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KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

EMPLOYEE STOCK OWNERSHIP PLAN FINANCING AS A MEANS OF ENABLING GOVERNMENTAL ASSISTANCE, PARTICULARLY SMALL BUSINESS ADMINISTRATION ASSISTANCE, TO CONTRIBUTE TO THE CORRECTION OF THE MALDISTRIBUTION OF THE OWNERSHIP OF PRODUCTIVE CAPITAL -- THE CHIEF CAUSE OF FUNCTIONAL DEFICIENCIES OF THE U.S. ECONOMY

COMMENTS AND SUGGESTIONS ON H.R. 3056 AND H.R. 2033 -- PROPOSED LEGISLATION TO MAKE AVAILABLE TO EMPLOYEE STOCK OWNERSHIP PLANS ALL FORMS OF ASSISTANCE FROM THE SMALL BUSINESS ADMINISTRATION

HEARINGS BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS, SUBCOMMITTEE ON ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

96TH CONGRESS, 1ST SESSION

MAY 8, 1979

TESTIMONY BY LOUIS O. KELSO, PRESIDENT, KELSO & CO., INCORPORATED, INVESTMENT BANKERS, ON BEHALF OF THE ESOP ASSOCIATION OF AMERICA, ITS MORE THAN 217 MEMBER COMPANIES AND THEIR MORE THAN 62,000 ESOP PARTICIPANTS

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THE ESOP ASSOCIATION OF AMERICA.

Louis O. Kelso appears before the House Subcommittee on Access to Equity Capital and Business Opportunities of the House Small Business Committee as Consultant on Economic Policy and Governmental Affairs of The ESOP Association of America. This non-profit trade and educational association is the result of the merger of the ESOP Council of America into the National Association of ESOP Companies and constitutes the operative association of corporations having ESOPs assuming the primary obligation for representing the interests of those companies with respect to matters affecting their ESOPs and the interests of the employee participants in those ESOPs.

At the present time, the Association's membership includes approximately 217 corporations with Employee Stock Ownership Plans (ESOPs), only a handful of which are Investment Tax Credit ESOPs or TRASOPs. In the aggregate, these ESOPs, exclusive of the Investment Tax Credit ESOP members, have approximately 62,000 participants.

The ESOP Association of America is headquartered at 47 Kearny Street, Suite 204, San Francisco, California 94108, telephone: 415-434-3631.

Louis O. Kelso is President and Chief Executive Officer of Kelso & Co., Incorporated, the only investment banking firm at the present time specializing in two-factor techniques of corporate finance. The identity and purposes of Kelso & Co., Incorporated are outlined in Appendix VI hereto.

IN THE SOLVING OF PROBLEMS, THE RIGHT QUESTIONS ARE MORE IMPORTANT THAN THE RIGHT ANSWERS.

With Congress, as with individuals, where a serious and socially significant problem requires solution, it is of grave importance that the inquiry begin with the right question or right questions. Indeed, it is more important to begin with the right question than it is, initially, to find the right answer. For wrong answers to the right question will in time be disputed and refuted and the right answers found. But individuals, and even whole societies, can be deterred indefinitely from solving their problems if they fail to formulate the right question -- the right problem -- in the first place. The right answer to the wrong question solves nothing.

The economy of the United States is not working well, and has not been working well for nearly half a century. It has performed much better for the rich than for the poor. It has performed much better for the 5% who, as all qualitative studies in recent years have shown, alone own non-residential productive capital, and perhaps for an additional 2% or 3% of lucky people and financial geniuses, but it has performed and is performing very poorly for the 90 plus percent majority of consumer units who do not own viable holdings of productive capital.

To own such a viable holding of productive capital is, in the

pragmatic and economic senses of the word, to be rich. To not own a holding of productive capital from which an individual or a family (consumer unit) can derive a viable income stream is, in a very practical sense of the word, to be poor and indefinitely chained to the process of work, for whenever one is prevented from working, by whatever means, his work income stops. Absent accumulated financial savings amounting to a viable capital estate, the individual, to continue living, must then become either openly or covertly a ward of charity. Except for top executives who help themselves to unconscienable retirement income systems, neither pensions nor Social Security nor any other arrangements will suffice to solve the non-worker's income problem for more than a brief interlude if the ratio of parasites (that is those who must take out without putting in) to producers passes beyond a tolerable level.

It would serve no purpose here to discuss what that tolerable level is. It should suffice for present needs to note that we have long ago passed it. Our taxpayers' revolts, our ever rising national and corporate debt, and our burgeoning unfavorable trade balances in international affairs all tell us the same thing. We have an economically degenerating economy.

The economy of an advanced industrial society, if it is to function satisfactorily for the great majority, if not for all of those who live under it must be built upon a comprehensible logic. In short, it must be a "system", for system implies logic. And the logic diagram, or the theory of the economic system, must be comprehended, articulated and blueprinted, so that those concerned have an operating manual to which they can turn when the "system" needs adjustment or change because it is not meeting its performace objectives.

We have been deluded by generations and schools -- priesthoods -- of economic theorists who either are unaware that, to function satisfactorily, a complex economy must be built upon a system concept, or they have myoptically focused on some petite aspect of the economy, as do the monetorists, for example, and proclaim that their recommended adjustments to that petite aspect will solve either all the problems, or certain major problems of the economy itself.

Years ago, in the early stages of the Great Depression, when I became aware of the co-existence of staggering poverty and privation throughout our land and throughout most of the world, side-by-side with the potential capability, in terms of resources, manpower, technical know-how, good will and zeal, to produce the goods and services equivalent to a general high standard of living, I launched a personal research program that led me to recognize something basic. There was no theory of capitalism! In other words, there was no logic diagram for a private property, free-market economy to which a legislator, a businessman, a banker, a financier, a jurist, or any of the participants in the universal game of producing and consuming goods and services could turn for answers to an economic malaise.

To be sure there were many logical components that virtually everyone recognized as parts of a capitalist, or private property, free-market economy: The device of money or a monetary system; the process of barter for use in trade; the idea of banking and central banking; the idea that the only fair and impartial determinate of economic value (Aristotle would say the only "just" transaction in the marketplace) must be determined in workably free competitive markets through the interaction of the laws of supply and demand -- the great contribution of Adam Smith; double-entry bookkeeping invented by the Italians in the 14th Century; the division of labor in order to increase overall production and reduce overall errors and wastage; the idea of insurance of various types of risk so that casualties of various sorts could be borne to a small degree by a wide base of population; etc. But there was no capitalist economic system; there was no theory of capitalism until the publication by Adler and Kelso in 1958 of THE CAPITALIST MANIFESTO. The great majority of those who pay lip service to the glories of private property, political freedom, and capitalism, are still unaware that there can be no such thing as an enduring capitalist society without a valid theory of capitalism nor without conforming to such theory. Nor are they aware that such a valid theory exists. A brief bibliography of the writings containing that theory is attached as Appendix I.

TWO-FACTOR THEORY AND ESOP FINANCING -- WHY, IN AN ADVANCED INDUSTRIAL ECONOMY, SUBSTANTIAL INCOME-PRODUCING CAPITAL MUST BE OWNED BY CORPORATE EMPLOYEES AND HOW -- WITH VERY SLIGHT CHANGES IN BASIC BUSINESS STRATEGY -- THIS CAN BE EFFECTIVELY ACCOMPLISHED THROUGH EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) FINANCING: THE MOST POTENT INSTRUMENT FOR THE PURPOSE, THE MOST ADVANTAGEOUS TO THE CORPORATION, THE MOST BENEFICIAL TO EMPLOYEES.

Although two-factor economics, or the theory of capitalism, is a new and fundamental concept, it is simple and straightforward. The reasoning runs as follows:

1. While it is true that people, participating in the economy through the performance of their various tasks, are a basic source of productive input, they are not the only source of productive input.

2. Non-human things, such as land, structures and machines, and, particularly in service enterprises, intangible capital such as patents and "firms", also make productive input into the economy.

3. The division of the input sources into two types is both necessary and adequate, because the ownership of labor power cannot be concentrated, while the ownership of non-human things can easily be concentrated. It is, after all, an individual's property in an input factor that entitles him to receive what it produces.

4. Under the logic and morality of a market economy, productive input into the economy is the basis for the individual's right to receive income from it. Economic outtake is conditioned on economic input. To accountants and businessmen, this relationship

is simply double-entry bookkeeping. To economists, it is "Say's Law" or "Say's Identity". To moralists, it is the Puritan Ethic, or simply the principle of economic justice defined by Aristotle. To lawyers, it is the principle of private property, under which the owners of capital and the individual owners of labor power are accorded the income equivalent of what each privately-owned input factor contributes to production.

Figure 1:

SAY'S LAW: THE BASIC LAW OF TWO-FACTOR ECONOMICS

For every dollar spent, somebody gets a dollar in economic value. Say's Law is simply a prose statement of the principle of double-entry bookkeeping, which is the logic of a private property, market economy.

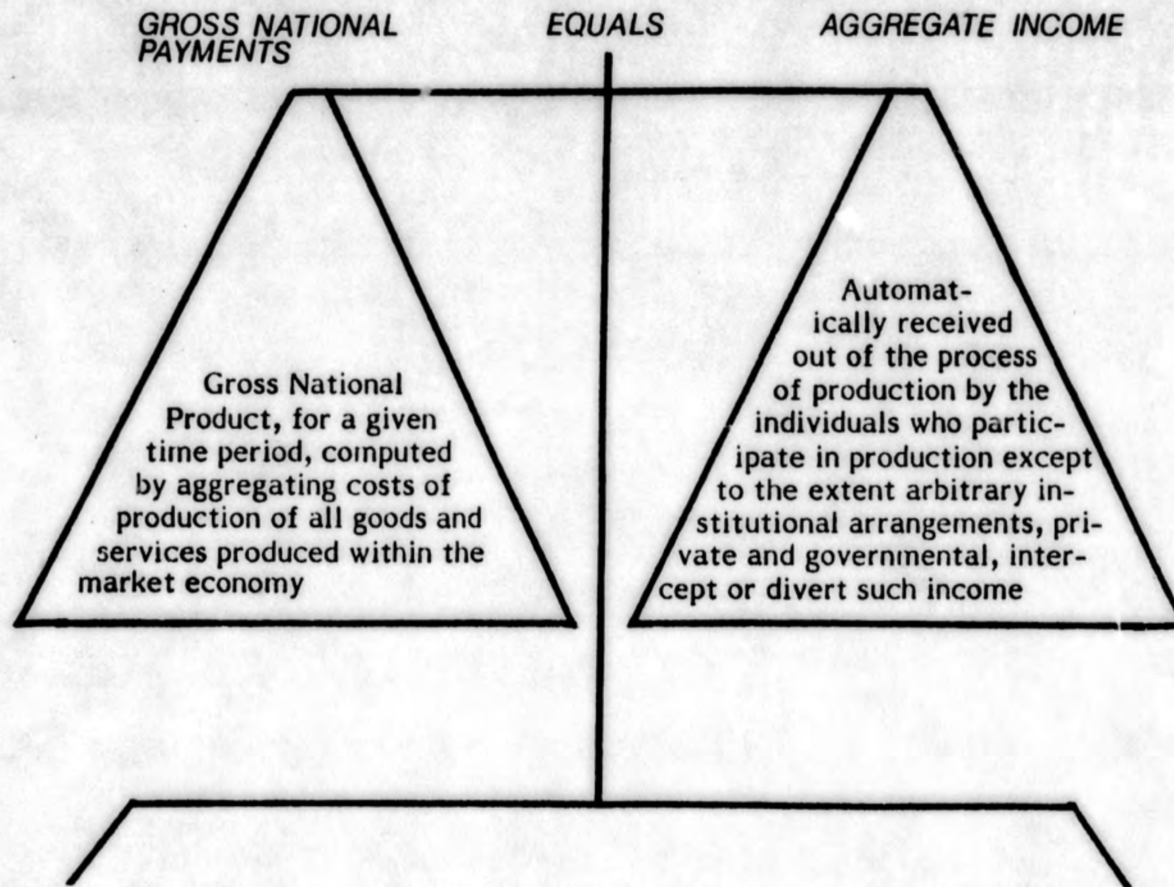

Figure 2:

SAY'S LAW ILLUSTRATED ON THE BASIS OF 1973 STATISTICS (IN BILLIONS)

Gross National Product

Less adjustments for capital consumption allowances, indirect business tax and non-tax liability, business transfer payments and other minor adjustments.

CONSUMER COSTS OF:

Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9
Services	133.6
Government and government enterprises	162.9
Foreign trade and transactions	9.6
	$1,054.3

Participant Income

Income Automatically Arising out of Production and Received by the Participants in Production

INCOME OF PARTICIPANTS IN:

Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5
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Services	133.6
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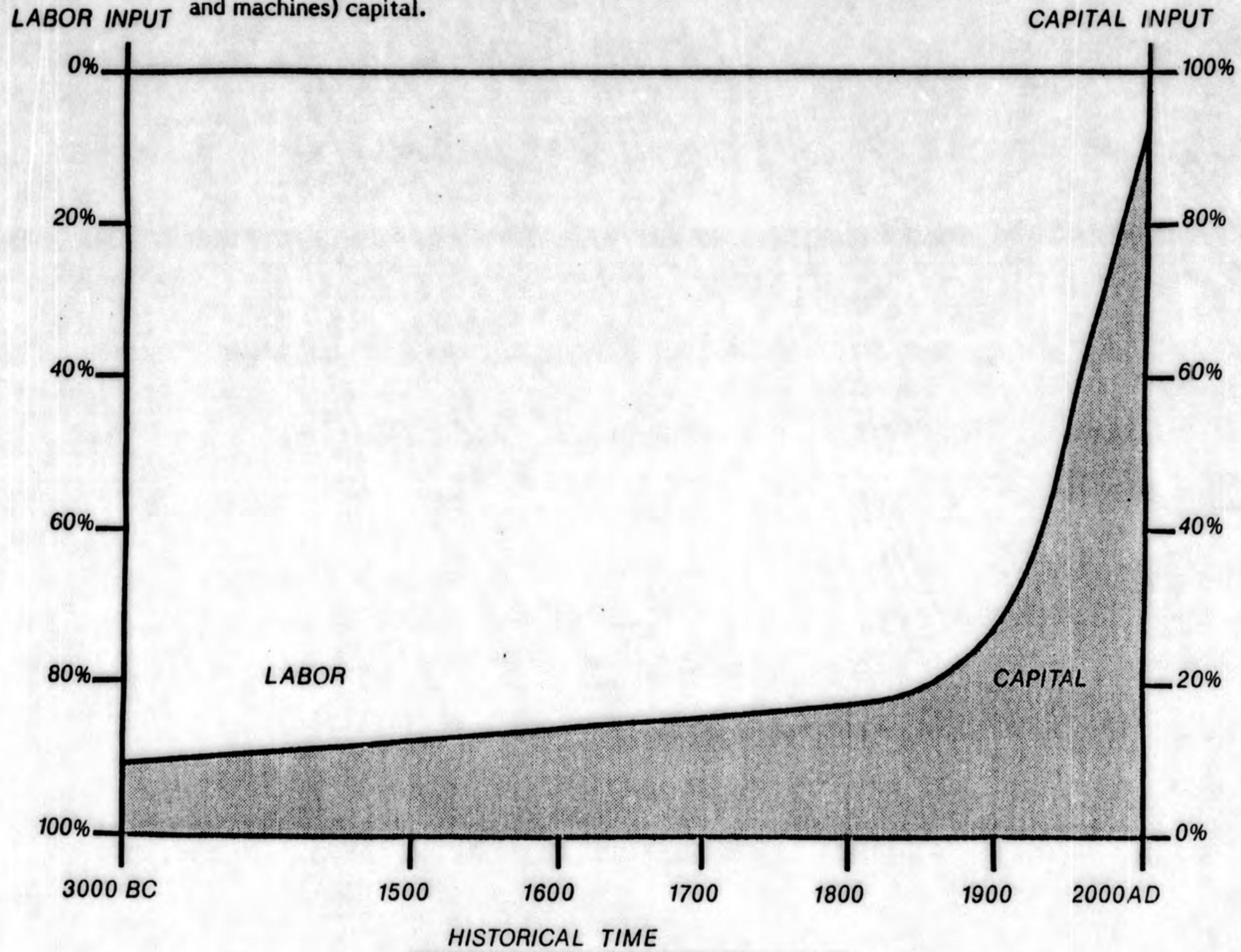
Foreign trade and transactions	9.6
	$1,054.3

5. Technological advance, which is the phenomenon responsible for the Industrial Revolution, as well as our own automation revolution, and all of the intermediate revolutions brought about by science and technology, changes, and is intended to change, the input mix. It shifts the burden of production off labor (the human factor) and onto capital (the non-human factor). Technological change does not operate directly on labor. It cannot increase the productiveness of a mature individual worker. It increases the productiveness of machines, tools, structures, land and processes. The economic productiveness of human workers -- what they can accomplish with their unaided muscles or minds has not changed during the course of history, if the value of that productiveness is determined objectively and competitively by the free operation of the law of supply and demand.

Figure 3:



6. In the United States economy, the world's most advanced, the process of technological change has gone so far that most of the goods and services today are produced by capital instruments; only a minor portion of the productive input is made by people. With rare exceptions, it is capital that produces affluence. Labor, in a free labor market, can normally produce only subsistence. The relative distribution of aggregate personal income between workers (roughly 3/4ths) and the owners of capital (1/4th) does not reflect the relatively higher productive input by capital because our governmental economic policy (the Employment Act of 1946), and hundreds of pieces of implementing legislation, attempts to repeal the law of supply and demand as it applies to the value of labor. This is the purpose of minimum wage laws, coercive fixing of wages, vast governmental make-work programs, government subsidies to industry and other government entities to "create" jobs, etc. The costs of all such efforts enter into the costs of production, directly or indirectly, and thus are inflationary precisely because they are not reflected in the increased production of goods and services by labor. Such costs, neither representing increased labor input nor labor shortages, are, in fact, disguised welfare. They are injected into the costs of the same quantities of goods and services that, prior to the coerced increases, would have been produced at lower costs. These attempts to overvalue labor constitute one of the principal means by which we monetize welfare.

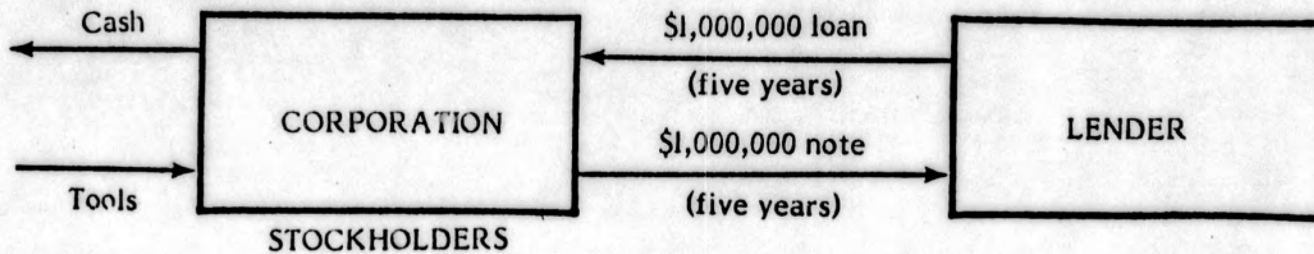
7. The shifting of the input mix from labor to capital would cause no economic problem, even under competitive labor markets, if the declining productiveness of labor were offset by increasing individual capital ownership, i.e., if, as technology diminished the productive role of the human factor, workers simultaneously acquired ownership of enough productive capital to compensate for their loss, or even better, enough capital to provide what few labor-dependent persons have ever achieved, a truly affluent standard of living.

8. Unfortunately, traditional techniques of finance, including the traditional pattern of lending by the Small Business Administration, do exactly the reverse of what the situation logically requires. They insure that all newly-formed capital will be automatically owned by those who own all existing capital. Under these techniques, the $100 billion-plus of new capital formation that comes into existence each year in the U.S. economy becomes owned by a tiny proprietary class -- approximately 5% of consumer units. If averaged over the past 15 years, less than 5% of new capital formation in the corporate sector (which produces more than 85% of total private sector goods and services) is financed by means other than out of direct cash flow or borrowings repaid out of cash flow.

Figure 4:

CONVENTIONAL CORPORATE FINANCE

Including internal cash flow, borrowings repaid from after-tax cash flow, accelerated depreciation, depletion, and investment tax credit, but excluding sale of new stock to the public for cash



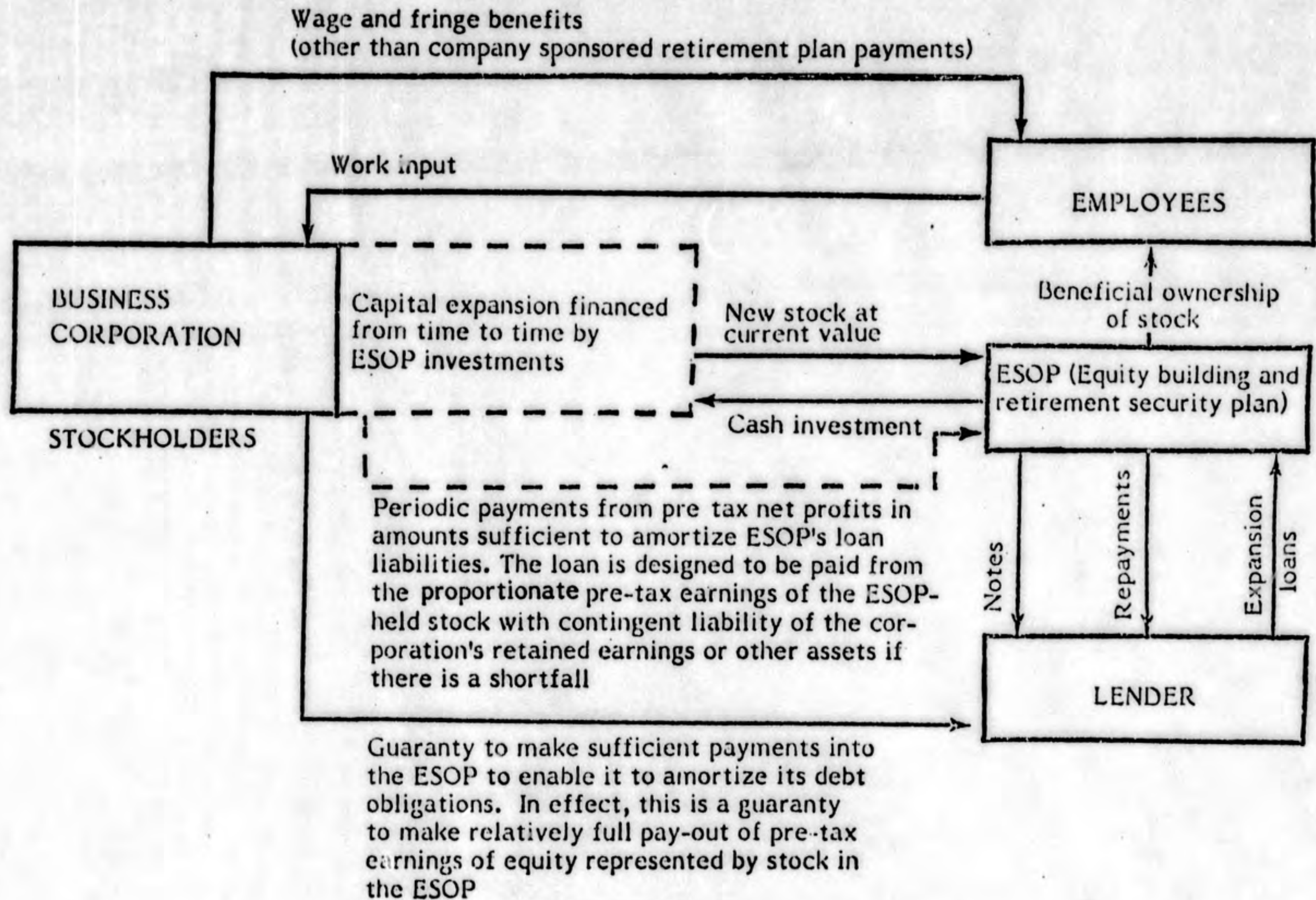
These methods of financing new capital formation have one common characteristic: They do not create a single new stockholder. The portion of new capital formation (less than 5%) financed by sale of equity stock to the public does not alter this propensity. Every qualitative study of stock ownership to date shows that ownership of virtually all individually-owned productive capital is lodged in the top 5% of consumer units. These are the families who have excess funds to buy newly-issued stock. Conventional finance has created this monopoly of the power to produce goods and services through ownership of productive capital.

9. The logic of business finance is to invest in productive capital that will pay for itself within a reasonably short space of time, normally three to five years, and then go on throwing off wealth indefinitely, its productive power being replenished through good management that, by research and development, keeps the firm's products relevant to market demand and through depreciation funds set aside out of gross income before net income is computed. Two-factor financing techniques, of which the most widely used today is the Employee Stock Ownership Plan or ESOP, makes this logic available to employees.

Figure 5:

BUSINESS CORPORATION FINANCED BY A PROPERLY DESIGNED ESOP

Intended simultaneously to (l) finance growth of the corporation and provide second incomes for the employees (if the stock is dividend paying and, after shares are paid for, the dividends can pass through the ESOP currently to the employees) and (2) to build retirement security in the form of equity capital ownership.



10. ESOP financing, on the one hand, provides low cost capital, through the use of pre-corporate-tax funds, to finance corporate growth, and on the other hand, builds ownership into workers without diminishing their take-home pay or calling upon their small or non-existent savings.

11. With minor legislative changes to provide capital diffusion insurance (modeled after FHA insurance) for lenders that make sound ownership broadening loans and to make the financing paper held by lenders discountable at a rate not in excess of the administrative costs of the Federal Reserve Bank, two-factor techniques could provide means for financing unlimited growth, while building market power, economic security, and growing current second incomes from capital* into the masses of workers; thus the market power of potential consumers would rise in step with the productive output of the economy.

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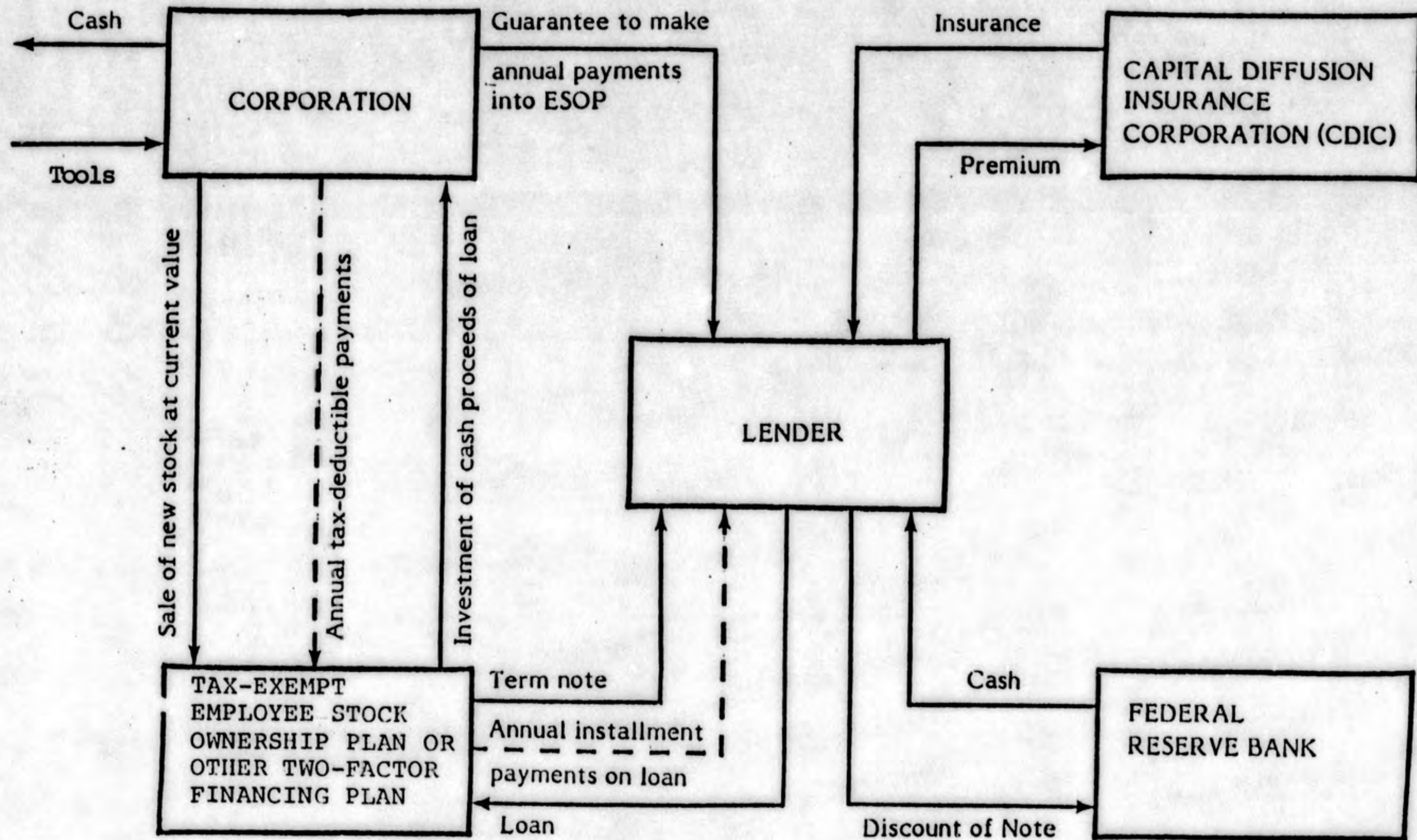
* Where the stock in the ESOP pays a dividend, the plan often provides that, after each particular share of stock is paid for, the dividends on it shall currently pass through the trust into the pockets of the beneficial owner-worker.

Figure 6:

FINANCING ECONOMIC GROWTH *

Financing economic growth by monetizing productive capital while building market power into consumers through ESOP financing



* An elaboration of this central logic diagram for the financial structure of a capitalist economy is set forth in Appendix V hereto.

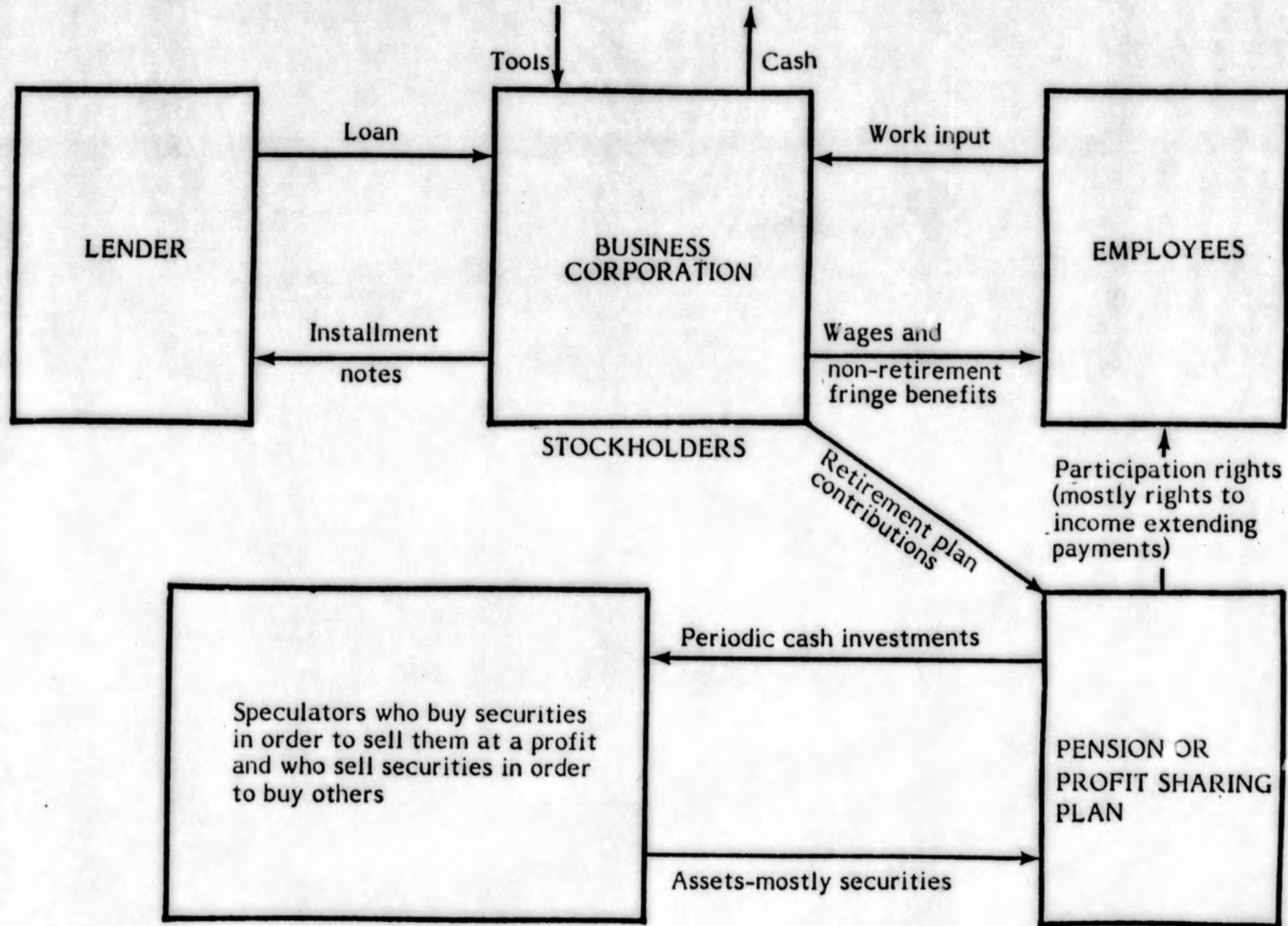
12. Inflation is eliminated. Institutional barriers, such as lack of "money" to finance solid, self-liquidating economic growth are eliminated; legitimate leisure, built upon the ownership of a holding of productive capital that will enable a man or woman to produce a viable income, becomes possible over a reasonable working lifetime; and the burden of public taxes imposed upon producers to support the non-productive and under-productive can ultimately be virtually eliminated. Fully productive households and individuals do not need to be subsidized.

13. The ESOP is an enormous cost-saver for the corporation which, sooner or later, can substitute it for a fixed-benefit pension plan, or any other pension plan or conventional profit sharing plan. All payments by the corporation into these conventional plans are pure cost.

Figure 7:

CONVENTIONAL FINANCING OF A BUSINESS CORPORATION

Conventional financing of a business corporation, other than by sale of new stock to the public for cash, with conventional pension or profit sharing plans invested wholly in assets purchased from sources other than the employer-corporation.



Compared with the ESOP (see Figure 5), not only does the identical dollar paid by the corporation to build stock ownership into employees also finance corporate growth, but corporate growth can be accomplished on pre-tax dollars. By comparing the ESOP (Figure 5) with conventional economic security-building plans (Figure 7), you will see that the ESOP enables the corporation to gain three dollars of advantage for each dollar spent. And it conforms to the sound economic goal of enabling employees, who work hard and well over a reasonable working lifetime, to retire singularly well off.

14. Finally, because the economic goal implicit in two-factor theory is to expand the U.S. economy (and any other economy that adopts it) sufficiently to enable all consumers to live well -- general affluence -- while also producing the technology to protect the environment, a change to a two-factor policy* by business and government could give us 25 years or more of legitimate full employment. This would be time enough for society to adjust to a world in which each person will spend less time in economic work and more time in the work of civilization.

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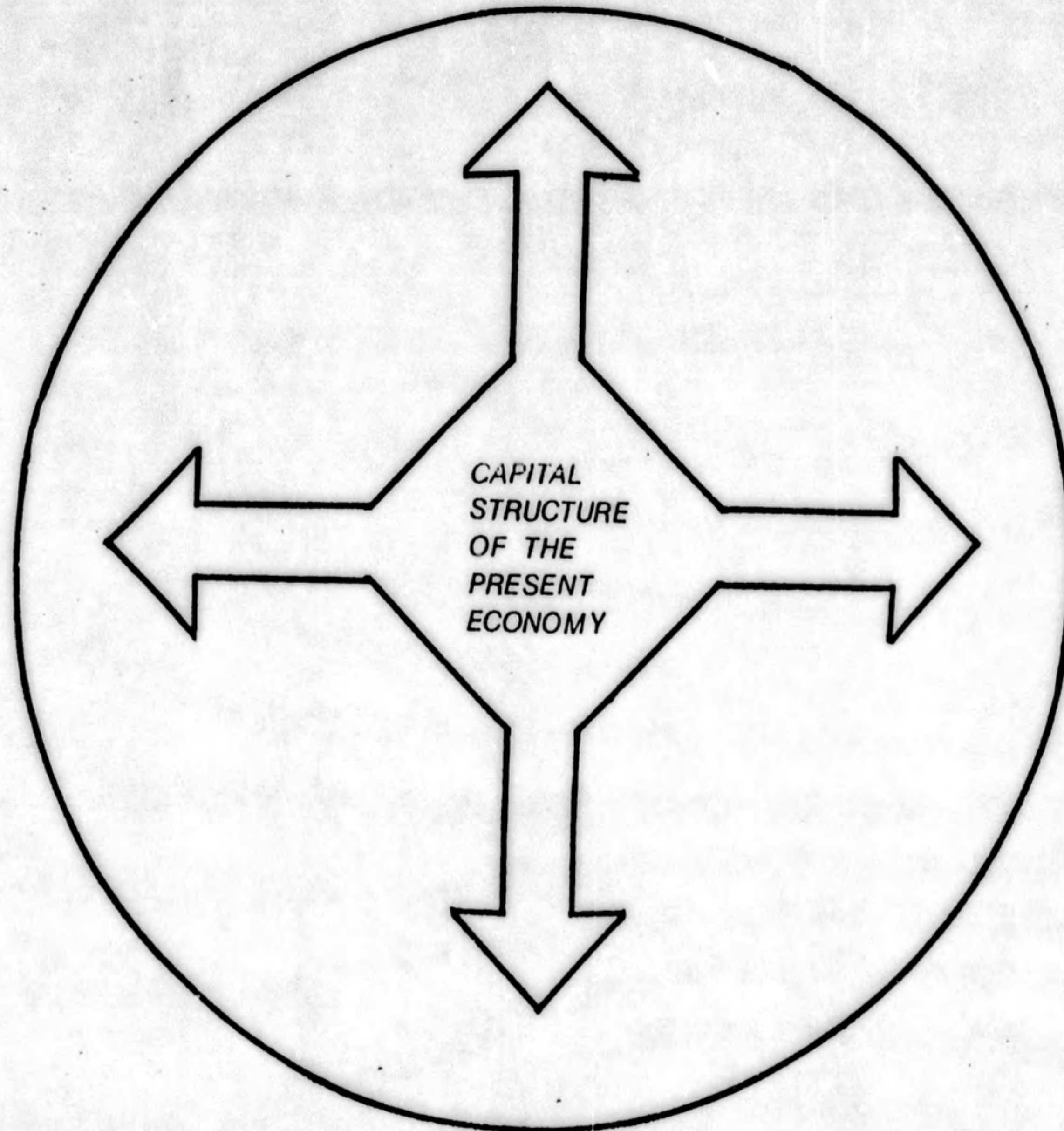
* Such a change in national economic policy was recommended by the Staff of the Joint Economic Committee in its Annual Report for 1976, pp. 171-173, inclusive. This extract is attached as Appendix II hereto.

Figure 8:

OBJECTIVE OF TWO-FACTOR ECONOMICS

Capital structure of the present economy, owned by 5% of consumers, expands ten-fold to create the SECOND ECONOMY, owned primarily by the 95% of consumers who now own no capital



IT IS TIME TO STOP FLOUNDERING IN ECONOMICS -- THE DOCTRINE OF LAISSEZ FAIRE IN ECONOMICS IS NO MORE SENSIBLE THAN THE THEORY THAT THE WORLD IS FLAT IS SOUND IN ASTRONOMY, NAVIGATION OR GEOGRAPHY, OR THAT DISEASE IS CAUSED BY THE SPONTANEOUS GENERATION OF GERMS IN MEDICINE. NOR ARE ANY ECONOMIC DOCTRINES OTHER THAN THE THEORY OF CAPITALISM USEFUL AS GUIDES IN MAKING ADJUSTMENTS TO OUR INTENDED PRIVATE PROPERTY, FREE-MARKET ECONOMY.

The theory of capitalism, or two-factor economics, holds that there is a very crucial place for government in business and that there are critically important and necessary relationships between government and business. But it goes further and gives us the means to determine what those relationships should be, how they should be designed and the respective roles to be fulfilled. The perils of our failure to use the operating manual for a capitalist economy in repairing the defects of our economy are simply that we are acting on expediency, improvising, guessing, and naturally, failing to solve our problems in the economic order.

The Employee Stock Ownership Plan (ESOP) is simply a logical application of the theory of capitalism. So is the Consumer Stock Ownership Plan (CSOP) of which one large and enormously successful working model has been functioning for 20 years. This latter device is the capitalist counterpart of the cooperative which comes to us from the socialist tradition. The name of the corporation is Valley Nitrogen Producers, Inc., a major producer of agricultural chemicals in the State of California. This is a concept that should, when combined with ESOP financing for employees of the enterprise involved, totally dominate public utility financing, savings and loan association financing, bank financing, insurance company financing, and a number of other areas, but its existence is unknown to most people, and the useableness of the device was inadvertently destroyed by Congress about 1965 at the behest of some monopolistically inclined lobbyists. Appendices III and IV hereto briefly describe the CSOP and its operating model.

The General Stock Ownership Plan (GSOP) is yet another application of the logic of two-factor economics, or the theory of capitalism, to large scale enterprises. It is provided for (in part) by Subchapter U, adopted by Congress as part of the Revenue Act of 1978 (enacting Title VI of the Internal Revenue Code of 1954, as amended), and a specific application of that technique has been under debate at the state level in the State of Alaska during the term of the legislature just ending. While the proposed Alaskan General Stock Ownership Corporation law was not adopted in the past session by the Alaskan legislature, the bill providing for it did pass favorably through the several committees to which it had been assigned. Through Subchapter U of the Revenue Act of 1978, Congress has given the states a temporary opportunity, for five years, to experiment with the GSOP concept.

The overall program based upon the theory of capitalism for the unlimited financing of business and the simultaneous building of viable capital holdings into major segments of the economy (necessarily politically designated segments) was blueprinted by

Adler and Kelso in THE NEW CAPITALISTS, published in 1961. This is the FINANCED GENERAL STOCK OWNERSHIP PLAN (FINGSOP). My overall study of financing tools built upon the theory of capitalism has convinced me that there are only limited applications for FINGSOP for qualifying businesses until Congress and the U.S. economy have adequately experimented with the ESOP and CSOP techniques, although it is clear that specific areas of economic cancer could be attacked anytime from this point forward by FINGSOP: The elimination of Social Security, the elimination of welfare, making the handicapped and mentally disabled economically productive, etc.

CAPITALISTIC TECHNIQUES OF FINANCING ECONOMIC GROWTH AND THE BROADENING OF CAPITAL OWNERSHIP TO EVENTUALLY INCLUDE EVERY CONSUMER UNIT

Lacking the logic diagram setting forth the theory of capitalism, it was inevitable, following the decision of the case of Ford Motor Company in the Supreme Court of Michigan* that the U.S. economy could not begin to finance a significant fraction of its requirements for new capital formation attendant upon the accelerating pace of the Industrial Revolution, much less the automation revolution in which we find ourselves today, so long as the owners of corporate stock were permitted to enjoy the major right of private property in their holdings of capital stock. That is, so long as the owners of stock could collect the wages of their capital -- the full proportionate return on net worth of the corporation, represented by the shares which they own. While private property in the means of production, both according to Karl Marx and according to Kelso and Adler, is the essence of a capitalist economy, our states, one after another, proceeded to abolish private property in corporate stock and to substitute for it the right of the shareholder to receive a few crumbs from the stream of wealth his capital produces when and if those crumbs are brushed off the table by the appropriate Board of Directors in the form of the declaration of dividends. The result of this was some good news and some bad news:

- We did, though by no means adequately, finance a mediocre rate of economic growth -- between 3% and 4% per year -- for over half a century; and

- Since most new capital formation was financed by the "plowing-in" of earnings made possible by the destruction of private property in capital ownership, which builds growth into a stationary stockholder base, the whole vast productive array of capital goods in our economy came to be owned by the pinnacle 5% or so of consumer units.

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* Dodge, et al. vs. Ford Motor Co., et al. (1919), 204 Mich. 459, 170 NW 668.

Since the whole function of technology is to transfer the burden of production from the human factor (labor) to the non-human factor (capital instruments, generally speaking land, structures and machines), thus making capital owners progressively more economically productive and those who own only their labor power to contribute to the processes of production progressively less productive, it was clear that some new and different expedients were called upon.

The revolutionary Administration and Congress that came onto the scene with President Franklin Delano Roosevelt in 1932, devoid even of knowledge that the logic diagram for a private property, free-market economy (which they did not repudiate as their goal) did not exist, were therefore free to go about legislating and through Executive Orders attempting to patch-up the broken down economy with more and more ad hoc expedients.

The two great lines of expedients that were innovated in the 1930's and which have been repeated in countless variations ever since were:

1. Congress voted through a series of laws, beginning with the National Labor Relations Act, to repeal the law of supply and demand as it applies to the price of labor; and

2. Congress began, and has continued down to date, experimenting with a vast variety of attacks on the effects of poverty, while leaving its causes, generally speaking, totally untouched. If people did not have enough food, they were given aid to families with dependent children, aid to the handicapped, aid to the blind, food stamps, etc., etc. If they could not pay their medical bills, they were given Medicare, Medicaid, Veterans hospitalization privileges, etc., etc. If they could not afford to educate their children, education was subsidized in hundreds of different ways. Etc. Etc.

By not asking the right question, namely, "Why are people poor?", we have preoccupied ourselves with implementing various answers to the wrong questions; answers that avoided, until the economy of World War II took over, an economically oriented internal revolution of force and violence, we did set in motion those destructive forces -- inflation, rule by force, and anarchy -- from which only the adoption and implementation of a capitalist economic policy can now save us.

Had we asked in the 1930's or subsequently the right question, namely, "Why are people poor?", we would certainly have instantly perceived the right answer, namely, "Because they are not rich.", i.e., they do not own holdings of productive capital of sufficient size to enable them, through that capital ownership, to produce the lifestyles they reasonably desire to live.

From the right answer to the right question comes the intelli-

gence as to the respective roles in the economic order to be played by business, government and employees in general. Too many people had become unproductive and our productive power and potentially expandable productive power had become too vast. Since mass production can only be supported by mass consumption, except in times of war (one of the expedients upon which we have repeatedly relied), the right answers were not forthcoming immediately.

With the right economic questions, and the theory of capitalism, our proper economic goals become clear:

1. To restore and to greatly accelerate the growth rate of the U.S. economy;

2. To make possible the financing of new capital formation at sufficiently high levels and low costs to facilitate and maintain a high economic growth rate and to achieve, for two or three decades at least, legitimate full employment through the private economic sector;

3. To reverse inflation and initiate long term hardening of the dollar;

4. To attack <u>the cause</u> of poverty by facilitating the building of significant ownership of productive capital and second sources of income into the U.S. private sector labor force and their families and eventually into all consumers;

5. To protect the quality of our environment as the economy grows and to finance the new capital formation and jobs that growth will require;

6. To increase the revenues of the Federal Government without increasing tax rates;

7. To expedite the achievement of self-sufficiency in energy by eliminating all institutional barriers to financing growth in energy-related enterprises, while lowering the cost of capital therein and building broad ownership of the resulting newly created capital into employees and into energy consumers without impairing their consumer goods purchasing power;

8. To reduce labor relations controversies at their source, by unifying the interests of labor, management and stockholders;

9. To take the initial steps to vest the dominant form of ownership of capital goods in our economy -- the ownership of corporate stock -- with the rights of private property, i.e., a claim of right to the proportion of the net corporate earnings represented by that stock; and

10. To initiate reforms in the tax laws intended to enable

U.S. consumers to become self-supporting, so that ultimately welfare, in any form, will not be necessary and Social Security can be reduced in scope to those few who will still need it.

From the foregoing, and from a perusal of the items on the brief bibliography, Appendix I hereto, it can be readily seen that H.R. 3056, which is before this Committee, closely resembles S. 388, originally referred to the Select Committee on Small Business of the Senate, is reasonably close to what is needed to enable the Small Business Administration to apply to at least some of its financing projects capitalistic principles of economics. It is also evident that the Report of the Staff of the Senate Select Committee on Small Business on "The Role of the Federal Government and Employee Ownership of Business" is a remarkably good report on the subject, considering that its authors did not rely upon two-factor economics, or the theory of capitalism, in preparing the report.

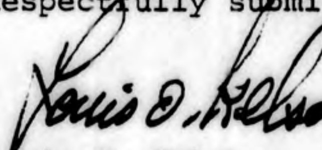
SUGGESTIONS AND COMMENTS CONCERNING THE TEXT OF H.R. 3056.

These are attached hereto as Appendix VII.

SUGGESTIONS AND COMMENTS CONCERNING THE TEXT OF H.R. 2203, REFERRED TO THE HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS.

Since H.R. 2203 relates to the same general subject as H.R. 3056, my comments and suggestions on H.R. 2203 are included in the hope that they may prove useful to the Committee in revising H.R. 3056. Among other things, I believe our analysis of H.R. 2203 will show that H.R. 3056 and S. 388 (which H.R. 3056 resembles) are superior and far freer from defects than H.R. 2203. My comments on H.R. 2203 are attached hereto as Appendix XI.

Respectfully submitted,



Louis O. Kelso

May 8, 1979

APPENDIX I

SUGGESTED READING ON TWO-FACTOR ECONOMICS

Books

THE CAPITALIST MANIFESTO by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1958. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

THE NEW CAPITALISTS by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1961. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

TWO-FACTOR THEORY: THE ECONOMICS OF REALITY by Louis O. Kelso and Patricia Hetter (Random House, New York, 1967; Paperback Edition, Vintage Press, 1968)

Testimony

Testimony by Louis O. Kelso before the Joint Economic Committee, U.S. Congress, December 11-12, 1975, on "Employee Stock Ownership Plan Financing and Other Financing Concepts Based on Two-Factor Economics"

Testimony by Louis O. Kelso, Norman G. Kurland and Patricia Hetter before the Senate Finance Committee, U.S. Congress, March 31, 1976, on "Major Tax Revisions and Extension of Expiring Tax Cut Provisions"

Reports and Publications

"ESOPS: An Analytical Report" prepared for the Profit Sharing Council of America, Chicago, Illinois, by Hewitt Associates, Deerfield, Illinois

"Employee Stock Ownership Plans" prepared by The Committee of Publicly Owned Companies, New York, New York

"A Symposium on Employee Stock Ownership Plans", The American University Law Review, Spring 1977, Volume 26, No. 3, prepared by The Washington College of Law, American University, Washington, D.C.

"Making New Capitalists -- A Creative Response to Income Inequities" prepared by the 1977-78 Twentieth Session, Executive Seminar in National and International Affairs, Department of State

FOR FURTHER INFORMATION CONTACT:

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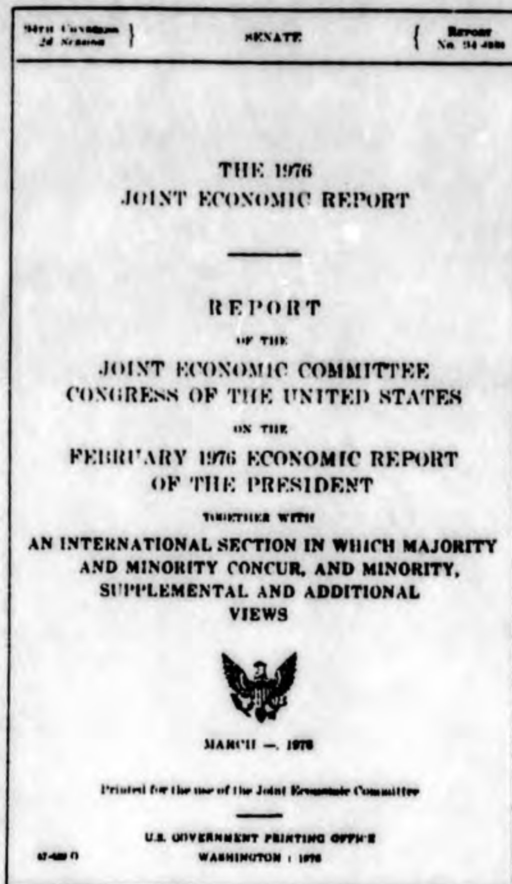
111 Pine Street, 18th Floor
San Francisco, CA 94111
Telephone: (415) 788-7454

EXTRACT FROM PAGES 170-173 OF THE 1976 JOINT ECONOMIC REPORT OF THE JOINT ECONOMIC COMMITTEE



94th Congress, 2d Session } SENATE { Report No. 94-690

THE 1976
JOINT ECONOMIC REPORT

REPORT
OF THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
ON THE
FEBRUARY 1976 ECONOMIC REPORT
OF THE PRESIDENT
TOGETHER WITH
AN INTERNATIONAL SECTION IN WHICH MAJORITY AND MINORITY CONCUR, AND MINORITY, SUPPLEMENTAL AND ADDITIONAL VIEWS

MARCH —, 1976

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1976

"Today's fears of capital shortage may turn out to be reminiscent of the growth-rate controversy of the early 1960s. In the wake of two back-to-back recessions from 1957 to 1961, many observers feared that the American economy was trapped in a pattern of sluggish growth and was destined to lose ground on its world-market competitors and perhaps even to be overtaken by its adversaries of the Communist world. America's confidence in her technological leadership was shaken by the early successes of the Soviet space programs. In fact, however, the American economy at that time was on the brink of one of its most prolonged periods of growth and prosperity with rapid investment and productivity gains.

Today again, after two business recessions between 1969 and 1975, separated by a period of great economic turbulence and very high interest rates, many observers fear that investment levels will not be adequate to avert future shortages and the associated inflationary pressures. The financial strength of many businesses has been sapped, and they are uncertain about the future. Substantial investment resources must be diverted for pollution control and expansion of energy supplies.

Again, however, the economy has the potential for sustained growth and productivity gains with subsiding inflation. A significant advantage over the earlier period is the present rapidly growing labor force. Thus, policies should be tailored to generate a prompt recovery of output and a sustained longer-run expansion.

Broadening the Ownership of New Capital

Wealth in the United States is concentrated in the hands of a relatively small fraction of the population. Unfortunately, the data on wealth are sparse. The last comprehensive attempt by the Federal Government to measure its characteristics and distribution was made by the Federal Reserve Board in 1962. It was estimated that more than three-quarters of the country's total wealth was owned by less than one-fifth of the people, while more than one-quarter was owned by just the top 0.5 percent. The Federal Government should remedy the lack of up-to-date information on personal wealth through periodic surveys and comprehensive reports on this subject.

The distribution of wealth reflects in large part the pattern of ownership of non-residential capital with corporate shares being one of its principle forms. This category of wealth is much more

concentrated than total wealth, with the top percentile of the personal income distribution owning 51 percent of the market value of individually owned corporate stock and receiving 47 percent of the dividends. Meanwhile, the new capital assets generated by businesses, which in recent years have averaged well over $100 billion annually, redound largely to the benefit of these persons who already have great wealth.

The number of shareholders, moreover, declined by some 18 percent from 1970 to 1975, and data suggest that young people today are not purchasing stocks in significant volume. Balancing this declining role of the individual investor has been the rise of financial institutions, which since 1950 have more than trebled their share of the market value of stock holdings.

To begin to diffuse the ownership of capital and to provide an opportunity for citizens of moderate incomes to become owners of capital rather than relying solely on their labor as a source of income and security, the Committee recommends the adoption of a national policy to foster the goal of broadened ownership. The spirit of this goal and what it purports to accomplish was endorsed by many of the witnesses at our regional hearings.

Without getting into specifics, the types of programs which could be established to help meet this goal will be outlined, Such alternative methods of broadening capital ownership are under study by the Committee.

In the individual firm, employee ownership can be encouraged directly through tax incentives to the employees to purchase stock or to firms to place newly issued stock into the hands of their employees. The latter approach, known as Employee Stock Ownership Plans (ESOPs), was examined in recent hearings by the Committee.

An alternative plan involves multifirm funds which would receive tax-favored contributions from affiliated firms and issue nonnegotiable fund certificates to the employees. This type of fund, which has been in operation in France and West Germany, may diversify its portfolio, although it may be limited to particular industries and regions.

Providing ownership opportunities not just to employees but to citizens at large could be accomplished through various devices. One example would be the establishment of funds which would

accumulate personal savings on a tax-preferred basis and use them to acquire a diversified portfolio of equity shares in corporations. For instance, individuals with earned income not exceeding $20,000 could be allowed to save up to $3,000 a year in one or more funds and to deduct this amount from their taxable incomes.

Whatever the means used, a basic objective should be to distribute newly created capital broadly among the population. Such a policy would redress a major imbalance in our society and has the potential for strengthening future business growth.

> To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership. Congress also should request from the Administration a quadrennial report on the ownership of wealth in this country which would assist in evaluating how successfully the base of wealth was being broadened over time."

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS
SAN FRANCISCO
WASHINGTON, D. C. NEW YORK

CONSUMER STOCK OWNERSHIP PLAN (CSOP)

For Building Equity Ownership Into Public Utility Consumers

A brief functional description of the technique for building capital ownership into public utility consumers will be useful here.

1. Escrow accounts with any designated banks, or with the public utility itself, would be established for each of the public utility's consumers.

2. By law the public utility would be given the power to mandate (that is, require) the subscription by each of its service consumers to their proportionate part (based on their relative estimated needs) of a ten-year moving capital budget of the public utility, covering the total capital formation requirements, except those financed through the utility's ESOP. Payments on this subscription would be synchronized with the utility's cash requirements. Methods for adjusting the subscription for over- or under-estimated needs would be designed.

3. Funds for the payment of each consumer's subscription would be provided by a consortium of banks, insurance companies, and perhaps savings and loan firms.

4. The subscriptions by each consumer would be payable solely and exclusively from the dividends received by the consumer from the public utility.

5. The public utility would be contractually committed, or perhaps legally required, to make a full pay-out of the proportionate earnings attributable to employees acquiring its stock through ESOPs and consumers acquiring its stock through capital-ownership financing escrows. Such dividends would be made deductible from corporate income for tax purposes, both at the state and federal levels.

6. The public utility's ESOP loan paper, and its consumer loan paper, would be made directly discountable with the Federal Reserve Bank at the minimal discount rate (1/2% at most, I estimate) as outlined in my written testimony to the Joint Economic Committee (see Pages 16-22).

7. The effective interest rate to the borrower (the ESOP or the consumer escrow) would not exceed 3%, and perhaps more closely approximate 2%, including generous bank profits.

8. Until the public utility's consumer stock has been paid for on a share-by-share basis, the dividends received would not be taxable to the consumer. However, as soon as the stock is paid for, again on a share-by-share basis, the dividends would become taxable income to the consumer, and would have the effect of offsetting, that is, reducing, the consumer's public utility service bill.

9. Thus the overall effect of the application of two-factor principles to public utility financing would be to hold down costs of production, on the one hand, by providing employees with an increasing second income through their capital ownership and motivating them to restrain their demands for progressively more pay in return for progressively less work (as at present), while, on the other hand, raising the power of the public utility consumer to pay his or its public utility bills. The payout period on most financings would be four to five years, I estimate, at the contemplated interest rates.

10. The low interest rate involved in the use of pure credit in such financing is not, in any sense of the word, "subsidized" by government. It is simply the use of pure credit (the power of people to contract with each other in contracts payable in money, in a society where all may enforce or defend their rights under such a contract) for the purpose of building self-sufficiency and productive power into the consumers of the society and for the purpose of motivating the employees in the economy. Nothing involved in the transactions enters into the government's income or capital accounts in any way. No governmental debt, deficit or subsidy is involved.

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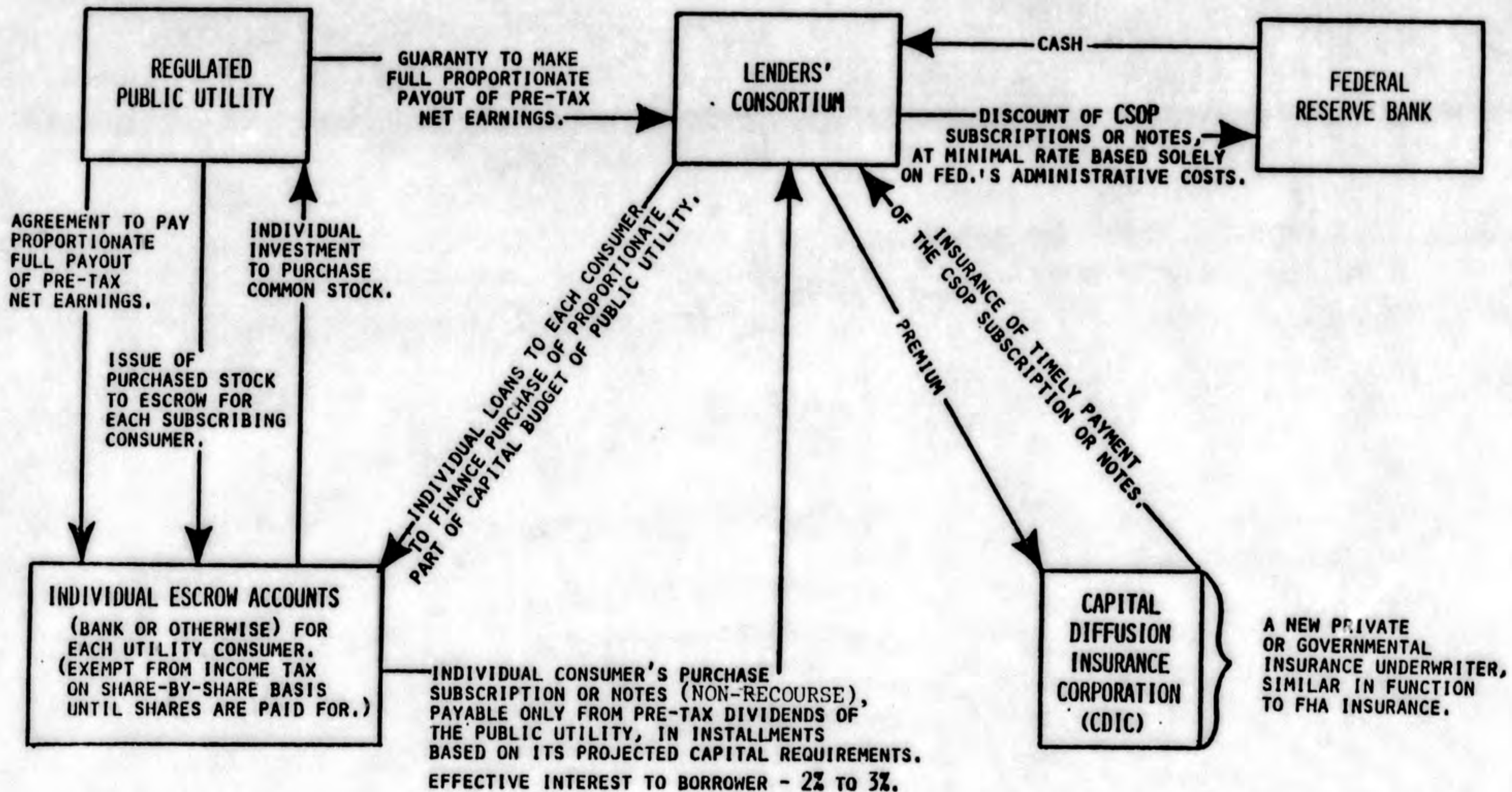
THE CONSUMER STOCK OWNERSHIP PLAN

A TECHNIQUE OF FINANCE DERIVED FROM TWO-FACTOR ECONOMICS FOR PROVIDING VIRTUALLY UNLIMITED LOW COST CAPITAL TO FINANCE SOUND, WELL-MANAGED, REGULATED PUBLIC UTILITIES WHILE BUILDING OWNERSHIP INTO CONSUMERS IN PROPORTION TO THEIR RELATIVE CONSUMER NEEDS FOR THE UTILITY'S SERVICES



Valley Nitrogen Producers, Inc., A California Corporation
The First Consumer Stock Ownership Plan*

In 1957, a number of farmers, led by a small independent fertilizer distributor from Modesto, California, by the name of Carl Haas, came to Kelso from the San Joaquin Valley. They said they were suffering from the Government's plan to reduce each year the number of acres on which they would be accorded cotton-support allotments under the Government's cotton allotment program, and that they nevertheless desired each year to produce larger cotton crops. There is only one way to do this, they explained, and that is to use progressively more nitrogenous fertilizers: Anhydrous ammonia, ammonium sulfate, ammonium phosphate, various dry and liquid mixes, etc.

*Explanatory Note - The Consumer Stock Ownership Plan (CSOP) is a technique of corporate financing, designed by Louis O. Kelso and based on the principle of two-factor economics.

In The New Capitalists, written by Louis O. Kelso and Mortimer Adler and published by Random House in 1961, Kelso and Adler pointed out that the logic of corporate finance is planned investment under which businesses acquire capital assets on terms where they are expected to pay for themselves within a reasonable period of years--normally three to five years; that the assets will thereafter proceed to throw off net income virtually indefinitely, sufficient funds being set aside out of gross income as depreciation to constantly renew the productiveness of such assets before net income is computed. Naturally other considerations are also requisite: competent management, intelligent research and development, constant market analysis, etc.

Nevertheless, said Kelso and Adler, given that logic, the question of who become the owners of the capital assets once, they have paid for themselves, is strictly a matter of:

- -- Financial design of the enterprise.
- -- Legal design of the enterprise.
- -- The identity of the ultimate beneficiaries of the extension of credit.

For example, when a corporation, using conventional methods, finances its growth by borrowing, the stockholders are the non-recourse beneficiaries of the credit extended. When the assets have paid for themselves, the stockholders of the corporation become the owners of the added assets, and thereafter the net income produced by the assets accumulates and/or is distributed for the benefit of the stockholders who are the owners of the corporation.

In the manufacturing of nitrogenous fertilizers on a commercial scale, the starting point is anhydrous ammonia, a product made by a nitrogen-fixation process, using nitrogen from the air and huge quantities of natural gas to provide the other principal ingredient, hydrogen. Such chemical plants must be large to be efficient, and must be operated continuously except for planned down-time for maintenance and occasional breakdowns.

Prior to Kelso's meeting with Carl Haas and his farmer friends, the price of anhydrous ammonia (and proportionally of all other nitrogenous fertilizers in which anhydrous is the basic ingredient) had been maintained for many years by several major petro-chemical producers (the "majors") at around $250 per ton. The farmers who came to Kelso insisted that this was an unreasonable price, and that their profit-ability depended upon their getting lower fertilizer costs. This, they were convinced, required their building their own fertilizer complex, the cost of which at the beginning would range somewhere in the $20 million area, and when expanded to serve their purposes (as it ultimately was), would require $100 million or more investment.

To do the task efficiently, Kelso realized the financial and legal design would require the certain characteristics:

-- Investment subscriptions would have to be proportioned to long-term fertilizer needs.

-- Subscriptions would have to be bankable, even though designed to be paid from dividend revenues.

-- Corporate income tax should be avoided, or in any event, kept to a minimum.

-- Investors would have to be contractually committed to buy their total requirements of fertilizer from the new corporation ("VNP") for as long as the anti-trust laws would permit. After research, Kelso concluded this would take seven years.

-- The wages of capital, i.e. the corporate net income, would, as a matter of contractual commitment to stockholders, be paid out fully and regularly, after debt service and operating reserves only, to the stockholders. This was made possible by the arrangement that locked the amount of subscription to the stockholder's estimated fertilizer requirements, and committed him to buy his total requirements from the corporation.

-- The corporation was given sufficient characteristics of a farmer-cooperative for tax purposes [although it was a business corporation for other purposes], so that

its income, under the tax laws prevailing until about 1965, would be subjected to virtually no tax. Its commitment to pay out net earnings to shareholders, plus depreciation approximately equivalent to its debt service, made this possible.

-- The then prevailing tax laws provided that dividends of a farmer cooperative, applied to payment of stock purchase price, would not constitute taxable current income to the stockholder. Only after the farmer's stock was paid for did subsequent dividends constitute taxable farmer-stockholder income, and then only as a reduction of farming costs [thus increasing farm profits], since such dividends were contractually adjustments of the farmer's purchase price for his fertilizer.

Thus all the characteristics of a Consumers' Stock Ownership Plan (CSOP) were present. Bank loans against the subscriptions paid for the plants as built. The payout of dividends was such that most stockholders paid for their subscription installments out of their dividends. So long as stock was being paid for, corporate income was free of tax and stockholders were not taxed on dividend income applied to stock purchase price.

The real power of these financing techniques to build highly capital-intensive enterprise, with some $100 million ultimately required, and to make significant stockholders out of some 9000 farmers, most of whom had never before owned a share of stock, was demonstrated by the fact that the plants paid for themselves notwithstanding that, just as VNP's first plants began production, the majors dropped the price of anhydrous ammonia from the $250 per ton area to $66 per ton, and proportionately reduced the prices of other fertilizers. In its subscription agreements, VNP was contractually committed to sell to its stockholer-customers at the prices established by the majors, so these reduced prices automatically became VNP's reduced prices.

The end result was not just to add considerable wealth to the farmer-stockholders, but to save all farmers of the State, Kelso estimates, well over $1 billion in fertilizer costs during the 15-year period before a world-wide fertilizer shortage drove up fertilizer prices.

Clearly, any regulated public utility with relatively modest Federal and state legislative changes, is an even more apt vehicle for CSOP financing. Even better if CSOP financing is used in tandem with ESOP financing that builds a reasonable proportion of ownership into employees.

Kelso & Co., Incorporated
November 8, 1976

APPENDIX V

LOUIS O. KELSO, INC.
LAWYERS AND COUNSELORS
111 PINE STREET
SAN FRANCISCO, CALIFORNIA 94111

TELEPHONE
(415) 788-7200

CABLE ADDRESS
LOKINC

January 17, 1975

The Honorable Gerald R. Ford
President of the United States
The White House
1600 Pennsylvania Avenue
Washington, D.C. 20500

Dear Mr. President:

I am dismayed at the inadequacy of the economic program as presented in your State of the Union Message. It incorporates the continued use of the Keynesian expedients that have papered-over our problems from the last depression to our new depression without correcting the structural defects that make our economy work so badly.

Up to now, it has been abundantly demonstrated that the chief Keynesian weapon against inflation is unemployment, and that the chief Keynesian weapons against unemployment are inflationary. Now that we have opened up a two-front war simultaneously on unemployment and inflation, using the same old Keynesian tools, we can hardly be headed for anything but the most colossal disaster in our economic history.

The alternative -- I am certain the only alternative -- is outlined in the statement I prepared for your Economic Summit Meeting on Inflation last September. A copy of that statement is enclosed herewith.

The program contemplated by my Summit statement, "A New Economic Policy to Meet the Needs of the American People and of the U.S. Economy," can effectively and within time limits short enough to permit restoration of confidence of the people in our economy, accomplish the following objectives:

-- Restoration and acceleration of economic growth to unprecedented levels through making possible financing of the enormous, self-liquidating new capital formation so desperately needed by the U.S. economy today, including making ourselves self-sufficient in energy, the building of hundreds of rapid transit systems, the total rehabilitation of our railroad system, the reawakening of our housing industry, the multiplication of our agricultural output by several magnitudes (since it is our best trade balance weapon), etc.;

-- Create legitimate (not boondoggle) full employment for two or three decades until we can get the American people in a position where a major portion of their incomes are derived from capital ownership;

-- Lay the foundation for arresting inflation and initiating the hardening of our money, for once the newly-formed capital has paid for itself, it will continue to throw off goods and services almost indefinitely;

-- Achieve these steps only through self-liquidating expenditures, rather than through welfare and tax cuts, which must be ever repeated and ever increased to close, year after year, the purchasing power gap;

-- Build market power -- adequate market power -- into the workers in the form of a second income from their privately-owned capital;

-- Finance these objectives without adding one cent to the Federal debt through the discount technique proposed in my Summit statement, which is nothing more nor less than a technique for monetizing self-liquidating newly-formed capital. Compare this with the present Administration program, which primarily monetizes welfare!

-- Permit the lowering of the interest rate on these selected basic types of self-liquidating new capital formation to 3% or less, assuring enormously greater economic power in the form of new productive industry.

I am also enclosing a copy of a bill for an act entitled the "Accelerated Capital Formation Act of 1975." This bill, which was introduced into the House this week by Congressman Frenzel from Minnesota contains very minor changes in the tax laws relating to Employee Stock Ownership Plan financing techniques that will radically enhance their attractiveness to corporations, to employees, to labor unions, and to voters. The provisions of this bill will accomplish all and more than would an increase in the investment credit which, for all its advantages in helping to stimulate business, never creates a single new stockholder. Rather, the investment credit merely exacerbates the concentration of ownership that is already our Number One problem.

LOUIS O. KELSO, INC.
LAWYERS AND COUNSELORS

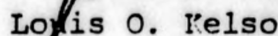
The Honorable Gerald R. Ford
January 17, 1975
Page Three

Mr. President, I urge you to consider these points, and if you are persuaded of their soundness, as I am, to help bring about their substitution for the programs now under consideration.

Irrespective of what welfare or emergency measures might have to be taken to prevent immediate suffering as the result of the failure of the economy, the program I have outlined alone is a long-term solution and its vigorous employment would minimize the welfare expedients needed in the short term.

I respectfully urge your attention to the foregoing.

Sincerely,



Louis O. Kelso

LOK:rah
Enclosures

cc: The Honorable L. William Seidman

KELSO & CO.
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SAN FRANCISCO, CALIFORNIA 94111

A NEW ECONOMIC POLICY TO MEET THE NEEDS OF THE AMERICAN PEOPLE AND OF THE U.S. ECONOMY

Proposals to the President of the United States
At the Economic Summit Meeting on Inflation
Convened in Washington, D. C.
September 27-28, 1974

By
Louis O. Kelso, Economist

As we meet to consider and recommend solutions to inflation and related problems now besetting the American economy, it is clear that fast and effective solutions are needed to:

— Resume and accelerate economic growth. The American economy derives its strength from its ability to bring into existence powerful capital instruments — the real source of its productive power and affluence — and to match them with skilled and motivated workers. We should never forget that economic strength depends on the ability to produce an abundance of low-cost, high quality goods and services, and to build market power into consumers in the process. Rapid economic growth is essential if we are to achieve self-sufficiency in energy within less than a decade; if we are to rehabilitate our railroad systems; if we are to rehabilitate our cities; achieve vastly expanded production of food and fiber at much lower costs in order to meet our share of the export demand and to solve our balance of payments problems; build a hundred or more new towns and a hundred or more rapid transit systems; and expand the production of basic goods and services in general.

— Create several million new jobs in the private sector in the course of expanding its output of goods and services. Certainly no one can suggest that we should find make-work employment in the public sector if, in fact, the expanding private sector requires more jobs.

— Protect the quality of our environment as we grow, which will further increase the need for new capital formation and for financing it.

— Achieve higher incomes for our poor and our middle classes, but by means other than increases in wages and salaries, in order to avoid increasing the costs of goods and services.

— Reverse inflation and achieve a gradual and continuous hardening of our money.

WHAT CAN ACCOMPLISH THESE OBJECTIVES WHEN SO MANY OTHER PLANS HAVE FAILED?

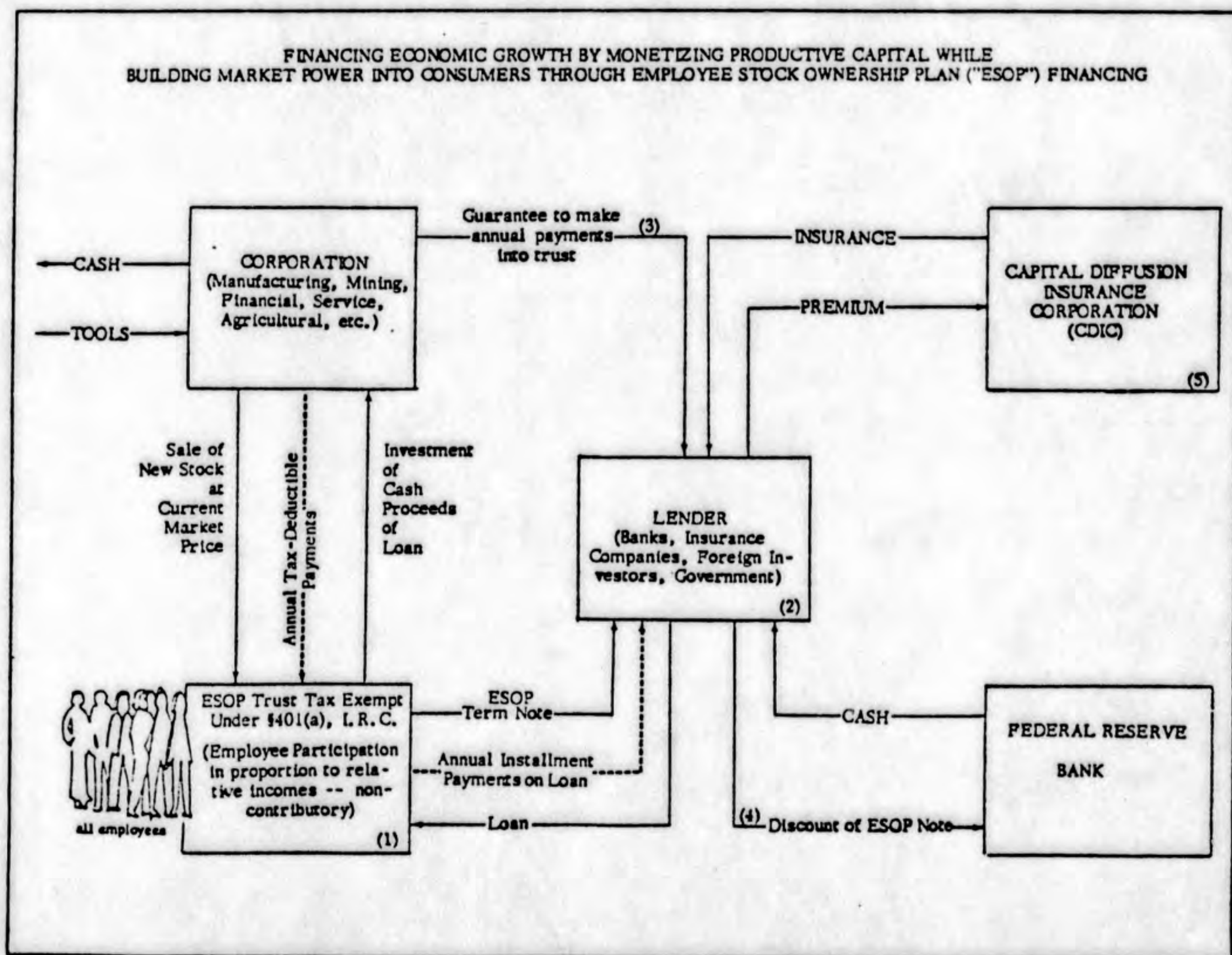
Modern inflation is of such nature that it can only be solved by radically increased investment in self-liquidating new capital formation. It is nothing short of a miraculous coincidence that we are facing a decade in which capital formation requirements exceed those of any past decade by several magnitudes.

Not only is it true that we can and must invest our way out of inflation, while solving the other problems noted above, but credit for doing so at low interest rates is *unlimited.* Expenditures during the coming decade of upwards of 4.5 trillion on basic private-sector new capital formation, if structured to radically broaden corporate equity ownership and to minimize making the rich any richer, will reverse inflation, build market power into most consumers, create two or three generations of intense full employment, and shrink to a fraction of their present size the various government agencies devoted to attacking the effects of poverty while leaving its causes untouched. This program is an attack on the *cause* of poverty, namely, the low economic productiveness of the individual who does not own significant income-producing capital. It will cause taxpayers' incomes to rise, the purchasing power of their money to grow, and their taxes to fall well below present levels.

WHAT ERROR IS RESPONSIBLE FOR OUR UNEMPLOYMENT, INFLATION, STAGNATED ECONOMIC GROWTH, AND INCOME DISTRIBUTION MISMATCH?

Present U.S. economic policy calls for solving the income distribution problems for all consumers through full employment, and to the extent that is not achievable, through welfare. At the same time, science, engineering, and management of business, industry and agriculture, strive ceaselessly to eliminate employment to minimize costs. Inflation flows relentlessly and unendingly from attempts of the Federal government to reconcile these unreconcilables, all of which take the form — recognizable or not — of the monetization of welfare. Money representing welfare is inflation in its essence.

THE BLUEPRINT FOR THE NEW ECONOMIC POLICY.



— EXPLANATORY NOTES.

1. The Employee Stock Ownership Plan ("ESOP") Trust is a tax exempt entity organized to conform to Section 401(a) of the Internal Revenue Code. Not only are payments into it by the corporation deductible from corporate income tax within specified limits (maximum 25% of covered payroll), but the employees can accumulate capital ownership in the Trust until their retirement, free of annual income taxation.

2. In addition to banks, insurance companies, and foreign investors, all of which are currently eligible to make ESOP loans, consideration should be given to enlarging the power of savings and loan institutions to make such loans.

3. The corporate guarantee to make sufficient payments into the trust to enable the trust to meet its loan amortization requirements is, in effect, a pledge of the general obligation of the corporation *payable in pre-tax dollars*. In tax theory, this is a contribution to a qualified employee trust. In economic theory, it is merely a commitment on the part of the corporation to make a high payout of the wages (i.e., earnings) of the newly formed capital.

4. The direct discounting of the ESOP note with the Federal Reserve Bank should be strictly limited to basic financing of high priority, self-liquidating new capital formation, such as railroad rehabilitation, the building of new rapid transit systems, the expansion of agriculture, etc. It should never be used for consumer financing or mere purchase of existing assets. The interest rate should be limited to the administrative cost to the Federal Reserve Bank and the administrative cost to the lender, including a reasonable profit. We estimate this rate should not exceed 3% per annum to the ESOP borrower. No consideration of risk should be involved in the fixing of the interest rate, since the risk is covered in another way. (See Note 5 below.)

5. We recommend that Congress organize a capital financing counterpart of the FHA Insurance Fund designed for use primarily in the consumer housing field. Its name, suggested here, is Capital Diffusion Insurance Corporation. (For further discussion, see Kelso and Adler, *The New Capitalists*, Random House [1961]; Kelso and Hetter *Two Factor Theory: The Economics of Reality*, Random House Vintage Books [1967]; Testimony of Louis O. Kelso and Norman G. Kurland, Financial Markets Subcommittee of the Senate Finance Committee, September 24, 1973.)

This basic financing design, omitting the Capital Diffusion Insurance Corporation, and the arrangement for discounting ESOP notes directly with the Federal Reserve Bank (both of which we recommend Congress provide for with the control conditions herein outlined) has been successfully used by more than one hundred U.S. corporations under existing law. The newly-enacted Employee Retirement Income Security Act of 1974 greatly strengthens and enlarges the opportunities for the use of ESOP financing. (See in particular Sections 404[a][2], 407[b], 407[d][3][A], 407[d][6], 408[b][3], 408[e], 2003[a], 4975[d][3], 4975[d][13], 4975[e][7].)

WHY WOULD THE PLAN BRING ABOUT A CONTINUOUS HARDENING OF THE PURCHASING POWER OF MONEY?

The classical definition of inflation is too many dollars chasing too few goods. Since this plan is based upon the radical expansion of feasible and self-liquidating newly-formed capital, it involves bringing into existence productive facilities that will not only pay for themselves once within a reasonable number of years (normally 3 to 5), but these capital instruments, their productiveness preserved by depreciation practices which involve setting aside funds to restore and perpetuate their productive power before net income is computed, continue almost indefinitely to push goods and services into the markets without further capital costs. Furthermore, since the typical ESOP Trust covers all of the employees of each corporation employing it for financing purposes, employees are gradually put in a position where their increasing wage demands conflict with their accumulating capital ownership, and wage demands may be expected to flatten out. Since the typical ESOP Trust is designed so that, once stock is paid for, any dividends thereafter paid pass through the Trust into the employees' pockets, it becomes possible to raise employee incomes without raising corporate costs. Furthermore, the ESOP, by building significant capital ownership into employees over a working lifetime, will gradually replace fixed-benefit pension trusts and profit sharing arrangements that are invested only in secondhand equities. Since these do not finance growth of the sponsoring corporation, they are pure costs which can be gradually eliminated.

Finally, the rapid acceleration of the real growth of the U.S. economy, desperately needed and calling for large increases in employment, will render unnecessary the governmental costs of creating make-work jobs producing nothing of market value. The rolls of the unemployed will fall and in due course many government employees will be attracted by the advantages of working in industry under conditions providing

opportunities for capital ownership, second incomes and economic security.

Second incomes from capital, paid to employees after their new capital holdings have paid for themselves, will enhance the market power of those with unsatisfied needs and wants. This "second income" is the wealth produced by capital — not monetized welfare such as is used today to close the purchasing power gap. The accelerated growth of the economy will make the poor richer without making the rich poorer, and will provide a larger income and property tax base for government. In the face of shrinking "need" or welfare demands, we can achieve every taxpayer's dream of a shrinking tax bite accompanied by increased purchasing power of the dollar.

CONVENTIONAL METHODS TO CLOSE THE PURCHASING POWER GAP OF THE POOR AND MIDDLE CLASS COMPARED TO THE PLAN BASED UPON ESOP FINANCING.

Conventional Economic Expedients	ESOP Financing Plan
Attacks only the effects of poverty.	Attacks the causes of poverty.
Increases dependence of the individual on the State.	Creates growing autonomy, increasing economic independence of the consumers who produce progressively more of their income through their privately-owned capital.
Progressively more inflationary.	Gradually deflationary through the hardening value of money. Living becomes easier because it is easier to produce goods and services and easier to buy and pay for them.
Demotivates economic activity through higher and higher taxes, redistribution and discouragement of craftsmanship.	By linking the worker's performance of his job with the acquisition of a viable capital estate, provides him the most powerful and satisfying motivating force in history.
Restrains economic growth.	Promotes accelerating economic growth.
Economy increasingly depends on taxation.	Economy increasingly depends on intelligent use of credit and the wise use of banking facilities to expand the private economy and enable all consumers to participate in production through capital ownership.
Numerous financial and institutional barriers to economic growth. "Where do we get the money?"	Institutional barriers to growth eliminated and only physical limits to growth remain.
Defy man's nature because they violate Machiavelli's Law: a man will forgive you for killing his father before he will forgive you for taking his patrimony.	The economy in which capital ownership is broadly owned conforms to the nature of man because it helps him to acquire a capital estate, protects his patrimony, and helps it to grow.
Concentrates economic and political power in the same hands and is eventually totalitarian.	Keeps the economic power out of the hands of the State and diffuses ownership broadly through all consumers. The State remains in the position of umpire and guide. The freedom of the individual can be protected by the individual, while political power from election to election is centralized in an administration. While government has enormous ability to make low-cost credit available for broadly-owned basic new capital formation, and has therefore enormous leadership capability within the society, economic power remains with the people.

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

111 PINE STREET
SAN FRANCISCO, CALIFORNIA 94111
[415] 788-7454

October 1, 1974

Mr. William Seidman, and
Professor Paul McCracken
Old Executive Office Building
Washington, D.C. 20500

Dear Bill and Paul:

The Summit Conference on Inflation was a confidence-inspiring event for those involved and, I think, for this country as a whole. The administration gained in credibility perceptibly.

The very public nature of the sessions, however, minimized the possibility of considering new ideas of a scope commensurate with the size and seriousness of the underlying economic problems.

A dozen or more speakers noted that they had heard "nothing new." Among them was Dr. Gwen Bymers as the mini-summit meeting of the Banking and Finance Community on September 20th — where the Bangert & Company proposal was presented. But the fact is that Bangert & Company's proposal is both new and critically relevant; it involves taking direct steps that lie within the powers of a democratic society towards eliminating inflation, financing greatly improved economic growth and bringing about two or more decades of full employment. I do not, of course, criticize Professor Bymers for not grasping the significance of what she had heard in the limited time available. My invitation came on such short notice that I had no time to prepare an advance summary of my presentation — a copy of which I now enclose.

As you sift through the suggestions and begin to formulate a new economic policy however, I urge you carefully to consider making a recommendation to Congress for amending the Employment Act of 1946 to expand the U.S. economic goal to include a policy favoring the broadening of the ownership of capital. While this would be a new departure, (or at least one that is new since the Homestead Acts), it is one directed towards the solution of the chief *real* problem. It would proclaim a new goal while also giving the Administration and Congress time to consider the means of implementation. If the implementation is timed carefully, any temporary revenue losses will be far less than the cost of make-work jobs and other welfare expedients required to shore up a stagnant economy.

I am fully aware that conventional banking thought is quite oblivious to the power and importance of using pure credit to finance new capital formation. For example, Governor Henry C. Wallich of the Federal Reserve Board, at the Conference for Corporation Executives on Wednesday, September 25, 1974, at the School of Advanced International Studies in Washington, D.C., stated:

> *"Conterproductive Proposals*
>
> "A variety of often ingenious suggestions were made during the pre-summit meetings that, upon closer analysis, have one feature in common: their application would require printing more money. Proposals to combat inflation burdened with this side effect do not carry conviction. *This applies, for instance, to well meant suggestions to expand credit in order to expand productive investment in order to expand output.* More output indeed would tend to restrain inflation, but not if it has to be financed by an expansion of money and credit." (Emphasis added)

The prevalence of this *non sequitur* variety of thinking is part of the explanation as to how we got into our present mess. Governor Wallich is certainly correct when he says, "More output indeed would tend to restrain inflation," and he is dead wrong when he asserts that such is not true if the expanded output "has to be financed by an expansion of...credit." Newly-formed capital in well-managed businesses (and the Federal Reserve Board can lay down regulations concerning the quality of feasibility studies) pays for itself *not just once, but repeatedly in cycles*, rarely of more than half dozen years each, its productiveness restored by depreciation practices that are universally used. Such *Ex Cathedra* and unsupportable statements should not shut off the only line of thinking that can lead us out of the inflation woods. Neither Governor Wallich, nor any one else could explain the financing of the industrialization of Japan over the last half century without acknowledging that new capital formation can indeed be financed out of pure credit without inflation. Japan's inflation came long after Japan had risen to high-level industrial status, and is due to essentially the same causes as that in the United States: the attempt to solve the income distribution problem through labor, when the great bulk of its wealth is in fact produced by capital. Japan's further mistake lay in failing to develop techniques, such as we have developed, to radically broaden the equity ownership base.

You both have copies of *Two-Factor Theory: The Economics of Reality*, written by Patricia Hetter and myself in 1967. In the appendix to that book is a draft of just such a revision of the Employment Act of 1946 which you could quickly adapt to suit your own views.

The world is facing a crisis arising out of the ultimately hopeless attempt to distribute as pay for labor the income derived from the overwhelming input of capital. This economic policy is clearly not working; nor can it ever work, for technology modifies the input mix into the economy in only one direction.

You have the opportunity to set us on the course to sound and necessary change in your formulation of the Administration's new economic policy recommendations to Congress.

Please give this suggestion your most careful consideration. I will be at your service, of course, should you find that I can be of help.

With best regards,

Sincerely,

Louis O. Kelso

APPENDIX VI

IDENTIFICATION OF KELSO & CO., INCORPORATED

Kelso & Co., Incorporated was formed in 1971 to provide a wide range of investment banking services other than public underwriting. It does not engage in any aspect of the stock brokerage business. Areas of emphasis in the firm's work are the designing of short and long range financing plans, private placement of debt and equity securities, both for new ventures and established businesses, and the acquisition and disposition of business assets.

Where appropriate, Kelso & Co., Incorporated emphasizes methods of financing expansion and accomplishing the acquisition, disposition and reorganization of businesses by means which effectively build capital ownership into the executives and employees of its clients. One means for implementing these techniques -- an area of specialization of Kelso & Co., Incorporated -- involves the use of Employee Stock Ownership Plan (ESOP) financing.

Louis Kelso, President and Chief Executive Officer of Kelso & Co., designed and implemented the first ESOP in 1956, some 18 years before his innovation was expressly recognized by Federal law. The complicated orchestration of the diversified disciplines required to design and implement an ESOP include economics, financial analysis, corporate finance, accounting, communications, employee business and economic education, law (including deferred compensation, general commercial and financial law, corporate, labor and securities regulation, both by the Securities and Exchange Commission and State regulatory bodies, and tax law), and employee and shareholder relations. The complete turnkey services provided by Kelso & Co. to clients frequently involve solutions to problems that are not achievable under conventional financing techniques. The experience and efforts of Mr. Kelso and his associates have resulted in substantial beneficial legislation regarding ESOPs, and the creation of a nationwide demand for the innovative forms of financing involved.

In the course of its work, Kelso & Co., Incorporated and its personnel have appraised and valued hundreds of companies, designed hundreds of financing transactions, provided sophisticated financial analysis, and solved intricate problems arising from the interplay of differing interests and objectives of directors, corporate management, shareholders, lending institutions, unions, employees and use of ESOP financing to solve estate planning problems.

Kelso & Co., Incorporated also provides consultation services to domestic and foreign governmental entities desirous of simultaneously accelerating economic development, freeing themselves from dependence on foreign capital, building broad purchasing power in potential consumers, reversing inflation, achieving low interest rates for self-liquidating basic new capital formation, and stabilizing business constituencies through creating widespread ownership of business equities.

The thesis upon which the need for a new form of investment banking service business with the characteristics, objectives and facilities of Kelso & Co., Incorporated was postulated in the following:

THE IMPLICATIONS OF TWO-FACTOR THEORY AND THE PRIVATE BUSINESS FINANCING TECHNIQUES STRUCTURED UPON THAT THEORY, NAMELY EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs), CONSUMER STOCK OWNERSHIP PLANS (CSOPs) AND GENERAL STOCK OWNERSHIP PLANS (GSOPs)

THE PREPONDERANCE OF OUR GOODS AND SERVICES ARE PRODUCED BY CAPITAL, YET FAMILIES OWNING SIGNIFICANT CAPITAL HOLDINGS ARE A MINUTE FRACTION OF THE POPULATION.

No one has refuted, or can refute, the basic argument of THE CAPITALIST MANIFESTO, THE NEW CAPITALISTS (by Louis O. Kelso and Mortimer J. Adler, Random House, 1958 and 1961, respectively) and TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (by Louis O. Kelso and Patricia Hetter, Random House, 1968) that it is the productivity of capital which is rising and that the productivity (or productiveness) of labor is at best stationary, and more probably shrinking.

The serious qualitative studies of the distribution of ownership of productive capital show that at most five percent of the households in the United States own capital holdings capable of significantly adding to their incomes and providing sources of purchasing power for them.

Robert A. Lampman, THE SHARE OF TOP WEALTH-HOLDERS IN NATIONAL WEALTH, 1922-1956, National Bureau of Economic Research.

Jean Crockett and Irwin Friend, "Characteristics of Stock Ownership", PROCEEDINGS OF THE AMERICAN STATISTICAL ASSOCIATION, Business and Economic Statistics Section, 1964, pp. 146-168.

Herman P. Miller, RICH MAN, POOR MAN, Thomas Y. Crowell, New York, 1964.

Ferdinand Lundberg, THE RICH AND THE SUPER-RICH, Lyle Stuart, Inc., New York, 1968.

The studies by the Stock Exchange showing quantitatively the number of families who own equity stock are not in conflict with the qualitative studies.

McClaughry Associates, Inc., EXPANDED OWNERSHIP, the Sabre Foundation, Fond du Lac, Wisconsin, 1971. At pp. 101-198 is a comprehensive survey of the studies on "The Distribution of Wealth in the Twentieth Century", by Professor James D. Smith of the Pennsylvania State University. All of the studies surveyed confirm the general accuracy of the Lampman analysis.

STOCK OWNERSHIP: CHARACTERISTICS AND TRENDS, by Marshall E. Blume, Jean Crockett and Irwin Friend, Working Paper No. 12-74, published by the Rodney L. White Center for Financial Research, University of Pennsylvania, The Wharton School. This study confirms the findings of the earlier studies.

IF WE ARE TO PRESERVE PRIVATE PROPERTY IN THE OWNERSHIP OF CAPITAL, RADICAL CHANGES IN OUR TECHNIQUES OF FINANCING MUST BE MADE.

If the means of production are to be privately owned, it is elementary that every household must own either one or both of the input factors. But technology is rapidly shifting the input burden to capital instruments while diminishing the relative productiveness, and in fact obsoleting increasing numbers of the labor force. The strenuous efforts of the economy to conceal this reality through government-subsidized production of non-consumer-destined goods and services (mostly military) are wearing thin, particularly in the face of growing resentment of poverty.

While labor power is almost universally distributed throughout the households of the economy, capital ownership is very narrowly held. Since private property functions in a private enterprise economy much like wiring in an electronic circuit, namely, to connect input to out-take, it is clear that the institution of private property must progressively disintegrate where a few of the households own the great bulk of the input factor, yet all must participate in out-take -- the distribution of purchasing power.

THE ECONOMY LOOKS TO WALL STREET FOR FINANCIAL LEADERSHIP, BUT WALL STREET FAILS IN THIS RESPECT.

Against this background of increasing capital productiveness and the failure of our financing techniques aggressively and logically to build millions of new capital-owning households, those financial institutions popularly called "Wall Street", led, in the minds of the American people, by the New York Stock Exchange, have failed to come forward with effective new ideas. In general, member firms of the New York Stock Exchange are engaged in bringing together the owners of existing capital (financial savings) and businesses which need to finance new capital formation in the time-honored and empirically discredited method described by Merwin Waterman in INVESTMENT BANKING FUNCTION in 1958. It takes no sophistication to understand that these methods are designed to give the owners of existing capital a monopoly of access to the ownership of newly-formed capital. They are techniques for concentrating the ownership of capital, rather than for building new capital-owning households in our economy. They are techniques for aggrandizing the productive power of those who already produce vastly more than they can or wish to consume, and systematically depriving the underproductive or the non-productive of the means of becoming economically productive and to so gain more purchasing power.

Glaring examples of steps towards concentration are added to the financial scene daily. Well in excess of a hundred billion dollars of newly-formed capital are put into place annually in the U.S. economy without adding significantly to the number of viable capital estates.

It seems unlikely that this disastrous course towards the destruction of the private property economy can be interrupted unless leadership in investment banking and in the securities industry champions new financing techniques more suited to the facts of life in an advanced industrial economy.

THE CONVENTIONAL ECONOMISTS HAVE FAILED UTTERLY EITHER TO SEE THE PROBLEM OR TO PROPOSE SIGNIFICANT SOLUTIONS.

This can be demonstrated no more effectively than by referring to Simon Kuznets' definitive book CAPITAL IN THE AMERICAN ECONOMY: ITS FORMATION AND GROWTH, published in 1961 by the National Bureau of Economic Research. In this volume, Dr. Kuznets (pp. 394-399) answers the question of why financing is necessary in connection with new capital formation by saying that it is because businesses have a need for capital instruments before they have saved the funds to buy and pay for them.

However, Dr. Kuznets is totally oblivious to the fact that in a private property industrial economy, all households and individuals have a need to own equity capital before they have saved the funds to pay for it. Indeed, they need to own equity capital <u>so that they can save the funds to pay for it</u>. Yet it takes no argument to demonstrate that while we have devised elaborate means for financing the purchase of consumer goods (which produce no marketable wealth and thus do not assist buyers to pay for their cost), we have virtually no techniques for financing the purchase by individuals of newly-issued equity securities, although new capital formation which takes place under reasonably competent management does normally produce income in amounts sufficient to pay for stock representing it.

TECHNIQUES FOR SIMULTANEOUSLY PROVIDING THE MEANS OF FINANCING CORPORATE GROWTH AND THE MEANS OF FINANCING FAMILIES AND INDIVIDUALS TO BECOME OWNERS OF VIABLE CAPITAL ESTATES ARE URGENTLY NEEDED. THEIR EMPLOYMENT ON A BROAD SCALE WOULD VASTLY INCREASE THE BUSINESS OF THE REGISTERED SECURITIES EXCHANGES AND THEIR MEMBERS.

The techniques outlined in the second half of TWO-FACTOR THEORY: THE ECONOMICS OF REALITY are responsive to this need and are receiving increasing attention and approval by businessmen, investment bankers, commercial bankers and political leaders. They are being successfully used in hundreds of corporations. They unquestionably can be supplemented and refined by members of the financial community. This study and refinement, and the development of action programs to begin large scale employment of such new techniques in the business community, must be initiated by aggressive leadership from within the financial and business communities and from within labor.

Less than 5 percent of new capital formation taking place in the American economy over the past ten years was financed by the issuance of equity securities. If 50 percent or 75 percent of such corporate growth had been financed through the issuance of equity securities in such manner as to make millions of new capital-owning families, the business of the New York Stock Exchange and the other registered exchanges, and of their members, would be vastly increased. A second means of engaging in production and a second source of income would be possessed by these millions, and the general health of our political economy would be immensely improved.

SPECIFIC COMMENTS AND SUGGESTIONS ON THE ORIGINAL TEXT OF H.R. 3056

Where it appears that it would be helpful to the Committee, reference will be made to the page and line of the Bill as referred to the House Committee on Small Business.

1. I would recommend to the Committee that it take the broadest view of the means by which the Small Business Administration can facilitate the growth and prosperity of businesses falling within the defined categories of "small business". Countless instances exist where small businesses do not have access to adequate capital funding for proper growth, even though they may be profitable, not threatened with closure, liquidation, or relocation. It is at least as important to build employee ownership in prosperous businesses as it is in those which are under threat of being shut down or relocated. This is implicit in the two-factor economic analysis of our economy. Preventive economic assistance by the Small Business Administration, in an economy where access to capital for growth is normally inadequate for small businesses as a whole may be far more effective, and certainly just as important, as emergency assistance from the Small Business Administration to small businesses in distress. Thus the initial statement of the purpose of the Bill could be broadened to reflect that it is the purpose of Congress that the Small Business Administration shall, within the existing scope of its authority, give either equal priority, or perhaps a higher priority, to ESOP financing of small businesses otherwise eligible for assistance because such financing simultaneously promotes the growth and financial health of the businesses involved and builds tax-sheltered equity ownership into their employees.

2. I would recommend to this Committee that it face up, in considering H.R. 3056, to the fact that there is but one workable method by which all employees of a business can acquire significant stock ownership in that business, and that technique is ESOP financing. The entire experience of the past decade has demonstrated that, and common everyday knowledge equips us all to know that:

- The overwhelming majority of employees have no after-tax savings which they can invest in productive capital. This unfortunate fact of life becomes more evident day-by-day as employees are squeezed between rising taxes and rising costs of living;

- Only the ESOP gives employees access to credit, under conditions where such access motivates them to work harder, more productively, and more diligently,* to buy shares

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* The arresting truth of this comment is reflected in the results of a survey set forth in a letter to The Honorable Russell B. Long, dated April 17, 1979, a copy of which is attached hereto as Appendix VIII.

of stock in their employer and to pay for those shares out of the income produced by the equity capital (real capital) represented by the shares so purchased. This technique of financing works for employees who are normally living from hand to mouth because they can buy capital stock on terms where it finances itself, and can do so even more effectively because the ESOP operates on pre-tax dollars;

- The ESOP raises the productive power of the individual employee by equipping him with the ownership of productive capital, so that over a reasonable working lifetime, if the ESOP financing technique is consistently used, it is capable of building economic self-sufficiency into the employee by his retirement age;

- Neither pensions nor profit sharing plans can accomplish this task, for they are not financing techniques at all. They are deferred compensation techniques and except for a minor amount of employer stock in which profit sharing plans may invest (at considerable risk to the plan fiduciaries), both profit sharing plans and pension plans are invested in secondary securities issued by other companies, governments, and so forth. Only in the case of the ESOP does the same dollar that builds financial muscle into the corporation, build ownership into employees, and at the same time gives the company access to the pre-tax dollar to finance its growth. Thus it is practical to say that in terms of employee economic security, and in terms of employer cost of that economic security, the ESOP is three times as cost-effective as either pension plans or profit sharing plans;

- References to "employee organizations" can be misleading and even disasterous, for they might be interpreted as permitting labor unions to obtain funding to buy stock of businesses through the Small Business Administration. It is not anti-union to say that labor unions should not acquire the ownership of capital stock in businesses with which they bargain collectively, but rather anti-collective ownership of capital. Individual ownership or individual beneficial ownership eventually becoming direct ownership upon separation, death, disability or retirement, by labor <u>union members</u> who are company employees is healthy. Collective ownership of company stock by unions with which those companies bargain is simply socialistic as are all other "collective" capital ownership schemes;

- There are other problems with the phrase "employee organizations". Three employees out of a total employee-body of 1,000 may form an "employee organization" by becoming a partnership. If the Small Business Administration finances that "employee organization", it will promote capital concentration rather than capital diffusion among all employees.

3. On Page 1 at Line 3, I would suggest the addition after the word "Employee" of the word "Stock", so that the sentence would read "That this Act may be cited as the 'Small Business Employee Stock Ownership Act'."

4. In Section 2 of the Bill and elsewhere in the Bill, I would recommend that the language be modified to enable the Small Business Administration to make loans to ESOPs of eligible small businesses whether or not those ESOPs own all of the stock of the particular enterprise. Employee ownership of stock is the important thing, not <u>total</u> employee ownership of the business. Successive loans by the Small Business Administration to the ESOP of a small business which is initially closely-owned by employees and/or non-employees will in time result in substantial employee ownership, and indeed may result in majority ownership and eventually total ownership. But I do not see any justification for limiting the clear benefits of the Act to instances where the employees, through an ESOP, own a business in its entirety.

5. So far as the motivational impact of an ESOP is concerned, the evidence is that such ownership merely needs to be "substantial" under the circumstances, whether or not it is total, or ever will be total. See, for example, the letter from Kelso & Co., Incorporated to Senator Russell Long dated April 17, 1979, to which is attached the results of a survey of the effect of ESOP financing in more than a score of companies to increase productivity, increase sales, increase government tax revenues notwithstanding the deductibility of payments into the ESOP's trust, etc. (Appendix VIII). This comment is applicable to Subparagraphs (1), (2), (3) and even (4) of Section 2 on Page 2 of the Bill. Let me illustrate the point by saying that we have used ESOP financing, in combination with purchase of a portion of a business by a venture capital supplier to acquire a spin-off subsidiary from a larger enterprise. Again, it is only important that the employee ownership be "substantial" under the circumstances, even though it may not be total. Furthermore, when the venture capital supplier wishes a market for his stock, the ESOP, if installed by a properly qualified and knowledgable investment banking firm, will be funded to solve that liquidity problem and provide an effective or even superior market, even though there is no public market for the firm's stock.

6. In connection with Subparagraph (5) of Section 2 of the Act, at the bottom of Page 2 and top of Page 3, this very sound declaration amounts in effect to saying that preventing poverty, like preventing disease, is better than medicating it after it has arisen.

7. While I can appreciate that this Committee is not the proper forum in the House of Representatives to deal with anti-trust matters, I wish to say that I thoroughly agree with Subparagraph (6) of Section 2 of the Bill. I am also aware that the members of this Committee are not without influence in the House of Representatives and I recommend their use of that influence to bring about modification of the anti-trust laws to make certain that in the case of every government-ordered divestiture, whether it be under

the anti-trust laws, the Federal Trade Commission Act, or under various other laws providing for divestitures, the employees be given every opportunity, including all reasonable governmental assistance, to buy such divested assets in preference to all other buyers, using ESOP financing for the purpose to assure that it is made for the benefit of all employees, and done in the most financially efficient manner. Please refer to the memorandum attached hereto as Appendix IX.

8. I would recommend that the phrase "other employee organizations" be deleted from Lines 15 and 16 on Page 3 of the Bill for the reasons mentioned in Comment 2 above.

9. I would suggest substitution for the phrase "employee organizations" in Line 19 on Page 3 of the Bill the word "employees". See Comment 2 above.

10. I suggest deletion from Lines 1 and 2 on Page 4 of the Bill of the phrase "or any employee organization,". See Comment 2 above.

11. Among those who are not technically steeped in the law as well as the lore of two-factor economics and ESOP financing, it is often overlooked that the word "plan" includes the trust of the plan as well as the formal plan itself. Thus it is both unnecessary and confusing to refer independently to the "employee stock ownership trust" or "ESOT" except in rare instances where the comprehensive term will not suffice and it is intended to refer to the trust alone and independently of the plan. For this reason, the word "an" in Line 12 on Page 4 might be stricken and the word "such" inserted, and the last word "trust" be stricken and the word "plan" be substituted.

12. For reasons noted above, I would suggest the modification of Subparagraph (c) of Section 3, Lines 13 through 20 on Page 4 of the Bill, along the lines of the following:

> "It is the final purpose of this Act to assure that the Small Business Administration shall guarantee loans to firms that are employee-owned through employee stock ownership plans, or to firms in which employee stock ownership plans have or are designed and intended to have a substantial stock interest *** ."

13. I would suggest the deletion of Subparagraph (A), Lines 24 and 25 on Page 4 and Lines 1 through 3 on Page 5 of the Bill. There simply is no proper "employee organization" other than the ESOP that can function equitably for the purpose of enabling employees to buy a business or an interest in a business. The ESOP assures broad employee ownership, because the comprehensive and long tested rules and regulations of the Internal Revenue Service and the provisions of the Internal Revenue Code so require. See Comment 2 above.

14. I would recommend the deletion of the words "full-time" from Line 4 on Page 5. While the extensive provisions of the Internal Revenue Code, ERISA, and the regulations of the Treasury Department and the Department of Labor thereunder both permit the exclusion of part-time employees from an ESOP, they also permit the inclusion of part-time employees in an ESOP, and many firms have found it extremely beneficial and advantageous to have part-time employees, who nevertheless may be long term employees, included in their ESOP.

15. I would suggest that the words beginning with the word "which", in Line 17 on Page 5 of the Bill to the end of that paragraph, be added at the end of Paragraph (C) in Line 11 on that page. I would suggest further that, because of confusion arising from the Revenue Act of 1978 (see Section 409A(a) of the Internal Revenue Code) there be added at the end of the revised Paragraph (C) the words "but excluding ESOPs as defined in Section 409A(a) of the Internal Revenue Code." I would then strike the remainder of Subparagraph (E), Lines 14 through 17 from Page 5, and change the numbering of the following subparagraphs.

16. In Line 4 on Page 6 of the Bill, I suggest striking the word "ESOT" and substituting "its ESOP", and striking the words "or employee organization".

17. I would suggest changing "ESOT" in Line 5 on Page 6 of the Bill to "ESOP" and making the same change in Line 7 on Page 6 of the Bill.

18. Following Line 9 on Page 6 of the Bill, I would suggest adding a new Subparagraph which, after renumbering subparagraphs as suggested above, would become Subparagraph (G) and would therein define "substantial employee stock ownership" in a business to be as determined by rules and regulations adopted for that purpose by the Administrator, or by special rulings of the Administrator where necessary. The problem here is that "substantial employee stock ownership" may have a radically different meaning from business to business, depending upon the characteristics, size, and other aspects of the business.

19. I would suggest striking from Lines 11 and 12 on Page 6 of the Bill the words "employee organizations" and inserting in lieu thereof the words "small businesses in general".

20. I would substitute the word "plans" for the word "trusts" in Line 13 on Page 6 of the Bill. In Line 16 on Page 6, before the first word "shall" I would suggest inserting the words "or businesses having substantial employee stock ownership through an ESOP".

21. In Line 21 on Page 6 of the Bill, I would suggest substituting the word "plan" for the word "trust".

22. In Line 25 on Page 6, I would suggest substituting the word "ESOP" for the word "ESOT".

23. I would suggest substituting the word "ESOP" for the word "ESOT" in Lines 2, 3, 4, 5, 9, and 24 on Page 7 of the Bill.

24. I would suggest the striking of the Subparagraph contained in Lines 9 through 12 on Page 7 of the Bill. The fact of the matter is that the Internal Revenue Code, ERISA, and the regulations of the Internal Revenue Service and the Department of Labor already over-regulate the vesting of ownership under ESOPs. Those regulations achieve a fair and just result, and any attempt to synchronize a vesting schedule tied into Small Business Administration financing, which may be mere supplemental or additional financing, would create chaos.

25. I would strike Subparagraph (iv) in Lines 13 through 22 on Page 7 of the Bill. Experience in working on several hundred ESOPs has convinced me that, while large disparities of salary range between management and sub-managerial employees are undesirable, it is equally undesirable that employees of a business not be deprived of the opportunity to acquire ownership merely because a highly paid manager, who has the power to make the decision as to whether ESOP financing shall be used or not, has half or more of his salary excluded. More damage is done by causing him to decide "no ESOP" than is done by giving him more shares of stock than he properly should have. There are other ways of getting at this problem. See, for example, Section 416(c)(7) in H.R. 462 from the 94th Congress, Appendix X hereto.

26. The sentence at the bottom (Line 25) of Page 7 of the Bill seems to be unfinished. I would suggest striking the period and adding the words "of stock of the employer small business concern."

27. I would suggest striking from Lines 2 and 3 on Page 8 of the Bill, the words "and using an ESOT".

28. I would suggest adding in Line 4 on Page 8 of the Bill, following the letter "a" the words "for such employees a substantial stock interest in a".

29. I would suggest striking the paragraph appearing in Lines 8 through 12 inclusive on Page 8 altogether. See Comment 1 above.

30. In order to synchronize the benefits of an ESOP for non-union employees with the benefits achieved by unions where they have collectively bargained for a pension or profit sharing plan, it is normally necessary to use what is known as an "off-set" clause. The effect of this clause is to reduce the stock allocation under the ESOP for a union employee by the exact amount which is allocated to him in his union plan that has been collectively bargained. Thus the union membership does not thereby give him an advantage over the non-union employee. This might be done at the end of the paragraph ending in Line 24 on Page 8 of the Bill by adding the words "provided, however, such ESOP may provide for a reduction in allocations to employees represented by a collective bargaining unit in proportion to the benefits allocated to such employee under his collectively bargained benefit plan."

31. I would suggest striking the paragraph appearing in Lines 1 through 7, inclusive, on Page 9. This is a subject which is elaborately regulated by the Internal Revenue Code, ERISA, regulations of the Internal Revenue Service and by the Department of Labor. It is already over-regulated, and nothing but chaos could arise out of attempting to synchronize the present clause with those already frozen into law.

32. Similarly, I would suggest striking the clause appearing between Lines 8 and 10, inclusive, on Page 9 of the Bill. This provision could in many instances prove unduly burdensome, without adding any advantage. Businesses need flexibility in being able to select new managers where some emergency in management has arisen. But the exclusion of a proper manager on the ground that he has not been in the business for a year may in fact prevent his being hired notwithstanding his qualifications.

33. I would suggest striking the paragraph appearing between Lines 20 through 24, inclusive, on Page 9 of the Bill. The question of voting rights and of vesting is another one of those already over-regulated subjects.

34. Subparagraph (ii) in Lines 1 through 3, inclusive, of Page 10 would seem to me to be surplusage. Sections 54.4975-7(b)(10-12) of the regulations of the Internal Revenue Service under Section 4975 of the Internal Revenue Code already requires a put for employee participants in closely-held companies where the stock is not publicly marketed, and leaves the employee free to take his chances on the public market where public stock trading is available. This seems to be adequate, and additional regulation would make ESOPs difficult to design for Small Business Administration financing.

35. Similarly, I would suggest striking Subparagraph (iii) from Lines 4 through 7 of Page 10 of the Bill. Manager-employees should manage, and non-manager employees should be beneficial owners, but should not interfere with management. Amateur management is the last thing such a concern needs. The difficulty with European type co-determination plans is that they inject amateur management into business corporations, and therefore add enormous confusion to the business scene.

36. For reasons often discussed above, I would suggest striking the words "or employee organization" from Line 18 and 19 of Page 10.

37. I would suggest striking the word "both" from Line 1 on Page 11 and the words "and personal assets" from Line 2 on Page 11. The function of the corporate form of doing business is to prevent personal liability of stockholders and employees. No positive good can come from imposing personal liability on managerial employees.

38. The word "becoming" seems to be missing between the words "upon" and "independently" in Line 17 on Page 11 of the Bill.

39. I would suggest striking Section 5 of the Bill appearing

between Line 21 through 25 on Page 12 of the Bill and on Page 13. The subject of fair employment practices is already over-regulated by other agencies of the government, and this section can only add confusion and frustration to the picture.

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

April 17, 1979

The Honorable Russell B. Long
United States Senator
217 Russell Senate Office Bldg.
Washington, D.C. 20510

RE: The Russell Long Study of ESOP Company Results

Dear Senator Long:

Results are in from 22 corporations out of our first pilot mailing to 30 corporations carefully selected to reflect a cross section of our ESOP company clients by sales volume, number of employees, and type of industry. We will be sending out a general mailing to the rest of our clients who have had plans installed and operating long enough to provide us with realistic results to add to the survey. This survey shows that your initial thoughts are correct: ESOPs are not a revenue drain on the Treasury -- they help offset deficits, they don't create them! Also, these plans have increased productivity in the companies surveyed and this is the best way to fight inflation. The ESOPs also created tax sheltered capital for these companies to use in increasing employment opportunity -- and this saves our government money and reduces transfer payments.

Key conclusions (average ESOP life 3.3 years):

1. Federal taxes paid (up $24,419,000) -- 112% increase.
2. Productivity per employee -- 38% increase.
3. Total sales -- 67% increase.
4. Corporate profits -- 125% increase.
5. Number of people employed -- 30% increase.

Average results (22 survey companies):

	Annual Sales	Employees	Productivity
Pre-ESOP	$20,858,000	333	$76,545
Post-ESOP	$34,597,000	433	$104,864
Increase	+67%	+30%	+38%

	Average Annual Pre-Tax/Pre-ESOP Income	Average Annual Taxes Paid
Pre-ESOP	$699,000	$300,000
Post-ESOP	$1,574,000	$636,000
Increase	+125%	+112%

111 PINE STREET, SAN FRANCISCO, CALIFORNIA 94111 [415] 788-7454

The survey covered private companies which have had an ESOP for an average of 3.3 years and, in the aggregate, had annual sales prior to the ESOP installation of $458,880,000. Today's annual sales are $761,136,000. Most of these companies have been in business for over 30 years; four for over 50 years; one for over 80 years; six have been in business for 10 years or less. These companies employed 7,323 employees prior to the ESOP installation and now employ 9,529 people. The average annual sales per employee (productivity) were $76,545 prior to the ESOP installation and are $104,590 now. The companies had profits in the period prior to the ESOP installation of $50,775,000 compared to $114,314,000 since then and in the same period. They paid taxes in the period prior to the ESOP of $21,777,000 and $46,200,000 after.

These companies range in current sales from $4,174,000 to $157,000,000; from 35 employees to 1,500; from $152,500 annual profits to $10,033,000.

The companies represented in our pilot survey are in the following fields of endeavor:

Manufacturing	Retail/Wholesale	Other
Paper	Food	Media Sales
Telecommunications	Cameras	Construction
Graphic Arts	Furniture	Trucking
Furniture	Automobiles	Hospital
Sash and Doors	Home Building Supplies	Drilling Equipment
Mirrors		Wholesaler
Paint		General Wholesaler
Plastics		Appliance
Saws		Distributor
		Food Processor

The combined additional revenue to the Treasury from corporate taxes (and capital gains taxes paid by shareholders selling to the ESOP) was $24,423,000 -- an average of $1,110,000 per company over a period of 3.3 years -- and this doesn't include participants' taxes. However, the value of shares has been substantially enchanced due to the increased profitability and net worth created by corporate stock sales to the ESOP plus larger after-tax accumulated earnings.

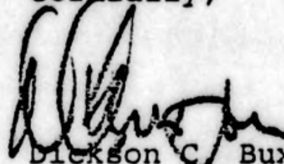
The stockholders have a continuing market for their shares and all employees have a vested interest in maintaining and building stock values for their own self-interest. This obviously works for the mutual benefit of all shareholders -- ESOP participants and others.

We will have additional information to you soon on the amount of stock in the accounts of the 9,529 people who work for these 22 pilot

survey companies; the percent this constitutes of the total fair market value of the companies; the projected value of employee accounts; and the additional revenues this will provide our Treasury. Also, the average number of years these companies have been in business prior to the ESOP installation.

Thanks, again, for the leadership you have given the Employee Stock Ownership concept. At last count, there were over 3,000 companies that decided to spread their capital base. There are still thousands more companies in our country large and stable enough to adopt ESOPs. Your new proposed legislation will be helpful in encouraging the formation of new plans for these companies.

Cordially,



Dickson C. Buxton
Chairman of the Board

DCB:ch
Encls.

CO.	Yrs. With ESOP	SALES ($000) Pre ESOP	Post ESOP	Incr.	%	NO. EMPLOYEES Pre ESOP	Post ESOP	Inc.	%	SALES PER EMPLOYEE ($000) Pre ESOP	Post ESOP	Inc.	%	PRE-TAX PROFITS ($000) Pre ESOP	Post ESOP	Incr.	%	TAXES PAID ($000) Pre ESOP	Post ESOP	Incr.	%
Group I																					
1	4	117,385	157,075	39,690		812	967	155		145	162	17		14542	23662	9120		7262	12835	5573	
2	5	51,239	124,386	73,147		937	1508	571		55	82	27		6214	15792	9578		2105	5544	3439	
3	2	42,268	87,500	45,232		767	1308	541		55	67	12		2469	20067	17598		850	6883	6033	
4	1	58,228	60,934	2,706		779	779	0		75	78	3		(3191)	1729	4920		(1595)	727	2322	
5	2	27,056	39,293	12,237		856	1016	160		32	39	7		1457	4728	3271		219	1463	1244	
6	3	29,935	35,381	5,446		173	204	31		173	173.4	.4		2121	2498	377		1021	876	(145)	
7	3	19,163	31,622	12,459		289	315	26		66	100	34		4060	6814	2754		2017	2931	914	
Subtotal		345,274	536,191	190,917	+55%	4613	6097	1484	+32%	86	100	14	+16%	27672	75290	47618	+172%	11879	31259	19380	+163%
Group II																					
8	7	8,994	28,634	19,640		361	447	86		25	64	39		6573	11836	5263		2884	5855	2971	
9	3	12,000	24,000	12,000		460	615	155		26	39	13		3045	1660	(1385)		1365	443	(922)	
10	5	5,000	23,300	18,300		68	175	107		76	161	85		1332	4532	3200		609	1766	1157	
11	3	11,524	21,105	9,581		62	89	27		186	237	51		1817	3085	1268		744	1248	504	
12	2	13,060	20,361	7,301		250	271	21		52	75	23		355	2331	1976		139	605	466	
13	2	9,535	16,042	6,507		441	618	177		22	26	4		433	1097	664		273	290	17	
14	7	6,396	16,015	9,619		90	180	90		71	89	18		2834	2143	(691)		1134	322	(812)	
Subtotal		66,509	149,457	82,948	+125%	1732	2395	663	+38%	65	99	33	+52%	16389	26684	10295	+63%	7148	10529	3381	+47%
Group III																					
15	3	11,213	14,572	3,359		459	400	(59)		24	36	12		1820	2599	779		618	507	(111)	
16	2	9,000	12,600	3,600		92	103	11		97	122	25		190	305	115		60	125	65	
17	3	7,343	11,209	3,866		85	91	6		86	123	37		1351	2487	1136		643	1098	455	
18	3	4,802	10,199	5,397		28	35	7		171	291	120		281	474	193		134	173	39	
19	4	4,985	8,601	3,616		172	217	45		29	40	11		1699	3101	1402		805	1016	212	
20	4	4,590	7,820	3,230		42	50	8		109	156	47		511	979	468		219	322	103	
21	4	1,851	6,313	4,462		30	55	25		62	115	53		562	1526	964		176	827	651	
22	2	3,313	4,174	861		70	78	8		47	54	7		330	869	539		99	344	245	
Subtotal		47,097	75,488	28,391	+60%	978	1029	51	+5%	78	117	39	+50%	6744	12340	5596	+83%	2754	4412	1658	+60%
TOTAL		458,880	761,136	302,256	+67%	7323	9521	2198	30%	77	106	29	+38%	50805	114314	63509	+125%	21781	46200	24419	+112%

COMMENT

Company 9: The company changed accounting methods, from Fifo to Lifo in 1976, the same year the ESOP was installed. If they had remained on the Fifo method of accounting, the pre-tax profits and total taxes would have been virtually the same in the three years after the ESOP was installed compared to the three years prior to the ESOP installation.

Company 14: This company added 90 employees and 17 outlets in 6 years. All profits went to pay off ESOP loans to acquire the company and expand operations through acquisition of outlets. Profit this year is expected to be over $1,000,000, as the loan is now paid off and expansion complete. 180 people own over $2 million of stock fully paid for.

Company 15: This company is unionized and in an industry that has been hit hard by strikes. Many companies in that field in that state are out of business - the union payroll was covered and the company is still in business.

Notes from Dickson C. Buxton:

Two companies declined to provide information but their Chief Executive Officers called me. In each case, their industry has been in serious trouble for the past 3 or 4 years and, although sales and productivity had increased, their prices had to be cut to stay in business and they paid far less taxes since the ESOP than in prior years. Their payrolls were the same and I asked why they hadn't laid off people to make a profit -- they said this was not their way of reacting to poor business conditions. One company had sold stock to the ESOP to get working capital to keep people employed! The other had paid off an ESOP loan which had been made 5 years ago to acquire 20% of the company stock from a large stockholder to the ESOP set up for their 1,000+ employees. This company is the largest of its kind in America (and very stable). When prices in their field (agriculture) are up again, their profit and taxes will be back up.

I have heard from executives in most of the other companies, and they report that results will be provided as soon as they are compiled -- they will be added in an update to this survey.

WE SHOULD AMEND THE ANTI-TRUST LAWS TO PROMOTE EMPLOYEE OWNERSHIP OF PRODUCTIVE CAPITAL

There is an area in the administration of our anti-trust laws that could, by a very simple amendment, cause most divestiture orders or consent decrees to contribute materially to the broadening of the capital ownership base of our economy, rather than to merely change the names of the concentrated owners, as happens under the present administration of these laws.

In 1958, Dr. Mortimer J. Adler and Louis O. Kelso published THE CAPITALIST MANIFESTO. In that book (see pp. 195 et seq.), Adler and Kelso mentioned the fact that, once one understands two-factor theory, it is clear that the most basic kind of monopoly power that can exist in an industrial society is the monopolization of the power to produce wealth, i.e., the accumulation by particular consumer units (families or individuals) of productive power through capital ownership in excess of what they can actually use, with a reasonable margin for safety, to support the lifestyle they desire to adopt. Our anti-monopoly laws are all designed to control or punish an individual company or collaborating group of companies that gets an excessive share of the market, because then the law of supply and demand will not work objectively and effectively to determine prices impartially. There is no explicit recognition under our anti-trust laws of the concentration of the power to produce wealth, which inevitably leads to the dependence of the many upon the few and all of the disenchanting ways in which that dependence expresses itself, and is dealt with.

It would seem that one of the most effective ways of speedily broadening the capital ownership base and, in the course of doing so, to expedite the enforcement of the anti-trust laws, would be amendments to the several anti-trust laws, of such nature that wherever divestitures are ordered or are voluntarily agreed to, the divested assets would be sold to the employees wherever feasible, even if feasibility required the seller to carry the credit on a long term, low interest basis as punishment for violating the anti-trust laws.

As we have repeatedly shown, the totality of conventional financing techniques are designed to make the rich ever richer, and are not designed to make the poor richer. All of the governmental and private programs inspired by the existence of poverty attack only the effects of poverty and never its cause. People are poor because they are not rich, i.e., they do not possess holdings of productive capital to add to the productiveness of their labor power if, indeed, there is a market for that labor power. This phenomenon is the result of various laws in the field of banking, securities and related fields. It is also a product of the laws relating to finance, banking, investment banking, and the practices of financial law firms, the financial accounting professions, etc. Since our Constitution purports to assure to all citizens equal protection of the laws, it is perfectly clear that, if people are morally expected to be economically self-sufficient and to produce what they want to

consume, the laws do not equally protect the rich and the poor. The whole massive machinery of business finance is operated squarely in the teeth of the idea of equal opportunity of the poor to acquire capital as compared with the opportunities of the rich to acquire more capital. There is a great inequality in the laws which makes it easy for the rich to increase their economic productiveness through capital ownership, and makes it virtually impossible for the poor to increase their productiveness by acquiring capital ownership.

Kelso & Co., Incorporated has developed the financing techniques by which employees of corporations are given access to the logic of corporate finance traditionally used by business itself. This is the opportunity to buy stock in a tax sheltered Employee Stock Ownership Plan (ESOP) and to pay for it out of the pre-tax yield of the capital represented by the stock so purchased. These techniques enable the poor legitimately to become economically self-sufficient over a reasonable working lifetime. Carried to its ultimate, this technique would eliminate the need for welfare or for Social Security, would accelerate the rate of economic growth, and would reverse inflation and bring about benign, gentle and regulated deflation.

The point may be illustrated with two examples:

Peabody Mines

Kennecott Copper Company, under a divestiture decree, was ordered to sell Peabody Mines, the largest coal mines in the United States, with holdings in several foreign countries. Kelso & Co., Incorporated did a preliminary feasibility study showing that through ESOP financing, the more than 100,000 employees of Peabody Mines could buy that giant asset from Kennecott Copper Company, pay the same price which it would receive from other bidders, and set an enormous example of the broadening of capital ownership and the beginning of a major solution to the economic ills of our economy. Kennecott Copper bluntly refused to study a carefully prepared proposal to this effect, and sold the asset for somewhat over a billion dollars to a group of six or seven giant conglomerates, thus perpetuating the concentration which the government had sought to terminate by the antitrust suit.

The Avis Case

Kelso & Co., Incorporated did an elaborate feasibility study demonstrating that the 70,000 or so employees of Avis could, through a properly designed ESOP, purchase, at market price, the 47 percent of the stock of Avis held by Richard Joyce Smith as trustee under an order of the Federal District Court to dispose of the stock in a way that would not upset the market. We ascertained that the financing to accomplish this transaction was available. Nevertheless, Richard Joyce Smith arrogantly refused to be deterred from his dribbling of the stock into the market through periodic public sales until Dave Mahoney, Chairman of Norton-Simon, Inc., came along and offered him a price well above the market. BARRON'S MAGAZINE, in a most precipient article, described the transaction under a heading entitled "Avis Comes Full Circle", meaning that after spending mil-

lions of dollars in an anti-trust suit against ITT, Avis had passed from one giant conglomerate into another giant conglomerate, and the government's work was automatically undone. Avis, which has incessantly advertised that its personnel "Try Harder" would, had we succeeded, have finally put their employees in a position where they would in fact have a reason to try harder.

Louis O. Kelso
President and Chief Executive Officer
KELSO & CO., INCORPORATED

APPENDIX X

United States of America

Congressional Record

PROCEEDINGS AND DEBATES OF THE 94th CONGRESS, FIRST SESSION

Vol. 121 WASHINGTON, TUESDAY, JANUARY 14, 1975 No. 1

House of Representatives

H.R.462

INTRODUCTION OF THE ACCELERATED CAPITAL FORMATION ACT OF 1975

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from Minnesota (Mr. FRENZEL) is recognized for 30 minutes.

Mr. FRENZEL. Mr. Speaker, I rise today to introduce the Accelerated Capital Formation Act of 1975. This is a refined version of H.R. 8590 which I introduced in the 93d Congress.

During the last session a great deal of progress in advancing the financing method known as ESOP or the employee stock ownership plan was made. A provision for study of the ESOP plan in restructuring the Penn Central and other Northeast and Midwest railroads was included as a vital section of the Railroad Reorganization Act. In the Pension Reform Act, signed into law last Labor Day, the ESOP was given special recognition as a form of employee benefit that could also be used to attract outside financing to meet the capital requirements of an expanding enterprise. In the Trade Reform Act companies utilizing ESOP will be given special preferences in the $1 billion program of federally guaranteed loans to companies expanding or locating in areas adversely affected by foreign competition. There were at least three other major pieces of legislation being considered in the 93d Congress which, though they did not reach the floor, contained ESOP provisions; these were railroad improvement loans, energy development and the Pan Am Assistance Act.

Though a great deal of progress has been made in recent years many people have questioned just what an ESOP does. Essentially, under existing law, the ESOP makes accessible to all corporate employees the techniques of corporate finance. Without any actual cash outlay from corporate employees—as in conventional employee stock purchase programs—and without any deduction in take-home pay or fringe benefits an ESOP builds blocks of corporate shares into employee ownership while providing moneys necessary for capital requirements. It has been used to finance corporate expansion, acquire new assets, accomplish divestitures or spinoffs and finance mergers, et cetera.

A standard ESOP incorporates a deferred compensation trust—technically a qualified stock bonus trust alone or coupled with a money purchase pension trust—into the financing process itself. In one common technique the employees trust borrows funds to invest in the employer corporation. This then allows the affected employees, subject only to the trusts paying off the loan, to become beneficial owners of the companies' stock.

The employer corporation obligates itself to make annual payments into the trust in amounts sufficient to amortize the debt out of tax deductible dollars.

The tax deduction makes it possible for the corporation to build greater capital ownership into the employees than it could otherwise, and the costs of financing its growth is about the same as if it conveniently borrowed and repaid—as to principal—in after-tax dollars. After the employers stock has been paid for in this manner the trust can, if desired, be diversified by tax-free exchanges of stock for other securities, or by a public offering out of trust.

This ESOP method, simply stated, allows greater benefits to the corporation than common expansion and financing techniques and permits the employee to gain a larger share of the organization he serves than conventional profit-sharing methods.

The first known use of ESOP financing, pioneered by Louis Kelso, involved an employee buy-out of a chain of California newspapers that was threatened with takeover by a major chain in 1956. But only in the last few years has the business world at large become aware of this innovation. A number of investment banking firms are pioneering this approach and several major firms have begun to recommend ESOP's to their clients. Over 100 corporations have, largely in the last year, adopted ESOP's including two of our larger electronic manufacturers. Many smaller firms and several major unions have adopted ESOP's.

In order to facilitate the use of the ESOP technique, and thus effectively link daily employee performance with the growth and operation of a business, the bill modifies the Internal Revenue Code as follows:

First, the bill removes the present statutory limitation of 25 percent of covered compensation as the maximum amount an employer can contribute to a qualified employee stock ownership plan when such payments are used to enable the plan to repay stock acquisition debt incurred in connection with meeting the employer's capital requirements. This places the sole limitation on financing contributions on the enterprise's capacity to service the debt out of cash flow. This reform reduces the cost of capital growth and transfers in the ownership of corporate assets, while accelerating the rate at which employees as individuals and as a group can accumulate stock of their employer and other income-yielding assets as a new and noninflationary form of employee benefit. Although treated as a tax deduction, this change would have the same impact as an investment tax credit in terms of encouraging capital spending; however, the investment tax credit increases the concentration of corporate ownership while ESOP contributions correct this economic factor.

This also rechannels corporate profits that would otherwise have gone into the corporate income tax base into productivity increases of the private sector, thus generating lower prices for consumers, expanded private payrolls, and a broadening base of taxable personal incomes and personal estates among productive workers.

Second, the bill provides a tax deduction to corporations for the amount of dividends they distribute either directly as taxable second incomes on stock held in an employee's account or which are used to repay stock acquisition indebtedness of the employees' trust. This provision also converts taxable corporate income into either taxable dividend incomes for employees to supplement their paychecks or their retirement and social security incomes or a more rapid rate of accumulation by employees of individual capital estates for their retirement security.

Third, the bill provides that a qualified employee stock ownership plan and trust shall have the tax characteristics of a charitable organization for purposes of estate, gift, and income taxes. This would encourage affluent taxpayers to make gifts to qualified trusts in order to reconnect the ownership of capital with a broader base of private individuals, namely productive employees some of whom have contributed to the building of the donor's wealth. Allocations to participants of the trust would become an immediate source of taxable second incomes—to the extent dividends are passed through the trusts—and a retirement estate for the employee-beneficiaries and their heirs. On the other hand, Government would lose no tax revenues since such contributions made to charitable organizations are already exempt from taxation, and profits from donated income-producing property are frequently accumulated tax-free within such organizations.

Fourth, the bill establishes a cutoff on further contributions in behalf of any employee when the value of the assets that employee has acquired during his working lifetime through one or more ESOP's exceeds $500,000. Such a safe-

guard on excessive accumulations acquired through tax deductions would be especially important in highly capital-intensive industries and would help foster more widespread and equitable sharing of ownership among Americans generally.

Fifth, the bill adds to the options of ESOP participants when distributions are made when they retire, die, or are otherwise separated from service. Although profit sharing plans are permitted to make distributions in many forms, the Internal Revenue Service has ruled that distribution from an ESOP must be made exclusively in company stock.

Although enabling employees to accumulate sizable holdings of employer stock has obvious motivational value, when an employee leaves the company and can no longer directly influence the yield on the company stock accumulated in his ESOP account, it is desirable to provide the departing employee and the remaining employees, through their ESOP, to arrange an exchange for his accumulated assets with other income-yielding assets or cash of an equivalent value. This bill would provide ESOP's the same flexibility in making distributions that is now enjoyed by profit sharing plans.

Sixth, the bill permits a repurchase option for plans of enterprises that are wholly owned by their employees, so that stock of departing employees can remain exclusively held within the employee group.

Seventh, the bill exempts lump sum distributions of income-yielding estates derived from an ESOP from any form of taxation, provided the assets are held to produce a taxable second income for the taxpayer or his beneficiaries. However, if the assets are converted into spendable income and not reinvested within 60 days, the uninvested proceeds will be taxed as ordinary income, instead of partially at the lower capital gains rate permitted under present law.

Eighth, the bill enables affected parties to seek advance IRS opinions on valuations on stock or other assets acquired by an ESOP where the parties to a financing transaction which utilizes and ESOP would be subject to serious risks or penalties if the IRS, upon subsequent audit, disagreed with the valuations or other key features of the financing plan. This is similar to the "no action" procedures already instituted by the FTC and SEC.

Ninth, the bill exempts payments to an ESOP made for financing purposes from treatment as a conventional employee benefit for purposes of any wage, salary, deferred compensation, or other employee benefit controls or guidelines that might be established under executive order, regulations, or future economic stabilization laws at the Federal or State levels. Instead, it would be treated as any other form of capital spending that would have a counterinflationary effect. In effect, it offers labor a trade-off for wage increases where wage ceilings are established.

I hope that the members of this body will carefully consider the legislation. I am hopeful that further progress can be made in this session.

A copy of the bill follows:

H.R. —

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TITLE.—This Act may be cited as the "Accelerated Capital Formation Act of 1975."

SEC. 2. PURPOSE.—The purpose of this Act is to provide incentives for accelerated financing of the formation of U.S. corporate capital and to encourage voluntary means for broadly diffusing equity ownership among employees of U.S. enterprises both (a) with respect to existing capital by means consistent with the protection of private property and (b) with respect to newly formed capital by means which extend the logic of conventional business finance to corporate employees.

SEC. 3. AMENDMENT OF INTERNAL REVENUE CODE.—The Internal Revenue Code of 1954 is amended by adding the following new Section 416 at the end of Subpart B of Part I of Subchapter D of Chapter 1:

SEC. 416.—EMPLOYEE STOCK OWNERSHIP PLAN FINANCING.

(a) DEFINITIONS. (1) "Employee stock ownership plans" means a technique of corporate finance described in Section 4975(e)(7) that utilizes stock bonus plans, or stock bonus plans coupled with money purchase pension plans, which satisfy the requirements of Section 401(a) and are designed—

(A) to invest primarily in qualifying employer securities;

(B) to meet general financing requirements of a corporation, including capital growth and transfers in the ownership of corporate stock;

(C) to build into employees beneficial ownership of qualifying employer securities;

(D) to receive loans or other extensions of credit to acquire qualifying employer securities, with such loans and credit secured primarily by a commitment by the employer to make future payments to the plan in amounts sufficient to enable such loans and interest thereon to be repaid; and

(E) to limit the liability of the plan for repayment of any such loan to payments received from the employer and to qualifying employer securities, and dividends thereon, acquired with the proceeds of such loan, to the extent such loan is not yet repaid.

(2) For purposes of this section, the term "employer securities" means securities issued by the employer corporation, or by an affiliate of such employer.

(3) For purposes of this section, the term "qualifying employer securities" means common stock, or securities convertible into common stock, issued by the employer corporation, or by an affiliate of such employer.

(b) Special Deductions. (1) In addition to the deductions provided under section 404 (a), there shall be allowed as a deduction to an employer the amount of any dividend paid by such employer during the taxable year with respect to employer securities, provided—

(A) such employer securities were held on the record date for such dividend by an employee stock ownership plan; and

(B) the dividend received by such plan is distributed, not later than 60 days after the close of the plan year in which it is received, to the employees participating in the plan, in accordance with the plan provisions; or

(C) the dividend received by such plan is applied, not later than 60 days after the close of the taxable year, to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities.

(2) Notwithstanding the limitations of section 404(a), there shall be allowed as a deduction to an employer the amount of any contributions paid on account of a taxable years (as described in section 404(a)(6)) to an employee stock ownership plan, provided such contributions are applied to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities.

(3) For purposes of sections 170(b)(1), 642(c), 2055(a), and 2522, a contribution, bequest, or similar transfer of employer securities or other property to an employee stock ownership plan shall be deemed a charitable contribution to an organization described in section 170(b)(1)(A)(vi), provided—

(A) such contribution, bequest, or transfer is allocated, pursuant to the terms of such plan, to the employees participating under the plan in a manner consistent with section 401(a)(4);

(B) no part of such contribution, bequest or transfer is allocated under the plan for the benefit of the taxpayer (or decedent), or any person related to the taxpayer (or decedent) under the provisions of Section 267(b), or any other person who owns more than 25% in value of any class of outstanding employer securities under the provisions of Section 318(a); and

(C) such contribution, bequest or transfer is made only with the express approval of such employee stock ownership plan.

(c) *Treatment of Participants.* (1) Qualifying employer securities acquired by an employee stock ownership plan through acquisition indebtedness incurred by the plan in connection with the financing of capital requirements of the employer corporation or its affiliates must be allocated to the accounts of the participating employees to the extent that contributions and dividends received by the plan are applied to the payment of such acquisition indebtedness (including interest), in accordance with the terms of the plan and in a manner consistent with Section 401(a)(4).

(2) Upon retirement, death or other separation from service, an employee participating under an employee stock ownership plan (or his beneficiary, in the event of death) will be entitled to a distribution of his nonforfeitable interest under the plan in employer securities or other investments allocated to his account, in accordance with the provisions of such plan. If the plan so provides, the employee (or beneficiary) may elect to receive all or a portion of the distribution from the plan in—

(A) employer securities, other than qualifying employer securities;

(B) cash;

(C) a diversified portfolio of securities;

(D) a non-transferable annuity contract; or

(E) any combination of the above.

(3) An employee stock ownership plan may provide for the required repurchase of qualifying employer securities from an individual receiving a distribution thereof if all other of such outstanding employer securities, whether or not acquired through the plan, are subject to repurchase from non-employee shareholders under similar circumstances.

(4) Upon receipt of a lump sum distribution, as described in Section 402(e)(4)(A), from an employee stock ownership plan, an individual may exclude from gross income that part of the distribution which consists of employer securities or other assets, if income producing, held or reinvested within 60 days in income producing assets of equivalent value, for the purpose of providing the individual with dividends or other forms of realized income from such assets. Upon subsequent sale or disposition of any employer securities or other assets distributed by an employee stock ownership plan to the extent that proceeds realized from such sale or disposition are not reinvested within 60 days in income producing assets, the total amount of such proceeds (or the fair market value of any such securities or assets that are transferred without adequate consideration) shall be treated as ordinary income to the individual.

(5) An employee receiving a distribution under paragraph (b)(1)(B) of this Section shall be subject to taxation under Section 402(a)(1), and the provisions of Section 116 shall not apply to such distribution.

(6) A contribution by an employer which is deductible under paragraph (b)(2) of this Section, or a contribution described in paragraph (b)(3) of this Section, shall not be included in the meaning of annual addition under Section 415(c)(2).

(7) No contribution to an employee stock ownership plan may be allocated for the benefit of any participant if the value of the total accumulation of employer securities and other investments under the plan for the benefit of that participant equals or exceeds $500,000, less the amount of any such accumulation for that participant under any other employee stock ownership plans.

(d) *Special Provisions.* (1) The acquisition or holding of qualifying employer securities and the incurring of acquisition

indebtedness by an employee stock ownership plan shall be deemed to satisfy the requirements of Section 404(a)(1) of the Employee Retirement Income Security Act of 1974 provided that—

(A) the requirements of Section 408(b)(3) and 408(e) of such Act are satisfied; and

(B) the same standards of prudence and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied.

(2) Upon application by an employee stock ownership plan, the Secretary of the Treasury or his delegate shall issue an advance opinion as to whether a proposed transaction involving that employee stock ownership plan will satisfy all the requirements described in paragraph (1) of this subsection, and any such opinion shall be binding upon the Secretary.

SEC. 4.—*Effect of Economic Stabilization.*— Payments by an employer to an employee stock ownership plan as defined in Section 416(a)(1) of the Internal Revenue Code of 1954, for the purpose of enabling such plan to pay acquisition indebtedness incurred for the purchase of qualifying employer securities or other contributions to such plan shall not be treated as compensation, fringe benefits or deferred compensation payments for the purposes of any laws, executive orders or regulations designed to control, establish guidelines or otherwise stabilize employee compensation or benefits, but shall be treated as the equivalent of debt service payments made in the normal course of financing the capital requirements of that employer.

APPENDIX XI

COMMENTS AND SUGGESTIONS ON H.R. 2203

Rather than undertake a detailed critique of the Bill (H.R. 2203), I believe that it will suffice if I point to the principal problems which the Bill in its present form creates.

1. H.R. 2203 properly recognizes that a major new source of financing small business must be opened up. I would recommend that serious consideration be given to the techniques outlined in my letter to President Ford of January 17, 1975, and in my statement before the Inflation Summit of September 27-28, 1974, Appendix V hereto.

2. Only the ESOP and CSOP (see explanation in Appendix III hereto) are appropriate devices for immediate use in assistance to small businesses, though the CSOP, unless the prevailing definitions of "small business" are rather enlarged, will have a more limited application. Where CSOP financing is appropriate -- and this requires reversing some past changes in the tax laws -- both techniques are capable of being simultaneously used to finance growth and broaden individual private ownership of productive capital.

3. It needs to be recognized that creating broader private ownership of productive capital is just as critical an economic defect in the U.S. as that of solving the problem of "creating jobs".

4. No legislation issuing from the Congress of the United States should undertake to finance communal ownership of capital. This is an appropriate approach to solving poverty in a socialist society, but not in a capitalist economy -- a private property, free-market economy. Thus all references to "community" ownership or "employee-community" ownership should, I recommend, be deleted from the Bill.

5. It should be recognized that, using the logic of a capitalist economy, there is a rationale to capitalist-oriented finance. Neither employees nor others should be "given" anything but the opportunity to buy and pay for viable holdings of productive capital. But it is critical that the arrangements under which they make such purchase be such that they can buy the capital on credit, and pay for it within a reasonable period of years out of what that particular capital produces. In thousands of cases, through ESOPs, we have shown that this is feasible, and corporations themselves, since that is the logic which they use at the institutional level, have traditionally demonstrated the soundness of that approach.

6. Any language that would lend the slightest support to the idea of governmental assistance to financing the acquisition of capital ownership by a labor union should be eliminated from the Bill. Labor union ownership is communal. Communal ownership is socialistic and anti-capitalistic. On the other hand, individual ownership of productive capital by human beings who are members of labor unions is most desirable. If we are seeking to promote indi-

vidual freedom, individual economic self-sufficiency, individual dignity, and individual ownership of economic power as a means of containing and counter-balancing the necessarily centralized holding -- between elections -- of political power, then only the building of capital ownership into individuals should be encouraged or indeed tolerated. This does not mean that corporations should not own the stock of subsidiary corporations, but that ultimate ownership of productive capital should be by individuals, and that such individual holdings should not be concentrated.

7. All intimations that techniques of finance not build upon the principles of two-factor economics will work efficiently or desirably or with satisfactory end results should be avoided.

8. In the present state of our economy, any method of acquiring capital ownership that depends upon the use of after-personal-income tax dollars of individuals, other than the already rich (who should not be made richer by any means) should be eliminated from the Bill. It is not feasible; it is pure fantasy to think that it is. Thus all methods of deductions from wages and so forth are unworkable. Crushed between rising taxes and rising costs of living, the worker can only hold multiple jobs and drop deeper into debt and suffer a diminishing standard of living. This is what is going on in America today.

9. Governmental bureaucrats are rarely qualified to function as investment advisers, management consultants, or business counselors to private enterprise. These functions should be left to the private sector under whatever guidelines government feels appropriate to protect the public against fraud and deception.

10. Employee participation in management is a subject which government best leave to corporations and employees. For the most part, not even all those in management are well qualified to manage. Those outside management are certainly, for the most part, not qualified to manage. Business management is a difficult, complex, and disciplined art. Those who wish to make it a career should do so by the most diligent application of their talents to it, either through on the job training, or formal educational disciplines, or combinations of the two. But in any event, amateur management -- the making of management decisions by people lacking qualifications -- is not good for anyone. It becomes even less desirable as employees become owners of the capital stock in their employers.

11. The most important innovations still required to actually begin to get significant movement in the direction of making ours a broad based private property, free-market economy are those summarized in H.R. 462 which Congressman William Frenzel introduced into the 94th Congress, the elements of which have not been enacted into law. The text of H.R. 462 is attached hereto as Appendix X. These modest and totally beneficial modifications still remain the heart of the most desperately needed innovations to accelerate the growth of our economy and to begin to build the ownership of that growth, and the ownership of businesses that

pass from generation to generation, into a vastly broader, privately owned shareholder base. Not that H.R. 462 contains all possible beneficial legislation. If Congress wants to open the door to a rush of business into ESOPs, it need only cut the capital gain tax on sales of corporate stock to ESOPs by 50%. The resulting growth in business, motivation of productivity, and opening up of our society would reimburse the United States Treasury hundreds of times over for any diminution in revenue. (See the survey of the effect of ESOP financing on productivity, sales, profits and corporate income taxes paid summarized in Appendix VIII hereto.) Amendments to the anti-trust laws which would assure that, if economically feasible, any divestiture pursuant to governmental proceedings will result in employee acquisition of the ownership of the divested asset would be most desirable. See the memorandum attached hereto as Appendix IX.