Income Maintenance

through

TWO-FACTOR THEORY and THE SECOND INCOME PLAN *

Memorandum for Panel
of the
President's Commission on Income Maintenance Programs
at its
Hearing in Los Angeles, California
11:30 a.m. - May 23, 1969

by Louis O. Kelso

INTRODUCTION:

> I am proposing a plan which, with a start-up time of five years, would take at least one million families per year off the welfare rolls, and would enable them to produce an income of $4,000 per year or more. Within a second five-year period, the rate of transfer from dependence on welfare to dependence on independent incomes could accelerate to five million families per year.

In the short space of time allotted to me by the Commission, it is not possible to do much more than to outline my argument, made more fully in a number of writings, that the long-range income maintenance problem of the United States must be solved through effectively enabling millions of additional families, and eventually all families and individuals, legitimately to acquire and own productive capital through ways that will enable us to build a vastly larger economy. The case for this approach -- the Second Income Plan -- is stated in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY, published by Random House in hardcover and by Vintage Books in paperback in 1968.

Here is the essence of the case:

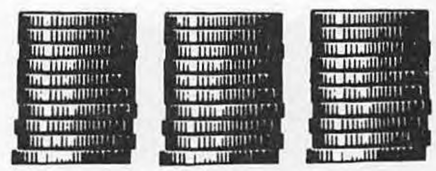
Conventional economic concepts, from Adam Smith through John Maynard Keynes, and governmental and business institutions based upon them, assume that the performance of labor is the primary method of legitimating individual income: that capital instruments increase "labor productivity" and that the goal of an economic system is to keep labor employed. The function of the welfare state is to raise funds by taxation or by borrowing to subsidize and thus increase the number of jobs, and to the extent the number of jobs is insufficient, to provide direct distributions of cash welfare. Administrative techniques aside, such approaches are based upon one-factor economic thinking: i.e., that however wealth is produced, it should be distributed as pay for labor to the maximum extent possible, and beyond that in the form of a dole, which may be named unemployment compensation, welfare, aid to dependent children, food stamp programs, guaranteed annual income, negative income tax, family allowance, etc.

Two-factor theory represents a quantum advance in the social sciences over traditional economic concepts. It recognizes the fact that there is productive equality between the two factors of production: the human factor (labor) and the non-human factor (physical capital in all of its forms, including land, structures, and machines). Two-factor theory and the Second Income Plan are concerned with the proper structuring of an economic system. This structuring would achieve income maintenance by planning the sustained and high-level economic productiveness of each family and single individual through employment, to the extent there is a market demand for employment, and beyond that through the ownership of reasonably sized and viable holdings of productive capital.

Of all the proposals to solve the income maintenance problem, two-factor theory and the Second Income Plan alone seek to solve it by raising the productiveness of each consumer unit in the economy.

Throughout this paper, the reference to *"CAPITAL"* is to physical capital, i.e., **LAND, STRUCTURES, and MACHINES**

and *NOT to money.*

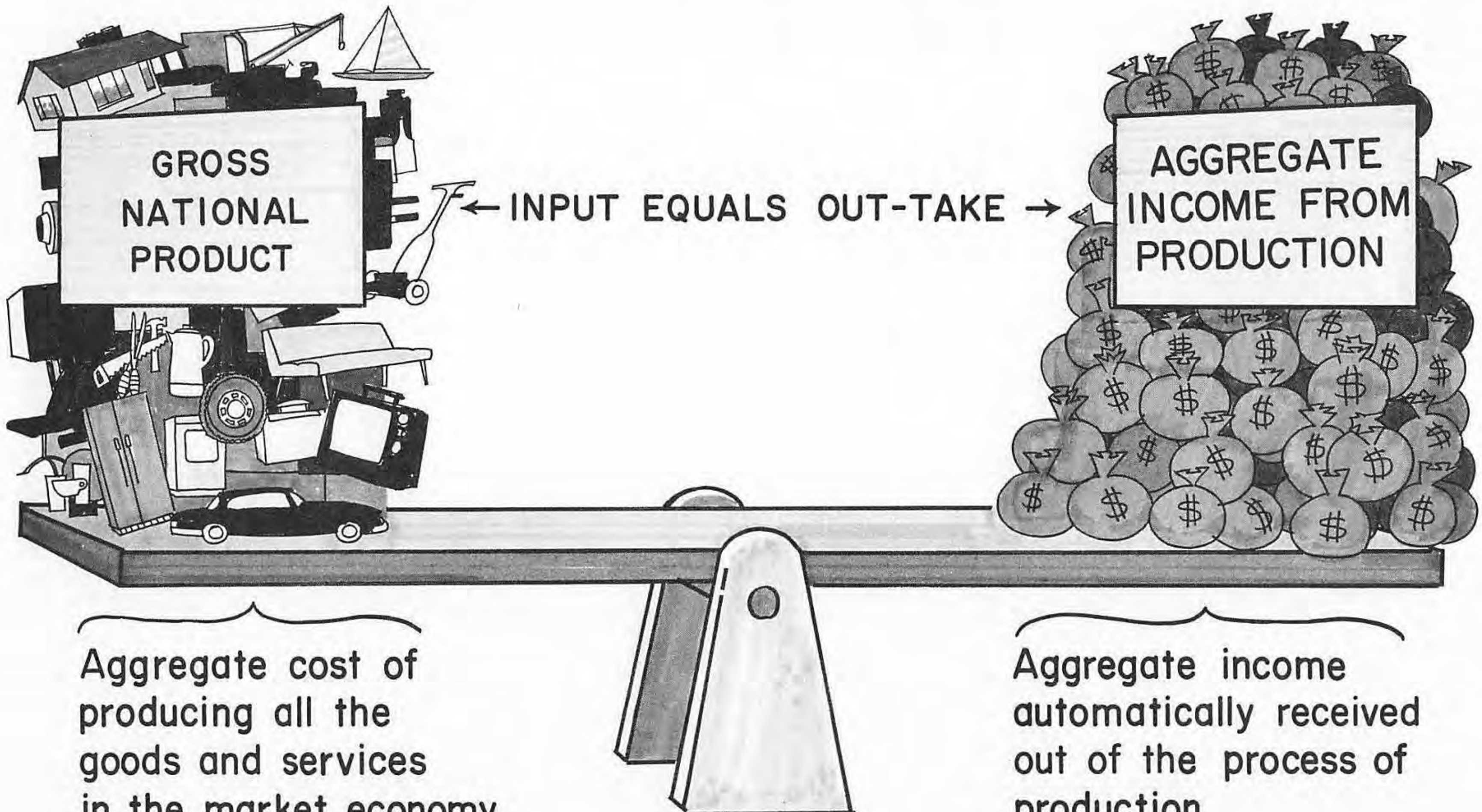


The purpose of charts and illustrations in this paper is to show basic relationships, rather than precise quantifications or percentages which are not important to the argument. The relationships shown are believed to be accurate.

WHAT IS THE LOGIC OF A MARKET ECONOMY?

The U.S. economy is, and is said to be, a market economy. What is the logic of a market economy?

Double-entry bookkeeping is the logic of a market economy



Aggregate cost of producing all the goods and services in the market economy

Aggregate income automatically received out of the process of production

"SYSTEM" means LOGIC...

IF THERE IS NO LOGIC TO AN ECONOMY, OR IF ITS LOGIC CANNOT BE IDENTIFIED, THEN THE ECONOMY CANNOT BE CALLED A *SYSTEM.*

THE LOGIC OF A MARKET ECONOMY IS

DOUBLE-ENTRY BOOKKEEPING

Input by a consumer unit is the basis for
Outtake (that is, personal income).

The market value of goods and services produced in a given time period is exactly equal to the purchasing power generated out of the process of production.

Productive input by the two factors, labor and capital, or human and non-human, measured in dollars, equals the purchasing power outtake, also measured in dollars.

Without attempting to quantify the relative input and outtake factors, the relationship can be illustrated this way:

Economic Input				*Economic Outtake*		
Labor Input	+	Capital Input	=	Workers' Income	+	Capital Owners' Income

The sole purpose of peaceful economic activity is consumption:

> To satisfy consumer needs and wants and to provide a sense of security that such needs and wants will continue to be satisfied in the foreseeable future.
>
> Increased income for a family or an individual in a market economy is a function of increased productive input -- input that is valued by the market because it is necessary to an end result for which the market exists to satisfy: consumer needs and wants.

Free men are committed to the principle of the market economy: that economic outtake should be the result of productive input.

This is the principle of double-entry bookkeeping.

It is the only imaginable concept of economic justice.

It is the only imaginable moral basis for economic activity.

It is the only principle of economic distribution (there are but two) consistent with each man's individuality, his human dignity, his economic <u>machismo</u>.

> No man wants to be a ward of charity (the other principle of distribution) unless he has no other choice.
>
> No man wants to support strangers with his own productive input; he detests carrying others on his back economically.

Understanding
TECHNOLOGICAL CHANGE

The only major causitive factor of change in human affairs is technological innovation. What is it?

It is a process by which man harnesses the laws of nature and makes her work for him THROUGH CAPITAL INSTRUMENTS: land, structures, and machines.

For all practical purposes, man's evolution takes place in his capital instruments rather than in his body, as in the case of the sub-human species.

Technological change does not raise the productiveness (or "productivity") of labor -- ever.

Technological change raises the productiveness of capital instruments, both through facilitating the addition of more capital instruments, and through the addition or substitution of better capital instruments.

Technological change shifts the burden of productive input at an accelerating rate from labor to the non-human slaves.

The greater affluence of any industrial society is due to its non-human slaves, not to the economic superiority of its people, or to their education, or to their experience, except as these are reflected in the addition of capital instruments to the economy.

In fact, the source of affluence, where it exists aside from slavery or theft, is increased productive input by the non-human factor: capital goods.

Announcing his plans to use Second Income Plan financing to build the industrial base of Soul City, North Carolina, on broad capital ownership, Floyd B. McKissick, former national director of C.O.R.E., declared on Lincoln's Birthday, 1969:

> "Abraham Lincoln freed the slaves only in the legal sense. Technology was the slave's real emancipator. Technology freed the human slave by transferring his toil onto the tireless backs of non-human slaves driven by water, steam, petroleum, and electricity. But the Black man has been alienated a second time, because he never has owned, and never had a chance to own, the machines that replaced [him]... For all his good intentions, Lincoln didn't free the slaves. He fired them... This time, Black people are determined to be the slavemasters. But our slaves won't be weak and defenseless human beings. They will be the non-human things that produce industrial wealth... We intend to work, and to work hard. But we do not intend <u>merely</u> to work. We intend to own."

The skills required to produce goods and services change; many old ones become obsolete, and a few new ones are added. Technological change is designed to eliminate dependence upon skills.

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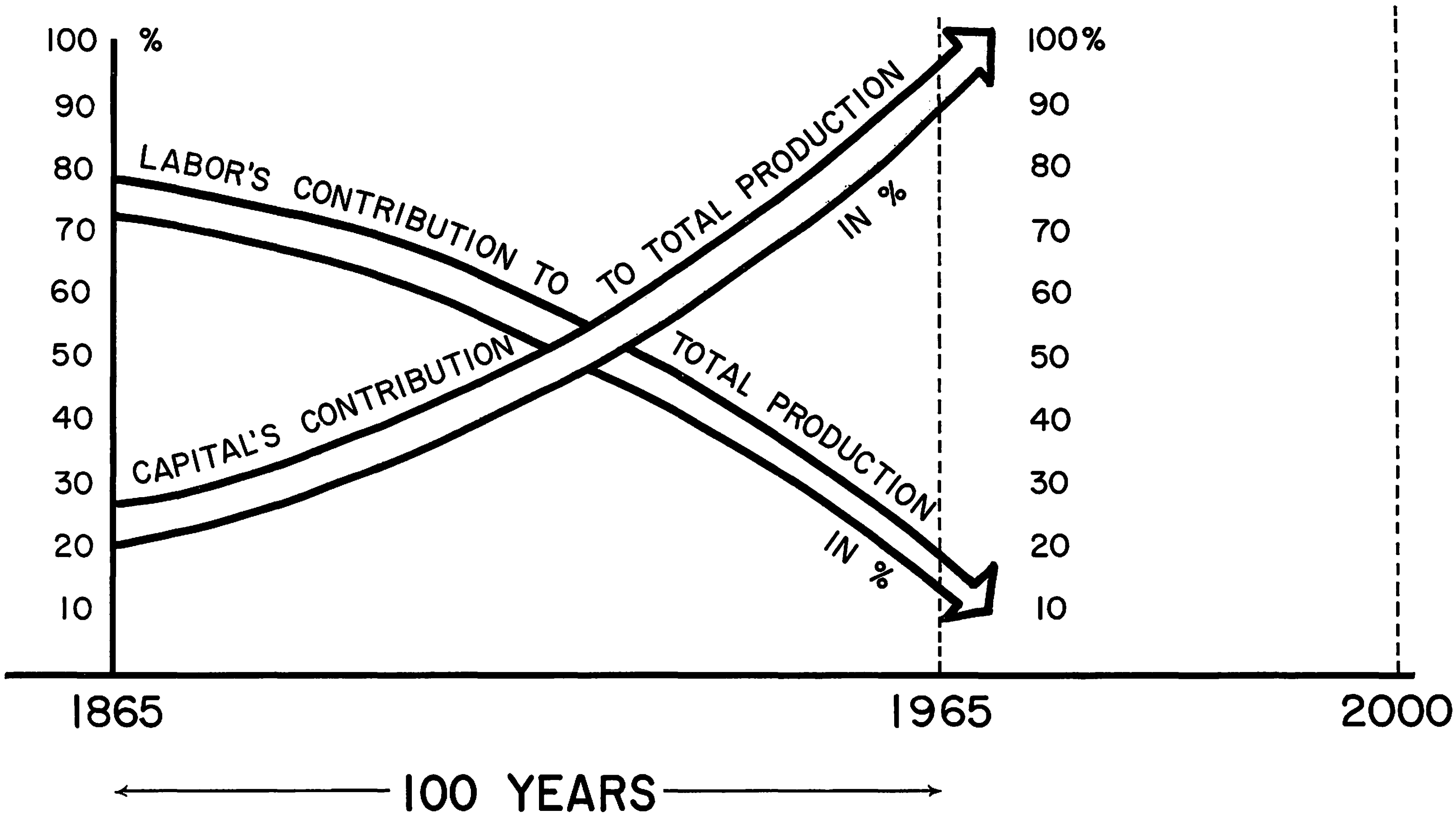
The skills required to produce goods are always changing; many old ones become obsolete, and [illegible]. Technological [illegible] eliminate dependence upon skills.

In the past century, capital has gradually taken over from labor :



But in general, each new generation of men "puts in" less and less of any kind of measurable human input -- muscular or mental. More and more productive input comes from capital instruments and less and less from labor. This shift in input mix accelerates with time; technology builds upon itself.

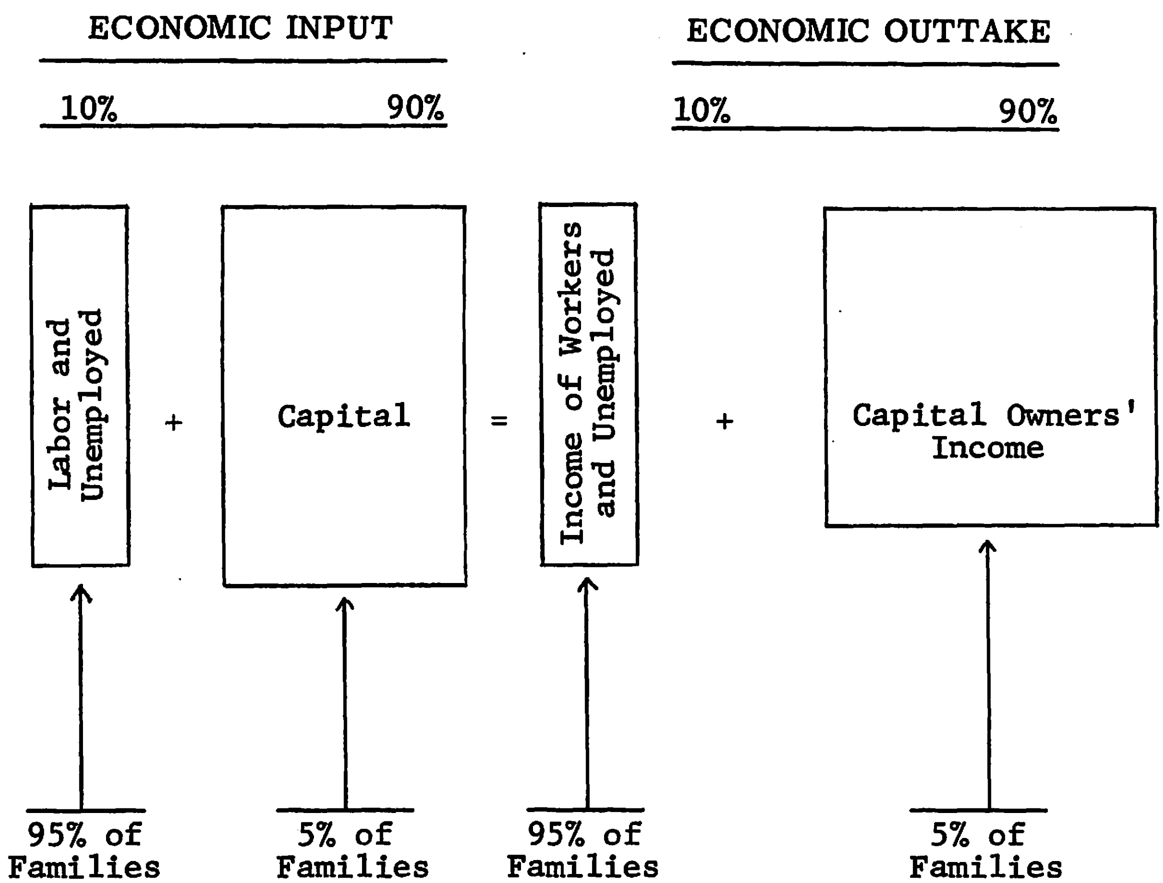
WHAT DOES THE SHIFTING OF PRODUCTIVE INPUT FROM CAPITAL INSTRUMENTS TO LABOR DO TO INCOME DISTRIBUTION?

If we remember that the logic of a market economy is double-entry bookkeeping, under which outtake from the economy is based upon productive input into the economy, then we know that as technological change moves forward, more and more of the productive input is by capital instruments and more and more of the income (under free market conditions) will shift to the owners of capital instruments. Less and less income will be received by the owners of labor power -- the individual workers themselves.

> If we actually had the determination of the value of labor under free market conditions, unsupported by minimum wage laws, overtime laws, the legalization of union coercion, and by governmentally subsidized and synthesized employment, my estimate is that labor in the aggregate would provide about 10% of the productive input into the economy and would receive about 10% of the resulting income.
>
> Since all of the studies that have been made on the distribution of the ownership of productive capital show that it is wholly owned within the top 5% to 10% of wealth-holders in the economy, what pattern of income distribution would a free market economy provide under present technological conditions? The answer can be illustrated as follows:

Economic Input and Income Distribution in the U.S. Economy

Assuming Free Market Conditions
and
The 1969 Level of Technological Development

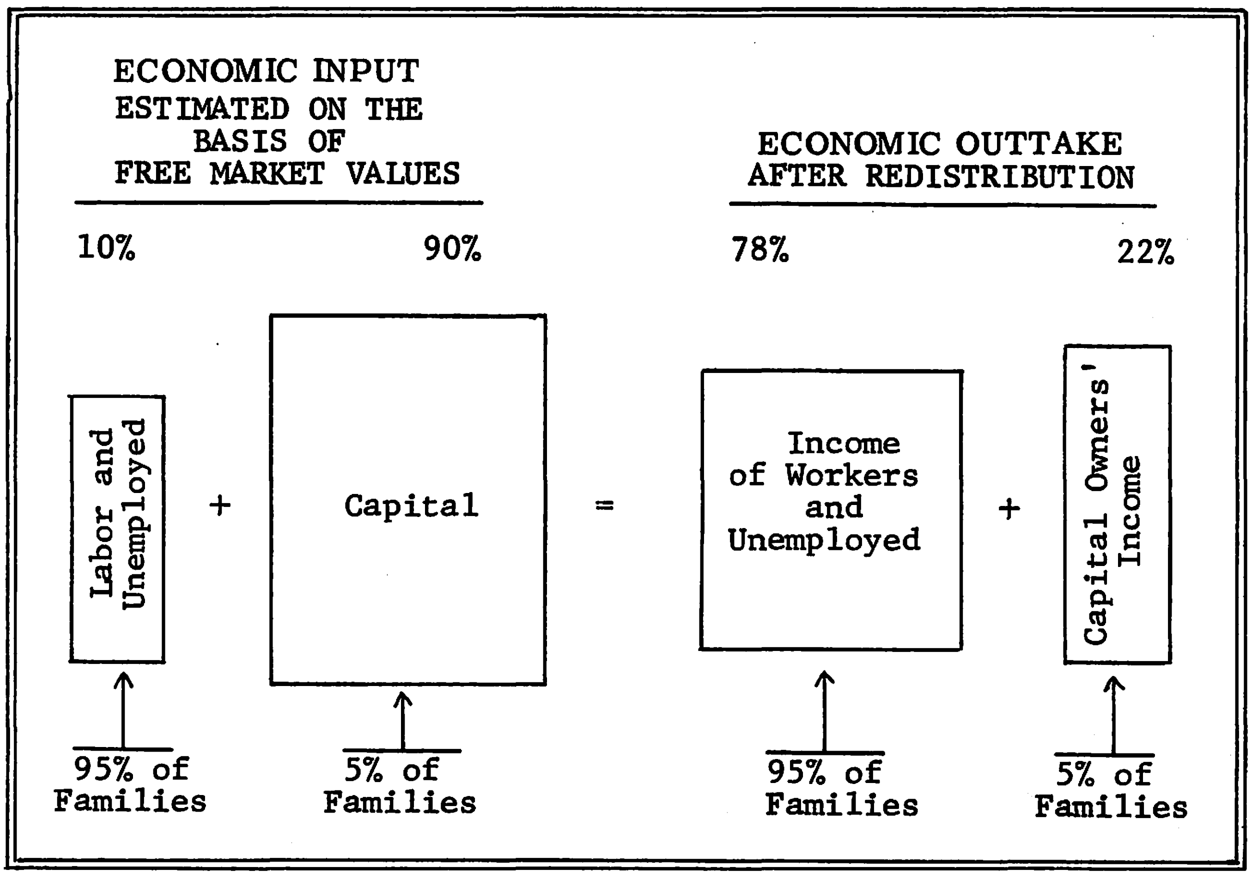


Obviously, if labor were to be suddenly evaluated at its free market value, the condition could continue only momentarily. Starvation of the masses, and the collapse of consumption, as well as production, would be instant.

GOVERNMENTAL MODIFICATION OF THE INCOME DISTRIBUTION PATTERN:

Since families without income would starve, and since production cannot be carried on in the absence of consumption, what has government done to prevent the collapse of the market economy in the face of the concentrated ownership of the most productive factor of production?

Through governmentally supported redistribution, achieved (1) partly by the legalizing of coercion and the threat of coercion in the fixing of wages and salaries, and (2) partly by redistribution of income through using funds collected by taxes of various kinds from one segment of the population to finance welfare and "created" jobs for the other segment, the actual picture looks more like this:



Even so, it is clear that under the accelerating rate of technological change and the continuing concentrated ownership of productive capital, the pattern of income distribution is such that we do not bring into existence more than a fraction of our ability to produce goods and services simply because the purchasing power to buy those goods and services, once produced, is not possessed by those who have unsatisfied needs and wants.

> Our techniques of financing new capital formation continue to add more productive power to those whose present productive power is already vastly in excess of their ability or desire to consume. At the same time, the under-productive (the poor) remain **poor.**

THE TWO BASIC APPROACHES TO SOLUTION OF THE INCOME DISTRIBUTION PROBLEM:

Route I

Increase governmental redistribution to the workers and the unemployed, who constitute 95% of consumer units, but who furnish only a small fraction of the economy's productive input, until these consumer units receive in fairly equal portions 95% or more of personal income.

The disadvantages of Route I are that:

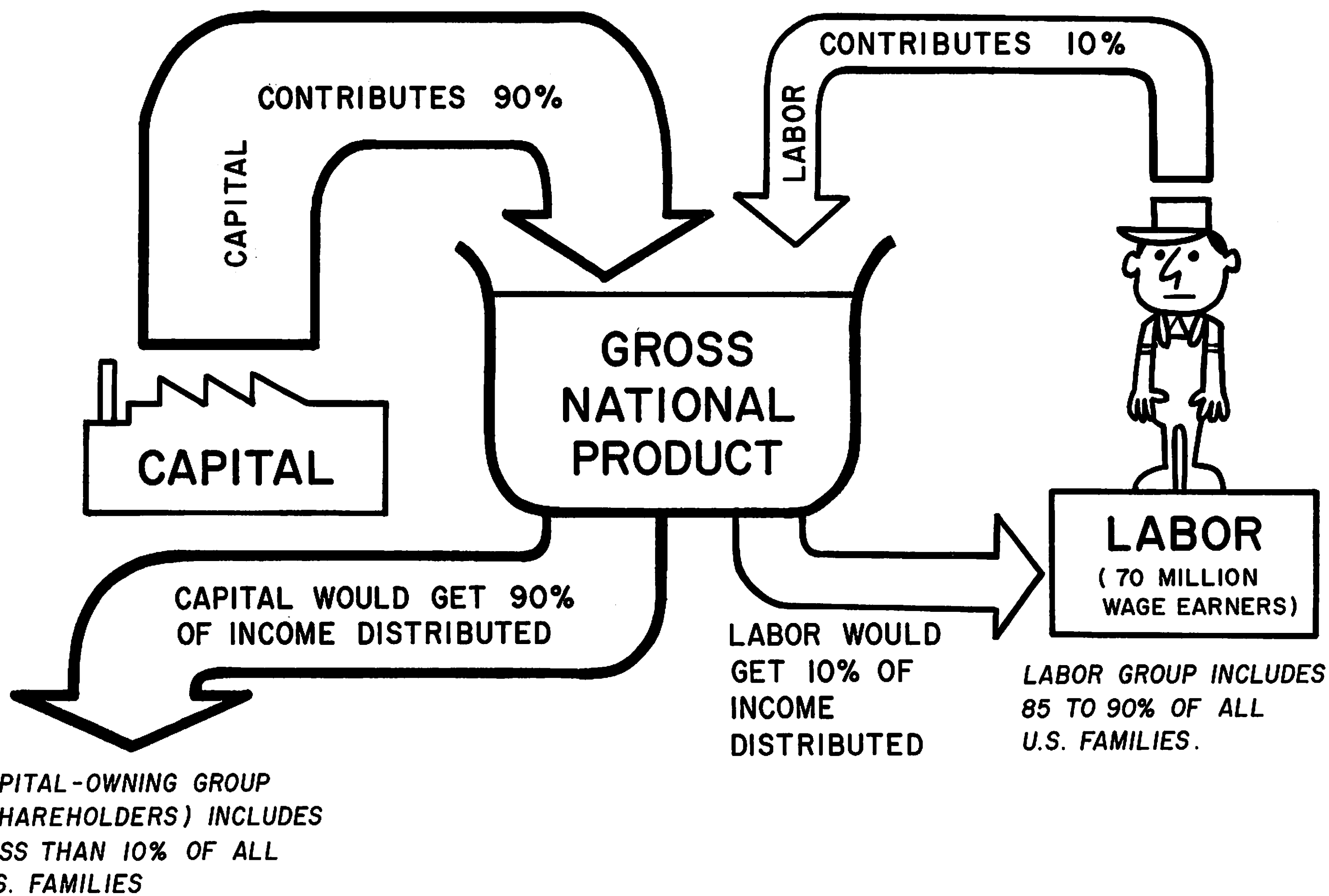
> Since <u>functionally</u> private property in capital instruments exists only where the owner receives <u>all</u> that his capital produces, it would totally destroy private property in the non-human factor of production.
>
> Since capital owners are discouraged by being deprived of the fruits of their capital, it would either slow down the rate of new capital formation on which increase in the output of goods and services is dependent, or the government would have to substitute

wage and price controls, and even government ownership of the non-human factor for private ownership -- an arrangement which has never been able to achieve economic growth rates comparable with those achieved under free enterprise.

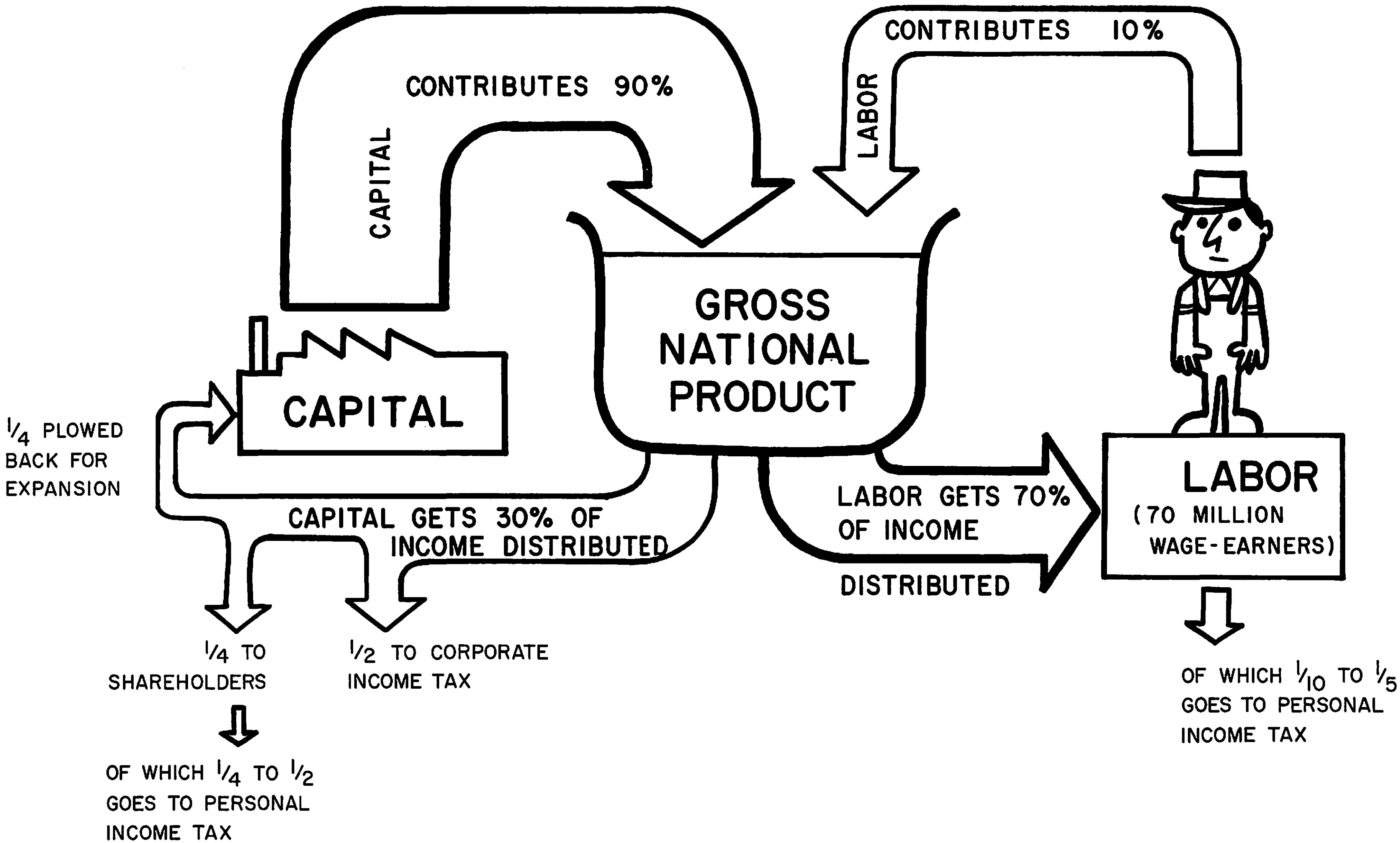
Route II

Make it possible on an accelerated basis for progressively more and eventually all of the non-capital-owning 95% of consumer units to engage in production through the ownership of both factors so that they may receive income, in accordance with the logic of the market economy, from both factors of production.

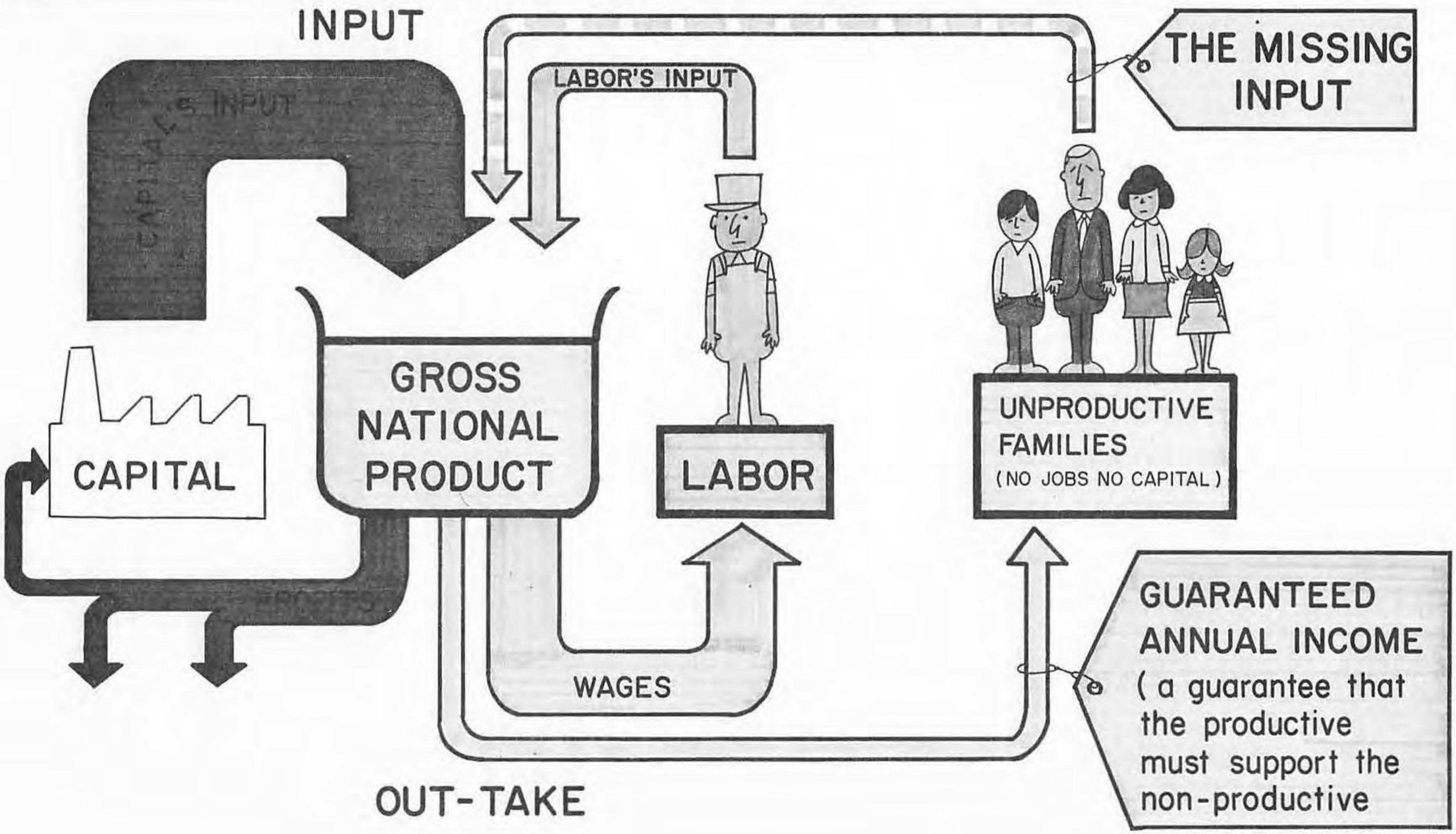
If wealth went proportionally to those who produce it, here's what would happen:



Wealth doesn't go proportionally to those who produce it. Here's what really happens :



Out-take without input violates the logic of double-entry bookkeeping



Except for the Second Income Plan, all income maintenance programs -- including the guaranteed annual income, the negative income tax, the expansion of unemployment compensation, governmental employment or subsidization of employment of the unemployed, etc. -- utilize Route I -- redistribution of output of the existing economy.

The Second Income Plan alone utilizes Route II.

ONE-FACTOR ECONOMIC CONCEPTS
and
TWO-FACTOR ECONOMIC CONCEPTS:

The income maintenance hangup is, and has always been, the attempt to make one-factor economic concepts work in a two-factor real world. Let me now -- in half a minute -- explain two-factor theory:

> It is the idea that each of the two factors produces wealth in exactly the same sense:
>
> This idea is contrary to explicit socialist dogma.
>
> It is also contrary to U.S. economic policy: the Employment Act of 1946 and the Economic Opportunity Act of 1964.
>
> Both political parties espouse one-factor economic policy.
>
> The various studies on economic goals that have been made in the U.S. since the T.N.E.C. studies of 1938-42 uniformly conclude that our proper economic goal is full employment, so they are contrary to two-factor theory.
>
> Two-factor theory is contrary to Keynesian doctrine.
>
> While physical capital does not pass unnoticed in the western economies, we assert that its function is to enhance the "productivity of labor."
>
> This, of course, is contrary to reality and to two-factor theory.
>
> If two-factor theory is sound, and if double-entry bookkeeping <u>is</u> the logic of a market economy, then the <u>only</u> way to eliminate

poverty, and to bring about a condition of general affluence, is to make it possible for every family and every individual to <u>produce</u> general affluence.

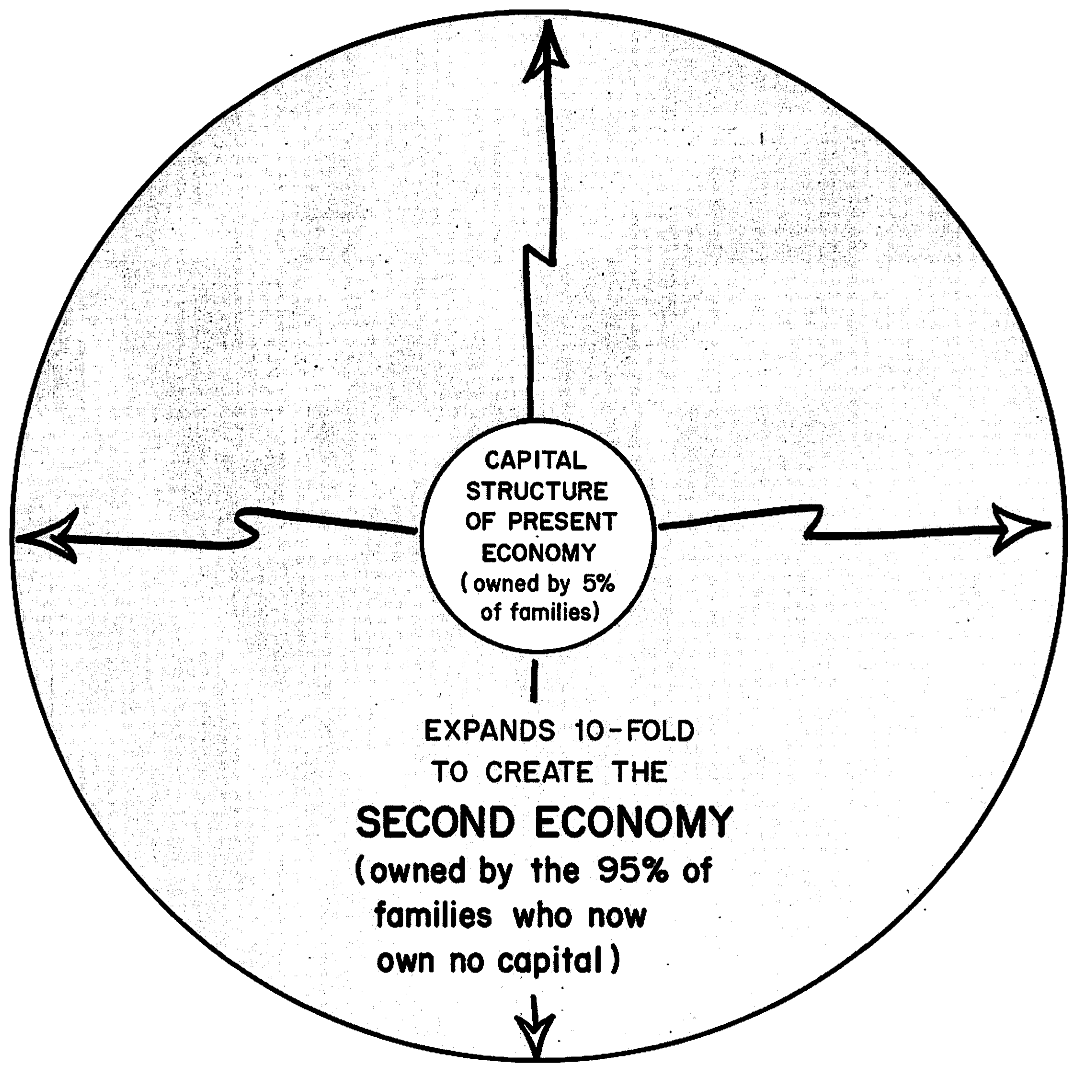
> To make a greater <u>productive input</u> into the economy.
>
> But if most productive input is by capital, the non-human factor, this means virtually every individual and family must be enabled to become the private owners of productive capital.
>
> To buy, pay for, and own viable holdings of productive capital.

The tools of the Second Income Plan -- financing techniques and modifications of tax laws and corporate practices -- are designed to build productive power into households and individuals now insufficiently productive so that they may be enabled to produce an affluent share of income. This method has yet to be employed as national policy in any economy. It is a method designed to protect existing private property, highly concentrated though it may be, and to build a Second Economy owned in reasonable-sized holdings by the great majority of households who own no productive capital in the existing economy. <u>This is the corrective method of the Second Income Plan</u>.

The object of the program which we are urging industry and business to undertake can best be illustrated like this:

Let the small circle below represent the capital structure of the present economy of the United States, and let the larger circle surrounding it represent a second economy, to be built over an estimated 25-year period through expansion several times over of the present economy:

Objective of the Second Income Plan



The principal tool of the Second Income Plan is one that can be used by business corporations under present state and Federal laws. It consists of a radically new and different use of the familiar qualified deferred compensation stock bonus plan in such way that it can both finance corporate growth and build equity ownership into employees without diminishing their takehome pay. It is beneficial to the corporation, its existing shareholders, the employees, and the economy. Its use is outlined below.

In THE NEW CAPITALISTS (Kelso and Adler, Random House, 1961) and in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (Kelso and Hetter, Random House and Vintage Press, 1968), we have shown that with modest legislative changes, equity ownership that can be built into corporate employees now under existing law could be built into non-corporate employees such as civil servants, teachers, judges, legislators, professionals, artists, invalids, widows with children, the aged, etc.

Income Maintenance

AND THE BUSINESS CORPORATION STRATEGY:

Roughly 80% of the goods and services produced in the non-agricultural, non-governmental sector are produced by corporations.

> This automatically means, under double-entry bookkeeping, that 80% of the purchasing power generated by the private economy (outside agriculture) arises in corporations.

Present strategy employed by business corporations consists of maximizing production and sales, minimizing costs, and being a law-abiding corporate citizen.

> Thus, while 80% -- approximately -- of the income (outside agriculture) generated by the private economy arises in corporations, there is no recognition that one concern of sound corporate strategy should be to make certain that income is channeled to people with unsatisfied economic needs and wants, and not to those whose needs and wants, however lavish, are already provided for.
>
> The chief productive factor in the modern corporation is the non-human factor of production: capital.
>
> > All modern techniques of corporate finance are designed to assure that the ownership of virtually all newly formed capital flows into the hands of the top 5% of wealth-holders who today own all the corporate capital.

What closes the purchasing power gap created by defective corporate strategy?

Answer: Government and consumer credit.

Government welfare distributions.

Redistribution of income from capital owners to non-capital-owners and from highly paid workers to the unemployed by graduated income taxes, personal and corporate; graduated estate taxes and graduated gift taxes; social security taxes, unemployment compensation taxes, property taxes, etc.

Government employment, particularly in public works, military overkill production, space waste, etc.

Governmental enfranchising of labor unions to use coercion in the marketplace to effect redistribution, by demanding progressively higher pay in return for progressively diminished quantity and quality of labor.

Governmental subsidies of agriculture, shipbuilding, military stockpiling, export of foreign aid, etc.

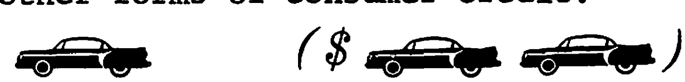
etc. *etc.*

Consumer credit closes the purchasing power gap today and makes it radically larger tomorrow.

A consumer may buy a home with a modest downpayment today

and pay for three homes over the rest of his lifetime.

The purchasing power gap is similarly, although less drastically widened by all other forms of consumer credit.



A CORPORATE STRATEGY FOR INCOME MAINTENANCE
BASED ON **The Second Income Plan:**

What can *BUSINESS* do to solve the income maintenance problem?

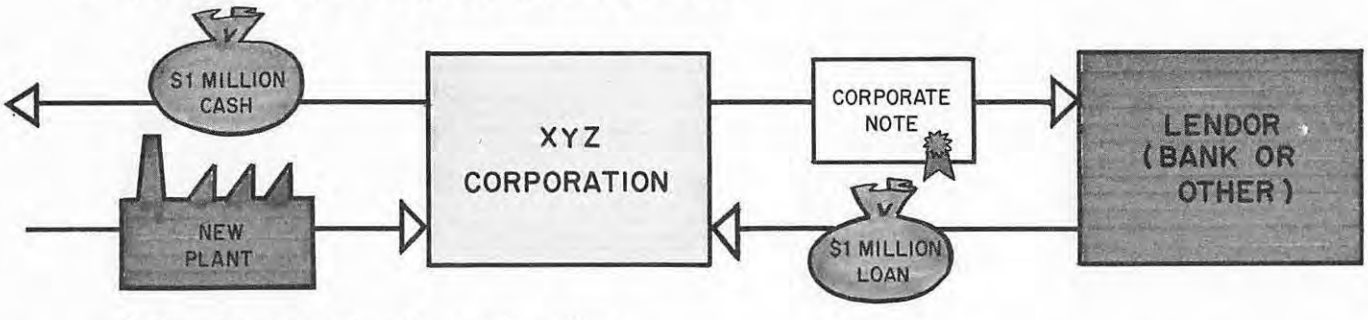
The answer is to employ as widely as possible

Employee Second Income Trusts.

The following illustrates how these operate:

2 ways to finance corporate productive capital (new plant)

1. CONVENTIONAL DEBT FINANCING:*

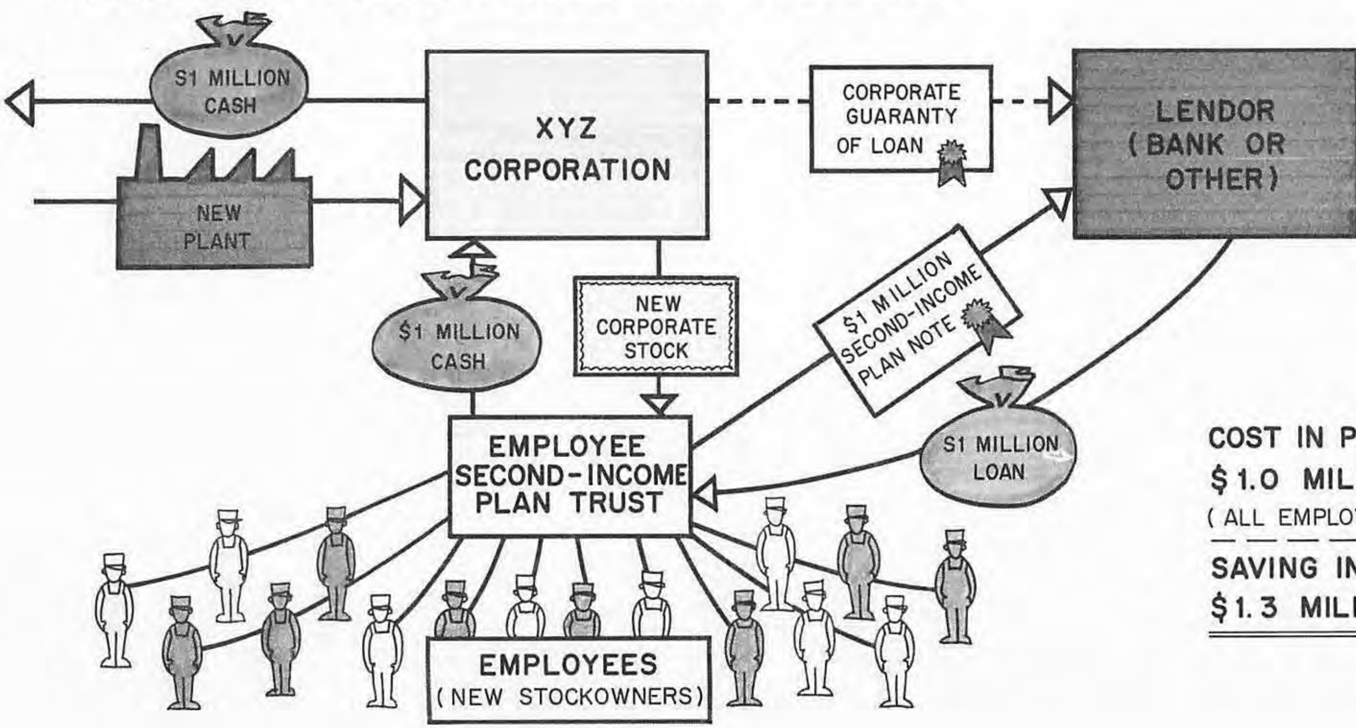


COST IN PRE-TAX DOLLARS $2.3 MILLION

(NO NEW STOCKOWNERS)

* Plowed-back earnings have similar effect

2. EMPLOYEE SECOND-INCOME-PLAN FINANCING:



COST IN PRE-TAX DOLLARS:
$ 1.0 MILLION

(ALL EMPLOYEES ARE STOCKOWNERS)

SAVING IN PRE-TAX DOLLARS:
$ 1.3 MILLION

The main highlights of the operation of these trusts is as follows:

An employee deferred compensation trust is established, or if one is already in existence, it can be remodeled to suit Second Income Trust financing purposes.

Loan financing from conventional loan sources -- insurance companies, banks, etc. -- is arranged so that loans are made directly to the deferred compensation trust.

The trust takes the loan proceeds and invests it in the sponsoring corporation's stock.

The corporation sells and issues its stock, at the full current market value, to the trust.

The trust gives its note to the lendor and may pledge the stock to secure it.

The sponsoring corporation guarantees that it will pay off the note to the lendor in annual installments <u>through the trust</u>, rather than directly to the lendor as it would if the corporation itself were the borrower.

The Internal Revenue Service, within the limits prescribed by the Code, will treat the corporation's loan repayments as "contributions" to the employee trust, because under this arrangement, the employees, including corporate management, become the owners of the stock as the debt is repaid, without any reduction in their takehome pay or fringe benefits.

WHAT CAN GOVERNMENT DO TO SOLVE THE INCOME MAINTENANCE PROBLEM THROUGH **The Second Income Plan ?**

The Second Income Plan can be accomplished in 2 steps:

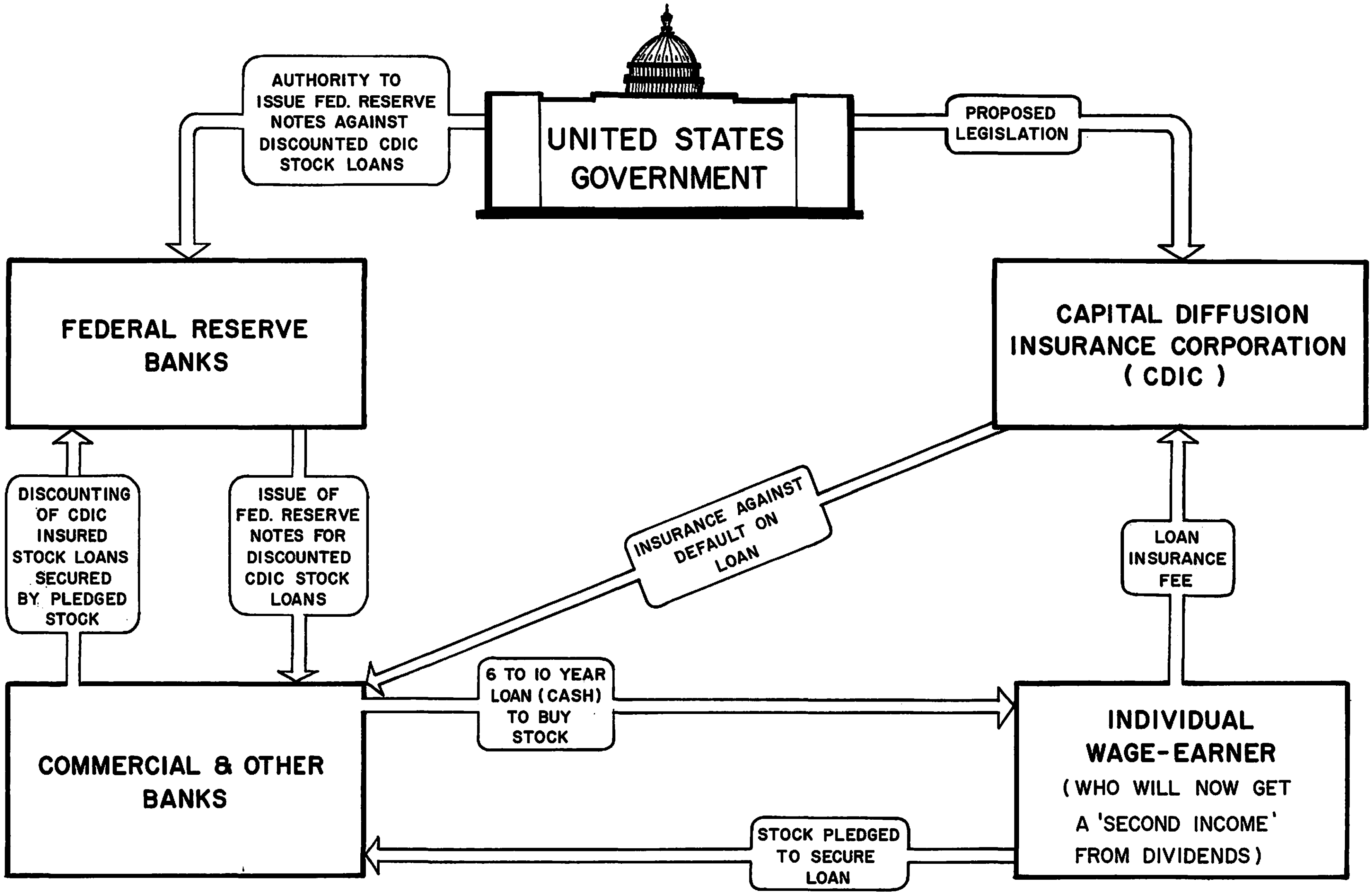
Step 1: An Act of Congress to:

- Repeal the "Employment Act of 1946" (with its narrow focus on LABOR alone.)
- Enact the "Full Production Act of 196_" (with its broader focus on both LABOR and CAPITAL)

This would establish the national policy.

Step 2: A series of "Ways and Means" by both government and business to encourage the widespread ownership of CAPITAL. This would implement the national policy.

How the Second Income Plan finances the purchase of stock by individual families.



A partial list of proposed "Ways and Means" to implement the Second Income Plan.

- Change death taxes to induce the wealthy to spread out their wealth.
- Encourage corporations to set up more employee stock-ownership trusts.
- Devise ways for closely-held family corporations to sell out to employees.
- Finance urban-renewal projects so that the displaced families can own shares in the new buildings.
- Finance government water-and-power projects (like TVA) so that the families who live there can become owners.
- Finance anti-trust divestiture of corporate assets so that thousands of families can become owners.
- Finance sale of government-owned corporations (like General Analine) so that thousands of families can become owners.
- Finance industrial development in impoverished areas (like Appalachia) so that the families who live there can become owners.
- Set up the "financed capitalist" program whereby families can borrow on insured loans (like FHA) to buy stock which pays for itself out of dividends.

I recommend further that government:

Launch an intensive investigation of two-factor theory and the Second Income Plan in the appropriate House and Senate committees, the Department of Health, Education and Welfare, the Department of Commerce, the Department of Labor, the Department of Urban Affairs, the Department of Transportation, etc.

Revise the national economic goal as set forth in the one-factor Employment Act of 1946, into a two-factor national economic goal. [See the Appendix to TWO-FACTOR THEORY: THE ECONOMICS OF REALITY.]

Hold hearings in the appropriate congressional and executive departments and solicit proposals for implementing the new two-factor economic goal.

Enact the negative income tax as a temporary expedient, acknowledging its structural deficiencies, for the purpose of alleviating immediate economic misery and simplifying welfare administration pending the broadening of participation in production through legitimate full employment and broader capital ownership.

Have Senate and House labor committees and the Department of Labor initiate studies on revising the goals of labor unions to encompass both factors of production.

Encourage the proper House and Senate committees to hold hearings on means of achieving legitimate full employment through application of the Second Income Plan.

Encourage the proper House and Senate committees and the Treasury Department to initiate studies for broadening the use of joint trusts in employee Second Income Trust financing, making individual contributions to employee deferred compensation trusts deductible for personal income and gift and estate taxation, as in the case of contributions to qualified charitable foundations; broaden the Treasury limits for the deductibility of corporate contributions to employee deferred compensation trusts; and make dividends payable into escrows, established to facilitate the purchase of capital ownership under the financed capitalist plan, deductible from corporate income tax and exempt from personal income tax until the stock being purchased has been fully paid for.

Conclusion:

Unlike income maintenance proposals based upon redistribution, the Second Income Plan is consistent with the institution of private property, the Puritan ethic and the American tradition of economic opportunity -- all deeply embedded in the mores, ethics and aspirations of the American people. The Second Income Plan addresses itself to the problems of all segments of society -- the up-tight blue-collar worker, the economically squeezed white-collar worker, the propertyless professionals, including corporate management. Everyone has something to gain from the Second Income Plan -- the young and the minorities, who find themselves economically unneeded in the existing economy; the retired generation on small, fixed incomes, the returning servicemen, as well as the out-and-out have-nots. The Second Income Plan, vigorously espoused and pursued, is capable of stemming the rising tide of alienation. By enabling the propertyless to acquire a capital stake in an economy growing at several times the present rate, it will knit into the economic fabric those who are now or soon will be outside of it. And finally, the Second Income Plan utilizes the genius of existing American institutions, and the know-how of corporate management, labor unions, and government.

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