the other hand, securitization itself refers to the packaging of original loan claims and the recombination of the cash flows they generate to create new securitized products. Another distinctive phenomenon in modern finance, derivatives, consists of financial instruments designed for risk hedging or speculative purposes, derived from price changes in underlying assets such as stocks, bonds, currencies, interest rates, and commodities. In derivatives, calculating cash flows plays a significant role in setting contract terms, valuing the instruments, and managing risks.[5]

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[4] When considering bank lending, if it is predicted that the borrower's cash flow will remain stable, it becomes possible to calculate the total amount (CF) at year T. By discounting this total amount using the interest rate (r) applied during the period, the present value (PV) can be determined, as expressed by the following equation:

$$PV = \sum_{t=1}^{T} \frac{CF}{(1+r)}$$

The total loan amount represents the discounted present value of the expected repayment amounts at the time of repayment, calculated from the borrower's future annual repayments. Veblen emphasized that loan credit amounts are determined based on the expectations of future cash flows, following the same logic. What he focused on was the capitalization of future earnings and the issuance of common stock secured by those earnings. Loan credit amounts are determined autonomously based on future cash flows and interest rates, independently of physical assets. The autonomous expansion of credit in a broad sense, including loan credit, encompasses this mechanism.

[5] Refer to the following literature, which demonstrates that cash flow is a key concept in the

In this way, the common element between Veblen's idea of the capitalization of earning capacity and securitization or derivatives is cash flow. From this fact, it is reasonable to hypothesize a connection between the capitalization of earning capacity and the development of securitization and derivatives.

However, there is a significant temporal gap between Veblen's era and the 1980s. Directly applying Veblen's theories as tools for analyzing modern phenomena would be unreasonable. Yet, as noted in Note 2, the concept of the capitalization of earning capacity that emerged in Veblen's time became more pronounced in the realm of bank lending during the interwar period. As bank lending extended into areas such as residential mortgages, incentives arose to liquidate claims in relation to liabilities. Even before the securitization boom of the 1980s, bank lending was already developing based on borrowers' earning capacity. This fact suggests the value of exploring the ideas that might have formed the origins of the concept of structuring securitized products through the recombination of cash flows.

Meanwhile, the innovative methods behind derivatives emerged in an environment of increased uncertainty and risk during the transition to floating exchange rates and financial deregulation. It is noteworthy that such innovations were underpinned by advances in financial theories, including John Burr Williams' investment value theory, Harry Markowitz's portfolio selection theory, the CAPM, and option theory as represented in the Black-Scholes equation. Additionally, theories by scholars like I. Fisher, J.B. Clark, and F.H. Knight underpinned these advancements. Among these theories, T. Veblen's ideas are noteworthy because they addressed cash flows—a concept common to phenomena like securitization and derivatives—in the form of the capitalization of earning capacity.

2. Survey of the Research History

How might Veblen's theory offer insights into the study of modern finance? Surveying the research history from the perspective of how Veblen's discussions have been positioned and evaluated is an effective method for examining this problem.

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design, evaluation, and pricing of securitization and derivatives products: Fabozzi, Frank J., ed. (1988), pp. 65, 83–87, 337–352, 1018–1023, 1481–1482; Bodie, Zvi, and Robert C. Merton, eds. (2000), pp. 109–111, 117–122, Chap. 8; Hull, John C., and Sankarshan Basu (2021), pp. 102, 206–207, 709–711.

Several studies that recognize the characteristics of Veblen's theory in the capitalization of earning capacity are discussed below.

Veblen was interested in the economics of the British Classical School and the German Historical School, as well as the diverse strands of American economic thought of the time, including both Neoclassical and Institutional perspectives. He analyzed the American economy from diverse perspectives, including institutions, culture, sociology, and economic theory. This paper focuses on the discussions in *The Theory of Business Enterprise* to examine the historical significance of his theory on the capitalization of earning capacity.

Veblen's views on this topic have been analyzed from various angles. For instance, some arguments identify the theory of the capitalization of earning capacity as a key characteristic of his work. Other studies evaluate Veblen's discussions in comparison with J.M. Keynes, or they organize his ideas as a theory of credit expansion and financial crises by contrasting them with the work of K. Marx and H.P. Minsky. Additionally, research has focused on Veblen's theory of intangible assets, while other studies connect his theories to contemporary finance. This section surveys the research history of these topics and clarify the significance of focusing on Veblen's theory of the capitalization of earning capacity.

Hake and Bruce (2002) explain that the core of Veblen's theory lies in the capitalization of intangible assets and credit expansion through collateralization of earning capacity, applying it to the corporate finance of a specific enterprise (i.e., Iowa Beef Packers).[6]

Raines and Leathers (1992) emphasize that capitalization based on earning capacity creates greater credit than capitalization based on physical assets, constituting financial innovation.[7]

Furthermore, Hake (1998) finds that Veblen's suggestion of earning capacity capitalization breaks through old methods as a facilitator of corporate mergers and acquisitions.[8]

Davanzati and Pacella (2014) discuss the mechanism of economic crises and credit expansion using earning capacity as collateral, which they identify as a system

[6] Hake, Eric R. and Martin Bruce King (2002), pp.495-505.
[7] Raines, J Patrick and Charles G. Leathers (1992), pp.433-440.
[8] Hake, Eric R. (1998), pp.145-169.

to gain monetary profits without expanding production.[9]

Baskoy (2013) interprets Veblen's theory of business competition and highlights his theory of business cycles and financial crises. This study emphasizes that the peculiarity of Veblen's theory lies in the evaluation and re-evaluation of capital based on future earning capacity in a credit economy driven by the pursuit of pecuniary profit and how this re-evaluation, diverging from actual earning capacity, leads to credit expansion and eventually crises.[10]

Cornehls (2004) evaluates Veblen's clarification of the mechanism through which future earning capacity functions as de facto collateral, leading to booms in using loan credit in monopolistic capitalism driven by the pursuit of pecuniary profit.[11]

Hake (2004) explains the relationship between future earning capacity and credit expansion in Veblen's theory, focusing on how credit expansion based on expected earning capacity becomes a powerful means of restructuring the ownership of physical assets in corporate mergers and acquisitions. This study finds the peculiarity of Veblen's theory in its focus on the significant discrepancy between the assets on the balance sheet and the capitalization amount in the stock market.[12]

In addition, some studies clarify the uniqueness of Veblen's theory by comparing it with other theories, such as those of Fisher, Keynes, Tobin, and Minsky. Wray (2007) identifies three commonalities between Veblen and Keynes. First, Keynes recognizes capitalism as a monetary economy and Veblen recognizes it as a credit economy. Second, both emphasize the importance of expected income from the present and future perspectives, with Veblen focusing on the efficiency of new capital and Keynes on interest rate changes. Third, both pay attention to the problem of insufficient demand. This study uses these comparisons to deepen the understanding of Keynes's "monetary production economy" and Veblen's "credit economy".[13]

Argitis (2016) reveals the genealogy of discussions on financial crises and credit expansion from Marx, to Veblen, and finally to Minsky, emphasizing the

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[9] Davanzati, Guglielmo Forges and Andrea Pacella (2014), pp.1043-1061.
[10] Baskoy, Tuna (2003), pp.1121 -1137.
[11] Cornehls, James V. (2004), pp. 29-58.
[12] Hake, Eric R. (2004), pp.389-395.
[13] Wray, Randall L. (2007), pp.617-624.

theoretical characteristic that the larger the opportunities for monetary gain, the lesser the incentives for real investment, leading to a mechanism in which expected future earning capacity diverges from actual earning capacity, creating a system that is inherently financially unstable and vulnerable.[14]

Medlen (2003) evaluates Veblen's discussion as a predecessor to Tobin's Q theory, focusing on the core of Q theory in placing the difference between the market valuation of firms' stock prices and the cost of replacing physical assets at the center of investment theory. In contrast, Veblen's discussion focuses on the nominal valuation of capital based on hypothetical earning capacity exceeding actual earning capacity, highlighting the difference between nominal valuation and actual earning capacity in capital markets. This shared perspective highlights the difference between Q theory as an investment theory and Veblen's discussion, which leads to crisis theory and corporate mergers and acquisitions.[15]

Davanzati (2014) notes the similarity between Keynes and Veblen in the theory of effective demand, emphasizing not only the analysis of the modern economy as a monetary economy but also the connection between exogenous wage increases and high investment and employment levels.[16]

Ganley (2004) compares Veblen and Fisher, highlighting the unique focus of Veblen's theory on intangible assets and clarifying the mechanism of divergence between putative and actual earning capacity, in contrast to Fisher's emphasis on capital and finance based on information gathering and risk analysis. Veblen's theory, which forms the foundation of institutional economics, diverged from Fisher's neo classical economics in the United States.[17]

Furthermore, several studies evaluate the contemporary significance of Veblen's theory. McCormick (2002) argues that Veblen's suggestions should be utilized to redefine capital, emphasizing the importance of knowledge and its social nature related to neoclassical growth theory. According to Veblen. the productivity of capital goods and land is inseparable from the knowledge and techniques used, highlighting the role of intangible knowledge in society in linking technological

[14] Argitis, Giorgos (2016), pp.834-851.
[15] Medlen, Craig Allan (2003), pp.967- 986.
[16] Davanzati, Guglielmo Forges (2014), pp.92-109.
[17] Ganley, William T. (2004), pp.397-403.

innovation, productivity, and growth.[18]

Dillard (1987) contrasts the monetary neutrality assumed in classical and neoclassical theories concerning production and employment with the emphasis Veblen and Keynes place on the active role of money as a capitalist institution. This study identifies the similarities between Veblen and Keynes, recognizing the pursuit of monetary gain as the purpose of capitalist enterprise activities. While Keynes contrasted industrial circulation as a function of real output with financial circulation as a function of financial transactions, distinguishing the functions of money, Veblen contrasted the roles of money and credit for industrial use and monetary gain. Veblen emphasized the autonomous expansion of credit and monetary nature of interest, a view aligned with Keynes' understanding that interest rates determine the marginal efficiency of capital. Veblen's recognition of insufficient effective demand during a chronic recession aligns with Keynes's view. Additionally, Veblen's emphasis on the activities of commercial enterprises seeking monetary gain is also consistent with Marx's theory of credit, which attempts to depict the movement of interest-bearing capital under a credit system. Veblen's theory of loan credit expansion and crisis, centered on hypothetical earning capacity, aligns with Minsky's theory of cash flow and the financial instability hypothesis. Veblen's theory and ideas presented in the context of monopolistic capitalism show similarities with Marx's view of capitalism in the 19th century and can serve as a theoretical framework to illuminate the development of capitalism in the 20th century and beyond.[19]

Finally, some studies highlight the applicability of Veblen's theory to modern financial phenomena such as securitization and derivatives from the perspective of modern significance. Medlen (2017) emphasizes Veblen's assertion that recessions occur as nominal capitalization diverges from the capitalizable amount of physical assets and that this occurrence is linked to monopolies. This study emphasizes that modern financial phenomena such as the flourishing of securitization and expansion of derivatives in structured finance are related to Veblen's evolutionary analysis of discounted expected income in its historical context.[20]

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[18] McCormick, Ken (2002), pp.263-277.
[19] Dillard, Dudley (1987), pp.1623-1647.
[20] Medlen, Craig Allan (2003), pp.119-142.

II. Basis of Capitalization of Earning Capacity

1. "Corporate Capital" and Industrial Equipment under a Credit Economy

The above survey of the literature shows that many researchers have noted the characteristics of Veblen's theory in the capitalization of earning capacity. Based on the concept of earning capacity, Veblen's discussion is evaluated and compared with the works of Fisher and Keynes as an analysis of financial crises, corporate mergers and acquisitions, and their relation to the prevalence of securitization and derivatives. A common point among many researchers is that the phenomenon of capitalization of earning capacity lies at the core of Veblen's loan credit theory. Therefore, the meaning of the concept of earning capacity in Veblen's theory and its potential as a theory needs to be clarified.

During the period Veblen observed, "corporate capital" consisting of equity and borrowed capital tended to diverge from industrial equipment. This phenomenon became noticeable during the monopoly period, reflecting the characteristic nature of "corporate capital". This divergence was caused by the autonomous expansion of loan credit. Compared with early 19th-century Britain, where capitalism had just been established and periodic crises were beginning to appear, the autonomous expansion of credit became more pronounced. This is because the use of credit was broader and larger than in the early stages of capitalism. Veblen characterized the stage in which massive fundraising was realized through the issuance of securities under the credit system.[21] He noted that the most characteristic point of the early modern monetary economy was the explosive increase in the use of credit. Moreover, not only quantitatively but also the free and ample use of credit occupied a central position in enterprise activities. Thus, credit has become indispensable for the operations of profit-seeking enterprises.

Before Veblen's time, economists did not explain the spread and presence of credit as indispensable elements in enterprise activities. At Smith’s time or earlier, the basic issue of economics was to address the accumulation of physical means of production, such as fixed and circulating capital. The issues cultivated in this context were the main topics. During Smith's time, the main theme was not the mechanism

[21] Veblen, T. (1994), p.133. Veblen introduces the credit economy as a German scholarly terminology and describes the early modern stage of capitalism as a still underdeveloped money economy. For more details, see Note 22.

of credit use, corporate organization, or the securities market but rather the phenomena of the monetary economy before these mechanisms developed. The main theme of economics during this period was increasing the material wealth of society as a whole and contributing to welfare from a utilitarian perspective. Thus, the pursuit was focused on how to maintain a prosperous and harmonious social order. Enterprise activities were considered in terms of how they could increase national wealth. The wealth of nations was placed at the center of the natural order, which was believed to ensure the welfare of humankind.

The traditional theoretical framework with which Veblen is concerned can be understood as British Classical Economics centered on Adam Smith. Veblen intended to examine modern corporate capital relative to traditional thought. Traditional theories of corporate capital were developed within the framework of the 18th-century natural order. The concepts of natural liberty, rights, and law form the foundation of capital theory. Traditional theories on the roles of capital and capitalists developed within this natural order. These traditional concepts of capital had validity in terms of the original objective of providing theories and policies for increasing national wealth. However, Veblen argued that corporate managers during his time did not base their understanding of capital on traditional concepts. Their understanding of the concept of capital differed from that of the old people.

Veblen's views on corporate management and the concept of capital are as follows. Guidelines for managing enterprises are not provided in a natural order. As Smith suggested, the purpose of enterprise transactions has shifted from enhancing social welfare to increasing the monetary value of money capital. In modern times, in which credit economies and corporate finance dominate, the monetary value of money capital has an indirect and ever-changing relationship with industrial equipment and physical capital, maintaining an independent position.[22]

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[22] Cf. Veblen, T. (1994), pp.135-136. The scenario that Veblen describes as a credit economy while drawing on the terminology of German scholars, refers to one in which capital markets have developed, making it possible to raise vast amounts of long-term funds through them. In this situation, monopolistic enterprises in the form of corporations have emerged, and a system of long-term finance has been established, built up by investment banks and capital markets to raise long-term capital for equipment investment. If we view the raising of vast amounts of long-term capital through capital markets as one form of credit utilization, then we can understand a credit economy as encompassing not only bank credit but also such extensive forms of credit utilization. This is exemplified by the development of heavy and

For example, during the late 18th and 19th centuries, dominated by British Classical Economics, the size of capital was expressed by the capitalization of production costs. For corporate forms such as joint-stock companies or individual businesses, the basis for capitalization was considered the physical equipment a company owned. Here, capitalization meant production costs or replacement costs of physical equipment, not the capitalization of income generated by physical equipment. This referred to the reproduction costs or reacquisition costs of physical equipment. While this remained the corporate form, this was the general method of capitalization. Even for corporations, most of the face value of issued shares represented the production costs of physical equipment. The total face value of issued shares was the nominal capitalization amount by law; however, in reality, it was the production costs of physical equipment. However, when companies began to take the form of corporations, changes occurred in the basis and content of capitalization. Thus, the corporation's earning capacity provided the basis for capitalization.[23]

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chemical industries and large financial institutions' activities in capitalist countries, such as Germany and the United States, from the late 19th to the early 20th century. These enterprises' activities differ from industrial capital, which is capital invested in businesses that combine physical means of production and labor to conduct production based on the capital–labor relationship.

Based on this, Veblen draws attention to the differences between his concept of "corporate capital" and industrial capital as understood by influential European and American scholars of the time, such as Karl Knies, J.K. Rodbertus, Böhm-Bawerk, and J.B. Clark. Veblen sought to clarify his theoretical position by distinguishing it from these scholars' understanding of capital and corporate capital. He was particularly interested in the reality of corporate capital under a credit economy. Specifically, he was concerned with how the concept of capital was understood in the practical world of business.

[23] According to various testimonies compiled by the Industrial Commission in the United States concerning capitalization, there were generally two main bases for the capitalization of a company. One was the idea that the capitalization amount of a company should be based on the actual value of its assets. The other was the idea that it should be based on the company's earning capacity.

The former approach is represented by the construction cost of the company's physical facilities. It suggests that capitalization should be based on the production cost of tangible assets and is considered unrelated to the company's earning capacity. Originally, an idea existed that tangible assets served as the basis for issuing bonds. This notion extended to preferred stock, which has characteristics closer to bonds than common stock, suggesting that tangible assets should also serve as their basis. However, when a company has consistently generated sufficient profits based on its track record, the idea emerges that common stock should be issued based on the company's ability to generate earnings above the historical average. This ability to generate above-average earnings

2. Earning Capacity as the Basis for Capitalization

Considering that the basis for capitalization extends to not only the production costs or reacquisition costs of physical equipment but also the earning capacity a corporation generates, the issued shares need to be organized. First, the total face value of issued shares is used as a measure representing the capital of the corporation, regardless of whether the basis is physical equipment or earning capacity. This represents the legal capital. As mentioned later, if a common stock is issued with future expected earning capacity as collateral, it will form legal equity capital. This earning capacity is legally considered equity capital even if based on income exceeding the average profit generated by a corporation's intangible assets, such as brand or technical capabilities. However, when shares are traded, a market valuation is formed which is separate from the legal capitalization amount. Veblen called this the effective capitalization amount. The nominal capital amount allowed by law rarely matches the effective capitalization amount. The effective capitalization amount is influenced by interest rates, dividends, securities supply and demand, and market trends. Furthermore, the amount of effective capitalization changes with market trends. A corporation's tangible and intangible assets are evaluated based on its earning capacity, which determines the market valuation. Thus, interest rates, dividends, and supply and demand are the effective capitalization amount that differs from legal capital. According to Veblen, corporations are not evaluated based on physical equipment or the nominal value of issued shares but on the differential profits they generate. If this ability is consistent,

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was sometimes capitalized as intangible assets, such as trademarks, patents, or goodwill. The idea that tangible assets serve as the basis for the issuance of preferred stock and bonds, while intangible assets serve as the basis for the issuance of common stock, became widely accepted. cf. US Industrial Commission (1901), pp. ix - x .

In contrast, another idea posited that capitalization should be based on tangible assets rather than earning capacity or intangible assets. This argument stems from the standpoint that the capitalization of a company should align with costs, according to sound management principles. When earning capacity serves as the basis, it becomes possible for even low-dividend companies to increase their market value. In such cases, the company's capital can be inflated through some form of intentional manipulation, such as stock watering, obscuring the real value of the assets. In this sense, capitalization based on earning capacity may be a desirable standard for financiers, but it is argued that it is not the proper method for corporate management. cf. Bonbright, James C. (1920), pp. 86-87; Bonbright, James C. (1928), pp.596-604.

it becomes an intangible asset. The basis for this is earning capacity.

Veblen provided goodwill as an example of an intangible asset formed based on a corporation's earnings capacity. Thus, it is the ability to improve a corporation's earning capacity, separate from physical capital, that can be evaluated as an asset. It is an intangible asset in the sense of nonmaterial wealth. This means that the elements forming the basis of this ability can be recorded as assets in accounting.[24] These abilities contribute to the improvement of a corporation's earning capacity without taking the form of physical wealth. They include various elements but can be summarized abstractly as superior technological capabilities, market dominance, managerial capabilities, and brand power. These elements bring differential profits to the corporation that exceed those of other companies. However, from the perspective of the economy as a whole, intangible assets do not increase national wealth. They primarily enhance a corporation's profitability and are therefore recorded as assets.

Thus, the basis for capitalization is earning capacity, and shares are issued in proportion to this capacity. In Veblen's time, no legal system was in place to authorize such actions. However, during the monopoly period in the United States, during which a relatively large capital market was developed involving investment banks, commercial banks, various institutional investors, and rating agencies, evaluation mechanisms supported the credit system for raising long-term funds. Based on this institutional foundation, the idea of evaluating the ability to generate earning

[24] Regarding specific examples, Veblen states the following:

> Various items, of very diverse character, are to be included under the head of "good-will"; but the items included have this much in common that they are "immaterial wealth", "intangible assets"; which, it may parenthetically be remarked, signifies among other things that these assets are not serviceable to the community, but only to their owners. Good-will be taken in its wider meaning comprises such things as established customary business relations, reputation for upright dealing, franchises and privileges, trademarks, brands, patent rights, copyrights, exclusive use of special processes guarded by law or by secrecy, exclusive control of particular sources of materials. All these items give a differential advantage to their owners, but they are of no aggregate advantage to the community. They are wealth to the individuals concerned differential wealth; but they make no part of the wealth of nations.

(Veblen [1994], pp. 139-140)

capacity as an asset emerged and was implemented. This provides interesting content for discussing the relationship between the emergence of economic theory and institutional development.

III. Capitalization Based on Earning Capacity and Corporations

1. Capitalization and Corporate Form

Veblen explored the relationship between the capitalization of goodwill and the corporate form, arguing that the capitalization of goodwill is most effective in industrial companies, typically railroads, steel companies, and mining companies, which usually take the form of corporations. Although Veblen does not explicitly state this, industrial companies generally possess large-scale fixed capital equipment. Significant fundraising through capital concentration, including small funds, is necessary to establish fixed capital equipment. Therefore, adopting a corporate form is essential for managing industrial companies. A corporation can be established by converting joint-stock companies or individual businesses. In this process, the new corporation inherits all the goodwill previously held in some form or name. This conversion may involve transforming a single corporate entity into a corporation or establishing a new entity through mergers with other companies. The newly established corporation realizes capitalization and credit use through modern methods, allowing it to more easily achieve differential profit compared to small- and medium-sized businesses remaining in older organizational forms, such as agriculture, fishing, and retail. The ability to generate differential profits, evaluated as goodwill and intangible assets, is more easily realized in corporate forms superior to small- and medium-sized businesses. Thus, the joint-stock companies are more compatible with differential profit generation.

In establishing a corporation, if it is not a conversion from an individual company, non-material assets (i.e., intangible assets forming the basis for capitalization) must exist. These include business rights, control over specific natural resources, patents, superior production processes, or a combination of these elements. If these intangible assets are absent, the foundation of goodwill must first be established through brand, quality clientele, and regional or general business relationships. Thus, an industrial company cannot start business operations solely with physical assets; it must build intangible, nonmaterial assets.

In typical modern corporations in the heavy and chemical industry, many shares are issued, meaning that their assets and liabilities are owned by a broad range of investors. Veblen generally understood the representative relationship between a corporation's physical assets (i.e., tangible capital and intangible assets, common and preferred stock, and bonds) as follows. Common stock generally represents a company's non-material assets. In contrast, physical property and tangible assets are represented by preferred stock.[25] Bonds represent physical equipment and working capital. Preferred stock is considered an element of a company's equity capital, with the practical effect of never repaying the principal. In this sense, it does not have the connotation of credit security. However, preferred stocks have a fixed dividend rate and are held by many unspecified investors, which makes them resemble to bonds. Therefore, preferred stocks can be considered as having credit security characteristics. Moreover, preferred stocks have almost no voting rights and are permanently entrusted to the company, meaning that they become equity capital. In contrast, common stockholders hold ownership and control over the company's physical property. The authority to freely dispose of all capital rests with common stockholders, representing intangible assets. Thus, the core of a modern corporation's capitalization amount is intangible assets represented by common stocks.[26]

2. Preferred and Common Stocks in Capitalization

Using preferred and common stocks in capitalization must be noted for its role in separating ownership and management. Owners of industrial equipment (i.e., capital owners) lose management rights. When preferred stocks form a large part of a capital structure, capital owners lose the company's management rights and control. This is because preferred stocks represent the property entrusted to common stockholders, with trustees managing and operating them based on their management rights without taking responsibility for the property to trustors. This substantially weakens the capital owners' management rights over industrial property. Additionally, other bonds and debentures represent capital such as

[25] As to why preferred stock is considered to represent physical assets and common stock intangible assets, see Notes 23 and 28.

[26] In the case of a relatively small and local joint stock company, it may also represent commodity property. cf. Veblen, T. (1994), p.143.

preferred stocks cause the loss of management and operational rights over the company's property.

Veblen understood that counterarguments can be made to the idea that the capital structure of preferred and common stocks in a modern company promotes separation between ownership and management. One counterargument posits that the idea of representing intangible assets with common stock is only theoretically true or holds only from the entrepreneur's standpoint, and that, in reality, the true nature of what common and preferred stocks represent should be hidden. Once issued shares are traded in the market, they are simply stakes in the company's total capitalization amount, making it impossible to confirm what preferred or common stocks represent.

In response, Veblen argued that while this view might seem valid superficially, the facts support his position. For example, when a company's monopolistic position strengthens and product sales increase, company profits increase, which affects common stock prices. Changes in common stocks' prices can affect tangible assets. Conversely, in the case of liquidation, only the residual property claims may remain. Thus, his view[27] that common stock represents intangible assets is consistent with empirical facts.[28]

3. Capitalization and the Scale of Physical Capital

As noted above, the total price of various securities representing a company's

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[27] Cf. Veblen, T. (1994), p.147.

[28] The situation under the credit economy, coupled with the separation of ownership and management in the form of joint-stock companies, explains the separation of the ownership of industrial equipment from the right to manage and operate it, contrasting it with the interest-bearing loans of the medieval period. In the medieval period, the profit derived from the management and use of production goods was considered to belong to the user. In contrast, the modern approach is based on the idea that the management of equipment and profit derived from it belong to the owner. Furthermore, it follows that the bulk of the profits should belong to those who financially control the company. This result is achieved by issuing common stock backed by intangible assets and preferred stock backed by physical assets, thereby expanding credit. Under such a system, a separation of ownership and management naturally exists in a credit economy, control of the physical facilities is vested in the owners of common stock, who possess the right to manage the material wealth (i.e., the physical facilities). This right is capitalized as having an industrial value and as yielding a disproportionate profit attributable to its owner, thereby legitimizing the owner's right of management.

capital traded on the market fluctuates owing to factors such as management manipulation, seasonal changes, and international political-economic situations such as war and peace. Consequently, the total corporate capital in an industry can diverge from the scale of physical capital. Additionally, it is influenced by constantly changing factors such as investors' psychological states, entrepreneurs' management strategies, seasonal changes, and political trends. Thus, market psychology significantly influences the size of and fluctuations in corporate capital. However, the issue lies in determining a stable relationship between nominal corporate capital and physical equipment, excluding passive fluctuation factors. Veblen presented two observations regarding this point.

First, the credit securities involved in capitalization can be used as collateral for further credit expansion, making the nominal total capital at any given time greater than the total amount of physical property included. Second, the current value of these physical properties becomes larger than if there were no credit expansion based on capitalization. Regarding the first point, the amount of corporate capital as nominal capital exceeds the amount of physical equipment by the amount obtained by borrowing or issuing credit securities, making it greater than the total amount of physical property. The second point is contrasted between cases in which external funds are raised through credit use (i.e., corporate finance) and those where they are not. When external funds are raised through credit use, not only does the nominal capital amount increase but physical equipment also expands, increasing the value of physical property, even at the current value, compared to cases without credit use. Thus, the mechanism of corporate finance increases both physical equipment and nominal capital amount.[29]

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[29] Veblen uses the classification of German scholars to draw a typology of development: natural economy, money economy, and credit economy. In a natural economy, distribution and exchange take place in kind (i.e., a barter economy). In a monetary economy, markets are created and goods are produced and distributed through the commodity market using money as an intermediary. In a credit economy, capital markets developed on the foundation of the expansion of commodity markets, and the monetary economy goes beyond them to dominate business and industrial activities. The capital market creates a higher level of credit economy, which gives rise to modern characteristics. In a credit economy, the capital market as a source of outflow of money capital and a source of capital supply plays an important function and takes a dominant position. cf. Veblen, T. (1994), pp.149-151.

IV. The Discrepancy Between Putative and Actual Earning Capacity

1. The Concept of Putative Earning Capacity

The argument that corporate capital diverges from the scale of physical capital arises from Veblen's discussion on the credit economy. As discussed in Notes 22 and 29, Veblen introduced capital market development as an essential feature of the credit economy. Unlike the commodity market, in which physical goods are traded, the capital market involves monetary gains resulting from differences in evaluations rather than physical value. From this perspective, Veblen explored the capital transaction characteristics of the capital market. In the commodity market, one's products are brought to the market, forming the market through transactions with specialized traders finding buyers. The ultimate buyers of goods purchase them for consumption, whereas capital transactions are based on the future earning capacity of capital. A crucial indicator in this process is how much capital will be returned incrementally in the future.

However, another question is what determines the value of traded capital. According to Veblen, this is determined by the future earning capacity brought about by capital. Thus, the value of capital is a function of earning capacity and not production costs or mechanical efficiency. While the value of capital is a function of earning capacity, it can also be influenced by market supply and demand. The earning capacity of capital depends on how easily it can be resold. Although this may also depend on the market's development level, it is an indirect influence. The most important point is that the basis for capital valuation is its future earning capacity. Hence, this basis is the expected future earning capacity. Therefore, an issue arises in evaluating and re-evaluating capital based on expected earning capacity.

Thus, capital in the market is evaluated and re-evaluated based on putative earning capacity. This process leads to capitalization and re-capitalization. A typical example is goodwill. In Veblen's view, a central factor is the capitalization of goodwill (i.e., intangible assets) and the issuance of common stock. This view is a prototype for issuing mortgage-backed securities through restructuring cash flows generated by pooling mortgage loans in the modern era. Although securities are issued based on tangible and intangible assets, this distinction becomes invisible in market transactions where they undergo independent fluctuations. This is because issued securities are traded based on expected earning capacity. Market participants differ in their expectations of earning capacity. Despite being based on various analyses and information, they are also based on different information and analytical methods, leading to diverse evaluation biases and judgments. The divergence between the present and the future, along with differing expectations among market participants, creates variability in changes to capital ownership. Owing to this dual variability, expected and actual earning capacity often diverge.

2. The Deviation of Putative from Actual Earning Capacity

For corporations, a discrepancy between putative and actual earning capacity generally occurs, as described above. This discrepancy can be created intentionally by manipulating or spreading false information to create favorable conditions for trading a company's securities. Astute managers may focus on how to trade securities, that is, the company's capital, advantageously according to market trends rather than how to sell products or manage labor. In modern corporations, managers' interests ultimately align with how to increase corporate value and trade the company advantageously, rather than pursuing continuous business profits or social welfare. From a societal perspective, there is interest in creating a discrepancy between material production costs and the material utility of products, aiming to achieve the utility of products to be higher than production costs. Corporate profit lies in realizing selling prices exceeding production costs. However, managers focus on creating discrepancies between putative and actual earning capacity. This discrepancy aligns with corporate management's interests. Whether this can be realized is uncertain and only a result; however, management will focus on creating this discrepancy as much as possible.[30]

What does this mean in creating a discrepancy between putative and actual earning capacity? Actual earning capacity is that which can be confirmed at present. Putative earning capacity is the future earning capacity that can be expected based on past or present earnings performance. By utilizing methods to make putative earning capacity higher than actual earning capacity, corporations can operate more corporate capital. Veblen posited that under fierce competition among enterprises, creating a discrepancy between putative and actual earnings capacity is inevitable

[30] Cf. Veblen, T. (1994), pp.156-160.

to gain an advantage.

The issue is how to make it possible to create a discrepancy between putative and actual earning capacity. Veblen focused on the use of credit, specifically to shorten capital turnover periods. Credit use shortens the procurement period for raw materials and sales period for products. Thus, sales through intercorporate credit would lead to shorter circulation periods for capital.[31] Shorter circulation periods result in shorter capital turnover periods, meaning that a larger scale of corporate capital can be operated within a certain period. Thus, credit contributes to earnings expansion. Veblen noted another effect, which was the increase in earnings through a larger scale of capital turnover. Expanding operating capital through bank loans or securities issuance can maximize earnings within a fixed turnover period. During the late 19th and early 20th centuries, Veblen observed that massive fundraising through security issuances was more notable than bank credit. Specifically, the use of credit, which allows for an increase in operating corporate capital, was realized through the issuance of securities based on a corporation's earning capacity.

Thus, corporations can increase earnings through two effects: an increase in the capital turnover rate and an increase in the capital amount through credit use. Consequently, the ability to use more credit signifies the ability to generate more earnings than other companies. Credit use generates differential profits, which can be assessed in terms of earning capacity and, if consistent, regarded as intangible assets.

Moreover, by observing the contemporary situation, Veblen noted the significance of corporate merger movements. He believed that creating monopolistic conditions through corporate mergers was an effective way to generate differential profits because corporate mergers reflect a drastic process through which monopolistic enterprises are created. Monopolistic enterprises can generate differential profits through factors such as market dominance, overwhelming technological capabilities, and brand power. If firms consistently generate differential profits, their inherent corporate ability will become an intangible asset. This allows for new fundraising through securities issuance based on these intangible assets as collateral.

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[31] Cf. Veblen, T. (1994), pp.92-94.

Thus, the core of creating a discrepancy between putative and actual earning capacity lies in the capitalization of earning capacity and the resulting credit expansion. This phenomenon was characteristic of the monopoly period in the heavy and chemical industry, during which corporations were the dominant type of enterprise and a vast capital market was formed.

Under such conditions, even during the stage dominated by the money economy, where companies were managed through joint stock or individual ownership, the separation of societal interests from management interests was significant. In a stage dominated by the credit economy, this separation became even greater because of the large-scale use of credit and easier trading by companies through corporate mergers, facilitated by investment banks and promoters seeking financial gains. As judged by managers, corporate management interests diverge significantly from company profits and societal interests.

According to Veblen, the essence of modern corporate management's sophisticated approach is not aimed at increasing the utility and sales of societal production, but at creating a discrepancy between putative and actual earning capacity which is the capital price discrepancies. At this point, Veblen's pecuniary profit is at the forefront. Unlike joint stock or owner-managers, the interests of managers diverge from those of the company and societal welfare.[32]

V. Conclusion

As Veblen observed, the capitalization phenomenon characterized American capitalism from the late 19th to the early 20th century. This phenomenon was also seen in Britain and continental Europe, as discussed by Marx and Hilferding, as fictitious capital resulting from capitalized periodic income. During the same period in the United States, capitalization was discussed in terms of defining capital and

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[32] Veblen cites an example of a railroad company where joint stock company finance in the form of industrial stocks was widespread. Incidentally, the issue of capital turnover is an opportunity to create a disparity between putative and actual earning capacity. In other words, Veblen says that the turnover rate of capital increases due to the shortening of the interval between the buying and selling of securities, causing a divergence between putative and actual earning capacity, with the former sometimes exceeding the latter. In Veblen, the increase in turnover and the expansion of operational capital by using credit are included in the expansion of corporate capital. cf. Veblen, T. (1994), p.160.

capital value. Veblen uniquely addressed this issue from the perspective of the capitalization of earning capacity. Veblen's theoretical distinctiveness lay in his analysis of the credit economy, where he observed that monetary assets tend to expand and deviate from physical assets. His explanation of capitalization highlighted key aspects of this divergence.

Monopolistic enterprises, particularly in the heavy and chemical industries, were characterized by the establishment of substantial fixed-capital equipment. These dominant business entities primarily took the form of stock companies. Capital concentration involved both large-scale and medium-scale capital, resulting in the separation of ownership from managerial control. Monopolistic enterprises raised significant funds through the capital markets to construct extensive fixed-capital facilities. They engaged in intense competition for financial gain, often in collaboration with major financial institutions. As a result, "corporate capital" increasingly diverged from physical capital.

Veblen theoretically examines the mechanism underlying this divergence by organizing several conceptual points regarding capital. Capital is the monetary value that generates profits. Capital value is determined by earnings capacity, that is, the ability to generate monetary profits. Capital comprises physical, monetary, and intangible assets. "Corporate capital" consists of equity capital and borrowed capital. This divergence arises from an increase in borrowing capital owing to the expansion of loan credit. This mechanism involves the following steps:

Enterprises increase "corporate capital" by raising external funds through securitizing their current capital. Competing enterprises attempt to gain advantages in the market by securing more capital than others. Monopolistic control and technology allow for securing differential profits over other enterprises. The ability to generate differential profits is an intangible asset; thus, stable differential profit generation becomes an intangible asset used as collateral for further borrowing or securities issuance. This enables massive fundraising in collaboration with financial institutions, resulting in significant monetary profits for both monopolistic enterprises and financial institutions. Economic booms and corporate mergers create scenarios for large-scale activities. Consequently, monetary assets diverge from physical assets.

Surveying the literature on Veblen's loan credit theory shows that many researchers have noted that its theoretical core lies in the capitalization of earning capacity. The capitalization of earning capacity is central to the expansion of credit and "corporate capital" in Veblen's theory. Despite recognizing this point, previous studies have not highlighted its relevance to modern financial phenomena, such as securitization and derivatives. In this context, Medlen (2017) points out the applicability of Veblen's theory in analyzing modern securitization and derivatives. Since Veblen's time, instances have occurred in which bank loans developed into medium- and long-term loans and mortgage loans based on the borrower's earning capacity. Mortgage loans led to a composition of securitized products (i.e., structured finance) through the restructuring of periodic cash flows from loan pools. This is the securitization process. Furthermore, cash flow restructuring has been applied to the derivative design. These developments are modern applications of capitalizing periodic income. Thus, the mechanism of capitalization of earning capacity and the extension of credit it secures, on which Veblen focused, has been implemented over a long period of time, supported by significant financial innovations, in these peculiar phenomena of modern finance. This mechanism was developed in a more sophisticated and refined form in the context of the need for the liquidation of mortgage loans and the development of risk-hedging instruments.

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