"RATIONAL CORPORATE FINANCE -- ANYONE?"

SPEAKER: LOUIS O. KELSO
Economist and Lawyer

November 9, 1972

MR. ALLEN: Our first speaker this morning is a long-time friend of mine and one of the most imaginative thinkers I know. He is an economist and a lawyer, but he makes the dismal science and the legal profession interesting.

Louis Kelso graduated from the University of Colorado with a cum laude degree in finance. He was editor-in-chief of the Rocky Mountain Law Review. He has practiced law, first in Denver and now in San Francisco, and he has, over the years, worked with such luminaries as Mortimer Adler of the Great Books Institute. He has developed a most innovative, timely, and appropriate view of the economic system we practice in the United States today. He writes of its major failures and where the opportunities lie for corrections. I commend to you for your thoughtful consideration the remarks of Louis O. Kelso.

MR. KELSO: Thank you. Mr. President, Louis Allen, ladies and gentlemen, it is a great pleasure to be here with you this morning, and to have a chance to talk to such a distinguished audience from the world of finance and venture capital banking.

I became interested in the subject that I am going to talk to you about this morning -- rational corporate finance -- some years ago in thinking about the basic strategy of the business corporation in the western world. That strategy, I concluded, consisted of essentially three ideas, three elementary precepts: firstly, maximizing production and sales; secondly, minimizing costs and, thirdly, staying out of trouble or being a good corporate citizen or whatever phrase you wish to describe the concept of "social responsibility."

The more I thought about that strategy, the more I became convinced that it is an irrational strategy. Regardless of how successful it may have been for a limited period of time, it is irrational. And the private business corporation is ultimately doomed to failure unless this strategy changes.

It is an irrational strategy because it does not explain how the customers get the money to buy. Mass production implies mass consumption, just as mass consumption implies mass production. Our corporate strategy, taken in itself, does not explain how the customers get adequate purchasing power. Indeed, it explains precisely the reverse. It explains why they do not get the money they need to buy corporate output because when you minimize costs you disemploy people; you fire people. There are many ways to minimize costs but none has ever been invented to touch that one in effectiveness or in popularity.

Now we are all familiar with what happens when you minimize costs by firing people who have no way of participating in the game of earning a living except through the sale of their labor power. The Government steps in -- we insist that it step in -- to correct that deficiency. We producers can not sell unless there are buyers. We can make credit sales for a short time, but it obviously gets us nowhere unless the buyers ultimately pay.

The underlying logic of a market economy is simply double entry bookkeeping. What each man takes out of the economy is supposed to be based upon and proportionate to what he puts in. But if his only means of making input, his only way to get into

the game, his only way of contributing to production is through the sale of his labor power in some form or other, maybe muscle, maybe brains, maybe talent, maybe genius -- some people even seem to contribute stupidity but, in any event, they get paid for it -- if that is the only way we get into the game, we expect the Government to step in and close the purchasing power gap both for the unemployed and for the under-productive.

How does the Government do it? I need not take your time to tell you; you know it too well. Welfare, of course. Much of our great ingenuity over the last four or five decades has been spent in inventing new names for welfare, and we have got some marvelous ones: The Great Society, the New Frontier, the guaranteed annual income, the negative income tax (which translates into positive income dole), and so forth and so forth.

Then, of course, there are all kinds of boondoggles. God bless that word because it is a very basic word to describe what keeps the American economy from falling flat on its face. Boondoggle is massive expenditures by Government for the purchase of goods and services that customers would not buy if they were spending their own money, at least not to the degree these increasingly gigantic expenditures represent.

Try sitting down and writing a list of goods or services that in one way or another are not subsidized by the Government. This will give you insight into the vast dimensions of boondoggle. It is very hard to find a product or service whose production or consumption is not subsidized in some way.

Now obviously the loss of autonomy and the loss of self-sufficiency that business suffers when it must depend on Government to make it work is serious. It is serious politically; it is serious for prosperity. The things that hold back our incredible productive power do not lie in the world of science. Nor do they lie in the world of management. Nor in the field of technology, nor in the field of engineering. The problem lies in the area of the power of the customer to pay for what he gets or what he wants.

We can produce incredibly more of everything you can think of that makes up a good economic life if only the customers had the money to buy.

Now there are some simple fellows, mostly economists, who jump to the very ready conclusion that if this is the problem, it can very easily be solved by giving away money. Jokers have been saying this for a long, long time, since Hilaire Belloc and his Distributism movement in England, and since the New Deal, the Fair Deal, the Great Society and the guaranteed annual income, which both candidates in the recent election supported but which Congress had the wisdom to refuse to adopt.

I think that the logic of a free market economy is the logic of double entry bookkeeping; the logic of taking out in proportion to what you put in, with the inputs and the outtakes being measured by competitive forces. That is not just the logic of the economy. That is the logic of human morality everywhere. Man is so built that no one wants to carry around a parasite who is a stranger. Those who are close to you, those you love, are, of

course, a different matter. Distribution within the family has always been based on need. But distribution outside the family, between strangers, is based upon exchange and trade, upon input in exchange for outtake. So that attempts to solve this problem by simpleton give-away techniques are inconsistent with the nature of man. Not only does no man want to carry a parasite around on his back or to be forced to support strangers, but it violates every man's dignity to be a parasite. The institutions of our society that do not enable men with unsatisfied needs and wants to produce enough income to satisfy those needs and wants, and through their adequate purchasing power to press hard on our great technology and our zeal to produce, are the problem. Our producers are not reluctant, our businessmen are not bashful, they are not just trying to get money, they are trying to produce and sell goods and services. But the people with unsatisfied needs and wants cannot legitimately produce enough income. How do we answer that?

I think we answer it by taking a good hard look at the traditional ideas of how wealth is produced. What you will find will come to most of you as a shock. Conventional economic thinking in every operating economy on the globe is based upon the idea that only labor produces wealth. There is, functionally speaking, but one factor of production. I am not saying that anyone, least of all the Marxists, are unaware of the existence of land, structures and machines -- the non-human factor of production. I am saying that

their working economic concepts are structured on the theory that land, structures and machines amplify the productiveness of human labor.

The only alternative idea consistent with human morality and double entry bookkeeping is that there are two-factors of production, not one. The idea that things -- I am now speaking in physical terms, in terms of land, structures and machines in general -- produce goods and services in precisely the same senses that human labor does, and that the whole function of technology is to provide a means whereby man, using his brain, can harness the laws of nature and make nature work for him. Through his body? Absolutely not. Through the non-human factor of production. In other words, the purpose of technology is to shift the burden of economic production off man's back to the machine and to the non-human factor generally. But our institutions pretend that the only way you can legitimate an income is to work; not only to work but much more importantly, that through work alone you can legitimate enough income to consume your share of what is produced by both capital and labor.

Let me say that this pretense is absolutely contrary to the logic of the system. It is illogical, even if full employment exists, in an economy where most of the wealth is produced by capital -- and that is the kind of economy we have. Year after year, increased output per man hour is not traceable to man; it is traceable to the non-human factor, and the mere fact that man invented the machine or made the machine, or participated in building the

structures or in improving the land does not make any difference. The inventor or worker has in every case been paid for his input. He is out of the picture when the machine or structure or land begins to produce income.

Now the implication of this insight is that if the purpose of technology is to shift the burden of production off man's back and to provide a more affluent life with more and more leisure and less and less toil, under a system that requires <u>outtake</u> to be based on <u>input</u>, we must have a society which enables more and more individuals or family units legitimately to acquire the ownership of the other factor of production. Why? So that they will be able to make enough input to yield sufficient income to consume their share of what both capital and labor produce.

The reason people are poor, if you look at poverty in the light of this concept, is that they are not productive or they are not adequately productive. We have had four or five decades of trying to solve that problem by attacking the <u>effects</u> of poverty, not the cause. When, for example, we see that a man does not have a house and cannot afford to buy a house, we buy him a house. We subsidize the interest and everything else. It is this kind of idiocy that caused George Romney to recently say that perhaps the Department of Housing and Urban Development ought to be abolished. I agree with him. Preferably, it should never have been started. It is a department aimed at attacking the effects of poverty, not the causes of poverty. A man who can produce an adequate income does not have a poverty problem. He does not have a housing problem. He does not have a medical problem or an educational problem --

at least not in the economic sense of the word. He can buy whatever the world has to offer. The cause of poverty is low productiveness. It can be solved in only one place -- in business and finance.

The pattern of ownership of productive capital is essentially this: The top five percent of wealth holders own it all. Now if capital provides most of the productive input, and a handful of people own all of the capital, you have an economy that is wired not to run smoothly, but to blow up. Unless something absolutely fundamental were wrong, it would be impossible to explain the world today. You could not explain why we have an incredible amount of untouched resources, despite environmentalists' claims to the contrary; immeasurable unused manpower, including that employed in 25 or 30 million wholly or partially boondoggling jobs created merely to legitimate incomes; untouched and vast knowhow; all this potential productive power on the producer's side. And, on the consumer's side, vast immeasurable poverty -- the need for all the things that make up an economically good life. We gloss over the vastness of our poverty when we pretend that because a man is not hungry he is not poor. All of us know perfectly well that you can have a full stomach and be so damned poor you want to commit suicide. Poverty is a lot more than the state of one's stomach for the moment.

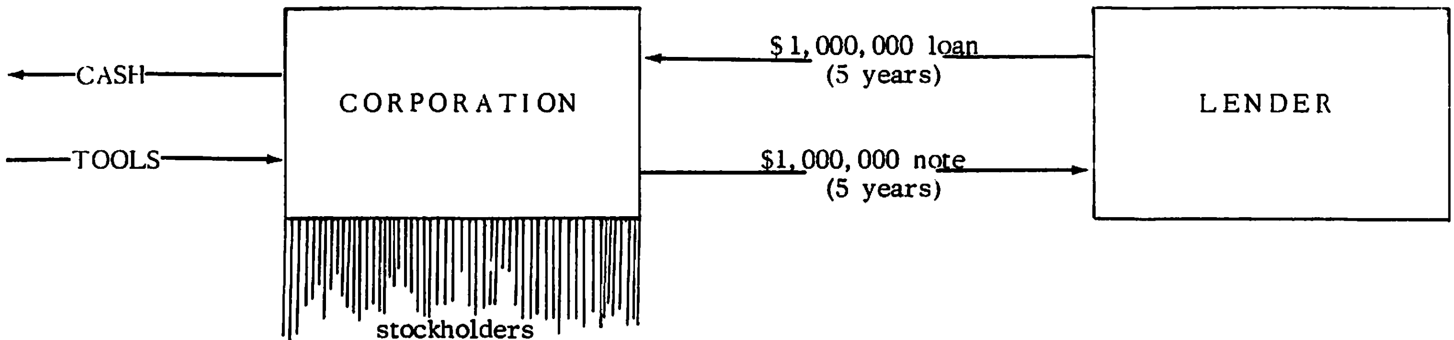
All the studies, the qualitative studies, of the ownership of capital show precisely the situation that I just stated. These include the ones made by the Temporary National Economic Committee; by Robert Lampman; by Dickinson, and more recently, by

researchers at Harvard and, very significantly, I believe, by a specially organized foundation called the Sabre Foundation at the specific request of the White House. The title of that study is "Expanded Ownership." It is a 1200-page report which resoundingly recommends to the President that our economic policy be modified from one in which we seek to solve all our problems through full employment (while the men in the business world seek relentlessly to destroy full employment), to one based both upon high employment and techniques for facilitating the expanded ownership of capital.

The statistics on concentration are not inconsistent with the New York Stock Exchange shareholder census which shows that from 1946 to 1972 the number of stockholders has expanded from roughly six million to 32 million. Those are quantitative figures, not qualitative ones. Most of the stock is owned by about four million shareholders. The holdings of the remaining 28 million are of such a size that if the shareholders accumulated their dividends for several years on end they might add up to the price of a pair of shoes. Their dividends are of no income significance.

In the reading material distributed to you was a sheet of paper with two diagrams marked Model I and Model II. I would like to show you why the present situation has come about. I have given you the conceptual cause -- a defective idea of how wealth is produced. Now I want to show you the mechanical cause which lies in the financial world.

Look at Model I.



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In this model, the assumptions are that a corporation on the basis of a feasibility study believes it should expand by adding plant or rolling stock or new tools or whatever, and that it can sell profitably the increased output. The logic of corporate finance, of course, is that the corporation invests in things that will pay for themselves. If corporate management invested on any other basis, I am sure it would not hold office very long. The rule of thumb is that newly-formed capital should pay off in three to five years. During depressions, it takes longer, and in some industries it takes longer. But in other cases, the time may be less than three years.

We assume for purposes of this example that the expansion will cost a million dollars. The corporation needs to get a million dollars of financing, so that it can carry out the expansion.

One way to do this is to go to a lender. The lender can be a venture capital supplier, a bank, an insurance company or whatever. The corporation presents the feasibility study and, after satisfying the lender, the corporation borrows the money, gives back a note, takes the cash, and buys the new tools. With that, it has accomplished its objective. The financing is completed.

The little lines at the bottom of the box representing the corporation stand for the shareholders.

There are, of course, other ways to finance that expansion. The corporation can earn profits and hold back the profits; in other words, hold back the wages of capital from the owners of capital, and, when enough has been accumulated, use the money to buy the new tools. The corporation must pay income taxes on that income, so that if it wishes to finance a million dollars' worth of capital investment and it is in a 56-percent combined state and federal tax bracket (in New York City it is 61 percent), it must earn in pre-tax dollars about 2.3 million dollars in order to have a million left over after taxes to pay the principal. I am disregarding interest because it is deductible for tax purposes.

Now, the corporation can, of course, finance its expansion in part out of accelerated depreciation, out of investment credit,

or out of depletion, if it is in a resource industry. For the moment, I am going to leave out equity capital -- i.e., sale of new securities to new buyers for cash. Let me just generalize about those financing techniques that I have mentioned so far. All of these techniques have a single uniform characteristic: when the financing process is completed, and the tools have paid for themselves or the company has paid off its loans, the same stationary stockholder base owns the incremental productive power represented by a million dollars worth of new tools -- or for the U.S. economy as a whole each year, about a hundred billion dollars worth of new tools. Those techniques cumulatively account for about 98 percent of all new capital formation. Functionally, these financing techniques are techniques for building incremental productive power into those who have no potential unsatisfied consumer needs or wants, and for denying that incremental productive power to the people who make up the potential consumer markets of the society.

To take an exaggerated example, a Howard Hughes with two billion dollars of productive capital is not going to buy anything more in the consumer market just because, if he sits tight for another five or six years, he gets a third billion dollars. The purpose of production is consumption. To accumulate, to hoard, productive power is as danagerous to a free society, a market economy, as if someone should manage to hoard the planet's entire supply of oxygen and force everyone to crawl on their knees to get a little whiff now and then.

The sale of new equities to the public or to investors for cash, which generally accounts for about 2% of financing of New Capital formation, has precisely the same concentrating effect. Why? Because it is a cash transaction, and because the only normal buyers for new equities are those who are already substantial capital owners.

But suppose we disregard the moral consequences of this arrangement and simply regard it as a business proposition. We are forcing ourselves into the arms of the totalitarian-style state, and the pressure toward totalitarianism does not originate in the labor union or in the ambitions of bureaucrats but in the board rooms of the modern business corporation because its directors are dominated by a defective strategy. This strategy destroys the potential ability of customers to buy what business produces.

Our national economic policy not only condones customercide -- it actually makes it inevitable. The economic policy of the United States of America declares that we can solve the income distribution problems through employment alone, through full employment.

Some years ago Simon Kuznets, who was the second man to win the Nobel Prize in Economics, wrote a book on the formation of capital in the American economy. Dr. Kuznets addressed himself to a very interesting question. He asked why do we have finance? What is the purpose of finance? And he answered his question by saying, "Well, we have finance because corporations need tools, they need land, structures and machines, i.e., productive capital, before they have accumulated the money to pay for it."

I think that Dr. Kuznets has made an absolutely sound explanation of the reason for finance. But since he is a one-factor economist -- an economist who does not think in terms of two factors of production -- he did not take the next step and ask, "Why do individuals, particularly individuals who have nothing to sell in the marketplace but their labor power, need finance?" If he had asked that question, he should have answered: because they need to own capital before they have saved the money to pay for it. Actually, if you want to be practical, they need to own capital in order to get money to pay for it. The sugar bowl idea of accounting and of economics -- that men can acquire capital only by diminishing their standard of living -- is valid only in a primitive economy. It worked in a crude way in the distant past; in a rare case, it will even work today. But applied to the population of the United States as a whole, the idea is so absurd as to be laughable. Unfortunately, this absurd idea happens to be absolute dogma with most economists.

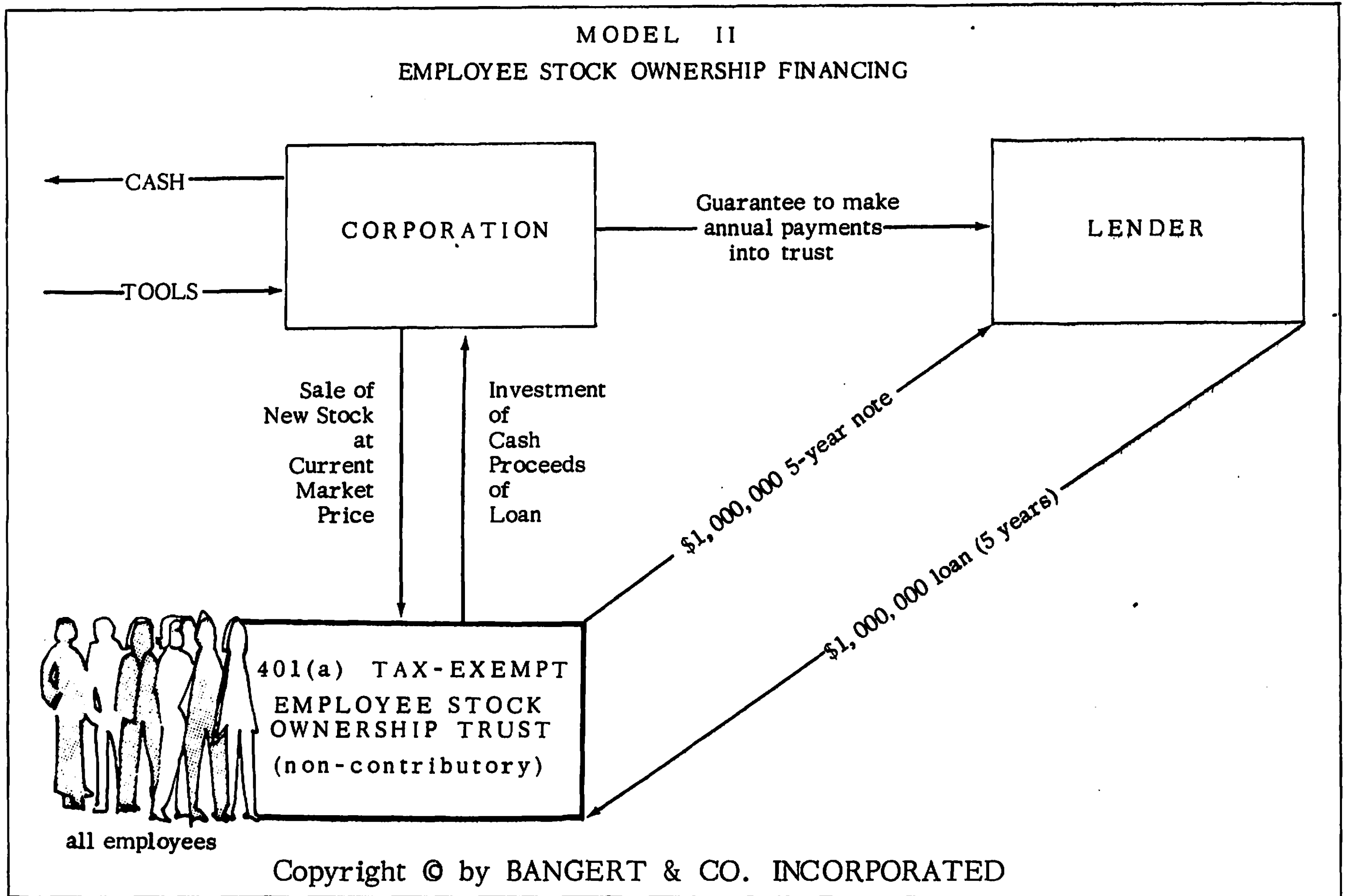
Pure credit, which is the power of a society to adopt laws under which people can contract with each other, enabling each party to enforce the terms of the contract, is all that is necessary to make credit available, using the logic of conventional corporation finance, to build capital ownership into those who do not have it without diminishing their take-home pay.

I tried for about a decade to get the investment banking fraternity to realize that there was a whole kit of tools, techniques for financing corporate growth, that would build ownership

into the capital-less employees of corporations, without taking anything out of their pockets or paychecks, and simultaneously providing low-cost capital to the corporation. I had no luck whatsoever. I must have talked to a dozen or so groups of investment banking people. But they were essentially brokerage people in the sense that what they were really thinking about during a luncheon talk was what the Dow Jones was doing at that moment and which customers they should call up in order to promote the churning around of pieces of paper that are outstanding in the Great Casino. This has almost nothing to do with the real world of economics. Not entirely, but to a very large degree, it resembles a crap game that is being played on the sidelines. I had no luck whatsoever.

Finally I saw that the way to make this innovation was to organize an investment banking firm that would operate on the principle that broadening the ownership of capital is part of the function of the investment banker where it also meets the client's objectives. In collaboration with several other people who are experienced in the world of finance, Bangert & Co. Incorporated was established with its headquarters in San Francisco. Bangert & Co. does not engage in any selling or buying of securities. It does not engage in underwriting. It engages in the service of working with venture capital suppliers, bankers, insurance companies and others to finance corporate growth, to finance the acquisition or divestiture of assets or the buy-out of close-holding shareholders, to structure the elimination of pension and retirement costs and to do many other things in ways that broaden the proprietary base of the businesses involved.

Now let us look at Model II.



This illustrates one of the basic techniques that Bangert & Co. uses. Some 15 different types of basic application of this technique have been devised; even so, I am sure that we have hardly scratched the surface. It is a whole new era of finance; it represents a whole new ball game. Let me explain the basic techniques

briefly, and then let me say what I think its significance to the venture capital world is. It is not the answer to all the problems, but I think that you will find it a very useful tool.

The assumptions are the same as in Model I, but in this case the corporation sets up an old, well-known device called a deferred compensation trust. These have been around for a long time. There are three varieties of them recognized by the Federal Internal Revenue Code, and the corresponding provisions of State laws.

In essence the trust is wholly exempt from taxes of all kinds. One tiny inroad was made in the Revenue Act of 1969, but it is not important and I think one day it will be eliminated.

These trusts are the ones you know as pension plans, profit sharing plans, and stock bonus plans. Conventionally, they have been used like giant piggy banks. The corporation sets them up, contributes money to them, and then those with the investment discretion go out in the big casino and buy pieces of paper floating around called blue chips. Virtually none of the funds go into new capital formation, and the investments are purchased at yields which rarely offset the inflationary erosion. So it is a thing that helps to make you look as if you were going somewhere when, in fact, you are either standing still or going backwards.

The testimony, by the way, before several Congressional and Senatorial committees that have studied these deferred compensation trusts, the so-called private retirement income systems, over the last three or four years indicates two interesting conclusions:

(1) Most people who participate in these plans never get anything. One economist -- from Columbia University, I believe -- testified that if the company gave the employee money and told him to go down to the nearest race track and invest it at the $2 window he would come out better than he would under the company's pension plan.

(2) If past service liabilities of these plans were fully funded, they would bankrupt most American businesses. The conclusion is that private retirement systems are not working in most cases. By and large, there is no hope that they ever will work because they are designed in a way that simply does not make sense.

But in the corporate financing techniques illustrated by Model II, we take the conventional deferred compensation trust and use it in a way in which it has never been used before, namely, we integrate it into the corporation's own financial structure. Here the corporation requests the lender to make a loan -- not to the company itself, but to its trust. The trust buys new stock from the corporation itself at market price, thus putting the cash in the corporation. The corporation issues the new stock to the trust, the trust gives its note to the lender, and then the corporation makes a guarantee to the lender that, whereas in Model I it borrowed directly from the lender and repays directly, under Model II, it borrows indirectly and will repay indirectly by making a payment into the trust each year of an amount sufficient to amortize the current installment of principal and interest of the note.

Now the differences between Model II and Model I are rather significant. In the case of Model I, when the financing process is completed, the same stationary stockholder base owns the incremental productive power represented by the new assets acquired by the corporation. Individuals within this small proprietary group may change by buying and selling stock to each other, but it still represents no more than 5% of U.S. families.

In Model II, when the financing process is complete, you have built productive power equivalent to a million dollars' worth of new capital into the employees of the corporation without taking anything out of their pockets or paychecks.

In the case of Model I, the corporation pays on the average, about 2.3 million pre-tax dollars to repay the principal of its loan, disregarding interest. In the case of Model II, the corporation will pay only one million pre-tax dollars to discharge the principal of its loan because the payments made into the trust by the corporation are deductible for corporate income tax purposes.

In tax theory, these payments are contributions to a qualified employee deferred compensation trust. In economic theory that isn't what is going on at all. In economic theory you have put the employees, by this technique of finance, in a position where they have, through their trust, access to non-recourse credit. This is the same kind of credit the stockholder has access to. The purpose of the corporation from the stockholder's point of view in Model I is to cut off personal liability. Thus the stockholder's capital ownership grows from the non-recourse (as to him) credit extended

to the corporation to enable it to acquire new tools. In the case of Model II, the employee is put in a similar situation through the design of the financing. In Model II the employee has access through the trust to non-recourse credit which is used to buy new stock, the proceeds of which are used to buy new productive power for the corporation, with the corporation making a commitment to the employees, as new beneficial stockholders, that it will pay out the wages of capital (i.e., proportionate part of pre-tax net income) relatively fully, so that they can pay for their stock while they are being temporarily deprived of the capital income until their stock has paid for itself. They pay for their stock out of what the underlying capital produces, without taking anything out of their pockets or paychecks. In other words, we have made the traditional logic of the corporation, which it uses for itself, available to employees who otherwise at the end of their working lifetime would end up propertyless. This statement, by the way, applies equally to corporate management. Management generally is the most strangely propertyless class in the entire society, indeed, in history. High incomes, high living costs, high taxes, high blood pressure, high mortality, but no capital. So that when management thinks about utilizing an employee stock ownership trust, it is often thinking about property ownership for itself as well as for other employees.

Fortunately, the tools under existing law are so ideal that it is difficult to imagine a more fortunate coincidence. Management cannot build capital ownership into itself without building capital ownership proportionately into other employees.

Now I do not need to tell you the motivational significance of this technique if properly used, and it can be used in any degree from zero percent to a hundred percent to solve a corporation's financing problems, either currently or over a period of years. The American economic dream is, always was, and I hope always will be, the acquisition of a privately-owned capital estate capable of providing an independent income. That is what Europeans set sail in their crowded little boats to come to the United States for. They did not come to the New World in search of better welfare laws.

From the standpoint of the management of the corporation, it is a beautiful tool because through it management can firm up its grip on control of the business. These trusts are normally operated by, and the stock is voted by, a committee that is appointed by the board of directors. The whole idea of two-factor economics separates the functional idea of <u>ownership</u> from the functional idea of <u>management</u>. The assumption is that anyone can be an owner, and that ideally everyone <u>ought</u> to be an owner, but it is not assumed that anyone can be a manager or that everyone ought to be a manager.

Now let us look at the concept from the standpoint of the venture capital supplier. Certainly, motivation is critical to the success of any business. Employee stock ownership financing techniques can make stockholders out of employees; there is a growing list of companies that demonstrates that. But from the standpoint of the venture capital supplier, it offers something

brand new. The Employee Stock Ownership Trust (ESOT) provides an in-house, private, company-controlled market for the stock. These trusts are designed to be invested primarily, or at least initially, in company stock. They can buy new stock from the company; they can buy it from close-holding stockholders; they can buy it from venture capital suppliers who have taken a risk to help finance the company's growth, and who seek to participate in that growth through their equity. The trust can borrow money so that it can make stock acquisitions. It can make those acquisitions in pre-tax dollars. If you should try to do this by a redemption, it would cost you over twice as much because you have to pay taxes on that income before you can use it for a redemption. Thus, the venture capital supplier can withdraw his capital and his profit, which is his reason for investing, without forcing the company into the arms of a conglomerate, which may disorganize it and ruin it for all time, or without forcing it into the public market, a step which may be equally disastrous because it becomes tied to wild, irrational forces that have no direct and immediate relation to what goes on inside the business. No doubt there is some correspondence over a period of years between the income performance of the corporation and the price of its stock, but as of any particular moment (and purchases or sales are made as of particular moments) this correspondence is at best a coincidence.

The techniques illustrated by Model II can be adapted to organizational start-ups; that is to say, a venture capital supplier can buy a combination of equity directly from the corporation and notes from its trust. The capital invested in the trust

is then reinvested in new stock of the corporation which, when paid for over a period of years, builds ownership into the employees. This enables the capital supplier to recover a part of his investment without any tax consequence at all, and have his equity ride in stock issued directly by the corporation, or conceivably even in stock acquired from the trust, which can use some of the stock which it buys to provide a sweetener for loans that are made to it where appropriate.

You still have the general credit of the corporation behind your financing, but the credit is twice as good as before because the debt is repayable in pre-tax dollars, rather than after-tax dollars.

The technique, of course, can be used to finance spin-offs and divestitures. I hope that during the next four years of the Nixon Administration, the Department of Justice will recognize that any divestiture should first be tested for acquisition by the employees before acquisition by any other buyer is considered. We need to broaden the equity participation base of the American economy.

Mr. Nixon announced shortly after his 1972 re-election that he was going to devote his next four years to building self-sufficiency into the American people. You know, and I know, that in an advanced industrial economy there is no way to be <u>self-sufficient</u> without the private ownership of a viable capital estate. So if he expects to fulfill that promise -- and it was a post-election promise -- there is but one way for him to go as far as the business world is concerned.

There are many applications of the technique I have outlined to you. The most that I can do in this already lengthy statement is to hope that I have made you aware of a completely new dimension to corporate finance, of a technique which enables management, in the long run, three to five years downstream, to raise employee income without raising costs. You see, we like to design these trusts so that when the stock has paid for itself, the income yield, any dividends on the stock, flows right through the trust into the employees' pocket. Where all the stock is closely held -- that is, held by promoters, capital suppliers, and employees beneficially through their trust -- we can even design a payment that flows through the trust, looking for all the world like a dividend, but actually payable in pre-tax dollars.

I appreciate very much the opportunity to talk to you. I hope that I have aroused some interest in pursuing a study of the subject. Thank you very much.

(Applause)

MR. ALLEN: We have a few minutes if anyone has any questions. Yes.

VOICE: Mr. Kelso, wouldn't it be true that the limit of payment to the trust in pre-tax dollars is limited by the number of employees and percentage of salary under the Internal Revenue Code:

MR. KELSO: Yes, sir, it is.

VOICE: It is not an outright guarantee?

MR. KELSO: Well, it depends on the size of your payroll. But, in many, many cases, it is an outright guarantee. By the way, it _is_ an outright guarantee. The guarantee is not limited to what is repayable through the trust. The guarantee, the amount that is tax deductible, is limited by the Internal Revenue Code provisions but the amount of the guarantee is not limted to that at all.

Let me say also that we can, under the right circumstances, get to 25 percent of pre-tax payroll by laminating a so-called stock bonus trust with a money purchase pension trust. We are also asking the Ways and Means Committee of Congress to sponsor the liberalization of those limits. I don't know what luck we are going to have.

VOICE: There are three or four things I see that I don't understand.

MR. KELSO: Yes, sir.

VOICE: First of all, the pension trust becomes leverage, does it not, and, therefore, you are taking, and let me shoot it out at you and tell me where I am wrong.

MR. ALLEN: Please be quiet so you can hear the question.

VOICE: The pension trust becomes leverage which is actually speculation and risk-taking with unsophisticated buyers', to wit, the employees' funds.

MR. KELSO: Let me take that one first because I may not remember several long questions. The question is, "isn't the trust leveraged, and aren't you speculating with the funds of unsophisticated buyers?" The answer is no.

VOICE: Why not?

MR. KELSO: The answer is no, because you have put the employees in a position where they have access to non-recourse credit to buy stock under terms where the underlying capital will pay for it without taking one cent out of their pockets or paychecks.

VOICE: But if the company fails, you are giving them a pension trust that is illusory, just like the ones you have rejected.

MR. KELSO: But with a great difference: The conventional pension trust does nothing to keep the employees from being in a position where they must demand more and more pay for less and less work, and this is a chief source of business failure.

VOICE: But an ESOT may invest in a business that fails just like the conventional retirement trust.

MR. KELSO: No. Any belief that the employees of U.S. business can be prosperous while U.S. corporations go down the tubes is a big hoax. There are a lot of people who believe that hoax, but it is not true.

VOICE: All right.

Secondly, doesn't IRS disqualify leverage investments now from the tax exemption?

MR. KELSO: No indeed. Only if you use the wrong type of trust. The trusts designed by Bangert & Co. do not suffer from this problem.

VOICE: Thirdly, when you have the corporation guarantee alone for future shareholders, isn't that eleemosynary in the sense that the present shareholders are guaranteeing money to be used by future shareholders and, if it is successful, they will dilute their own

equity in the same corporation and have taken all the risks themselves?

MR. KELSO: You have asked about half a dozen questions there. If capital is purchased on terms by the corporation where it will pay for itself -- in other words, if that is the logic of corporate investment -- all this technique does is to put employees in a position to get the credit through which the capital is acquired, under terms where they are deprived of what it produces until it pays for itself, which it then proceeds to do. I can tell you specifically what the stockholder does lose. It isn't that he is diluted. He is not diluted, except temporarily. In the long-term he is enriched. Because once the capital has paid for itself, it works for all shareholders, including the new employees. But the existing stockholder is frustrated if he desires to acquire all future productive power through the financing process, even through he may be destroying the free market economy in the process.

VOICE: Don't all of your theories assume a profitable investment of the capital derived?

MR. KELSO: Certainly.

VOICE: And on the down side, you have caused the existing shareholders to dilute their equity and to pay for somebody else's investment at their own risk?

MR. KELSO: But the essence of the risk of collapse comes from putting the entire labor force of the U.S. economy in a position where it must relentlessly demand more and more pay for less and less work, including more and more pay for no work whatsoever,

like the 50 or 60,000 firemen riding around in the cabs of locomotives where there is no job for a fireman at all. That is what is destroying American business.

Keep in mind that it is under traditional finance that the Penn Central, and Lockheed, and the Chicago Northwestern, and God knows how many other corporations, are going down the tubes or are being supported by the Government. It is the mis-match between unsatisfied needs and wants and the power to produce sufficient income that creates the major cycles in the U.S. economy.

Let me give you an example to demonstrate this. If you put human physical consumer needs and wants in terms of food, housing, clothing, vacations, books, opera tickets, etc., over any period of time, you will find it is a very smooth rising curve. Now, if you plot the physical capability of the economy to satisfy those needs and wants over the same period of time, you will find that this, too, is a smooth rising curve, which rises even more steeply.

Now, if you plot the economic cycle or, even better, the gyrations of the stock market over the same time period, you get a line that goes up and down like a yoyo. What does that tell you? It tells you that the disconnection -- the discontinuity, to use Peter Drucker's word -- is due to our failure to build incremental economic power to produce into those with unsatisfied needs and wants through effectively building capital ownership into them. That is where the instability of the economy comes from. It is this failure that disconnects the economy and the stock market from the otherwise happy physical facts of life.

MR. ALLEN: Time for one more.

VOICE: The concept of payment on a pre-tax basis using a profit sharing formula is something that is excellent and I think we all see the point. I should appreciate a bit of comment on your limitation of time, the pay out time, in utilizing this technique. As near as I can see, if you pay ten times price-earnings ratio for a business with the limitation of 25 percent pre-tax, you have got a 40-year payout period. Is that valid?

MR. KELSO: We have done it in about 20 businesses, and we expect to close another ten in the first part of next year. It has taken as little as two years to pay out in some of them. I think what you are missing is that the price-earnings ratio is an after-tax ratio.

VOICE: I am talking about pre-tax.

MR. KELSO: Well, ten times pre-tax earnings -- is that what you are saying?

VOICE: That is where he is wrong.

MR. KELSO: You see, price-earnings ratio is based on after-tax position. Let me give you a statistic which clarifies this. If you will look at the annual pre-tax return on invested net worth of the top 4,500 corporations in the U.S. economy, it has fluctuated between 20 and 26 percent over the last dozen years. What this technique does is to plug the employees into that stream of yield in terms of pre-tax dollars.

Let me correct one other misimpression. We do not in most cases use a profit sharing formula. The commitments of the corporation to the typical trust is an absolute commitment. That is

to say, it is a commitment to make a fixed payment into the trust each year; it is guaranteed by the general credit of the corporation. This requires a little known but nevertheless legally available trust that has been in the law, or available under the law, for a great many years.

(Applause)

MR. ALLEN: Thank you very much, Louis. I am certain that the close attention paid by this audience and their questions proved that your novel ideas have stimulated many of us to re-think some of our economic thinking. All of us sincerely appreciate the fact that you were willing to take time out of a busy schedule to come down to Monterey to enlighten us.