765

EMPLOYEE STOCK OWNERSHIP PLANS (ESOP's)

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

FIRST SESSION

PART 1

DECEMBER 11, 1975

Printed for the use of the Joint Economic Committee

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EMPLOYEE STOCK OWNERSHIP PLANS (ESOP's)

THURSDAY, DECEMBER 11, 1975

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:30 a.m., in room 1202, the Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Javits, Percy, Fannin, and Long; and Representative Long.

Also present: Robert D. Hamrin and Loughlin F. McHugh, professional staff members; George D. Krumbhaar, Jr., minority counsel; M. Catherine Miller, minority economist; and Michael J. Runde, administrative assistant.

Chairman HUMPHREY. I have asked Lieutenant Governor Kroupsak of the State of New York to join us here, and Congressman Haley to be with us—I should say assemblyman, I did not mean to make you a Congressman right away, but it is nice to have you here. Dan Haley has spoken to me so many times about Mr. Kelso, I thought that we ought to have him here with us.

We are very fortunate to be honored by the presence of two of our distinguished Senate colleagues, Senator Long and Senator Fannin. We are pleased to have them. They are both on the Finance Committee We look forward to their participation.

I have a brief opening statement.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Our first witness this morning is Mr. Walker from the Treasury Department, and we will get to him in just one moment.

Today's hearing is the first of a 2-day set of hearings which will be focused on employee stock ownership plans. Our esteemed colleague, Senator Russell Long, and chairman of the Finance Committee, has taken the lead in the Congress in terms of interest in these proposals. We are so pleased that Senator Long could be with us.

We will be examining some of the broader economic implications of expanding the ownership of stock by employees through the ESOP mechanism, hearing from economists, from lawyers, and administration officials. I hope also from business people. Tomorrow, we move to more microconsiderations as we closely examine how ESOP's work at the corporate level, and what types of corporations may or may not benefit from these types of plans.

I am sure there is a need for a great deal of information on these proposals. The American public is not too well informed.

As I said in the press release announcing these hearings, these plans have been heralded as the basic solution for many of our economic ills. Specifically, one of our chief proponents who will be testifying today, has said that widespread adoption of ESOP's will accomplish the following objectives: The restoration and acceleration of economic growth to unprecedented levels; create legitimate full employment for two or three decades; and lay the foundation for arresting inflation.

I must confess that these are some claims. Certainly no one since I have been chairing this committee has come before us with any program that promises that much.

We have convened here today to see what degree of merit there may be in ESOP's, not only as they operate at the corporate level, but also their aggregate impact on the economy.

We have to examine these proposals in complete objectivity, hoping to learn. I feel that this kind of comprehensive investigation is long overdue. Corporate interests in adopting ESOP's has been growing rapidly. Many corporations already have adopted ESOP's—estimates range from 150 to as many as 500.

This interest was considerably sparked by the Tax Reduction Act of 1975 which provided an additional 1 percent to the investment tax credit, if the dollars saved were put into an ESOP.

I believe, Senator Long, that was your child, is that not right?

Senator Long. Yes.

Chairman Humphrey. This bill was actually the fourth one in the past 2 years in which Congress has included an incentive for instituting what we call ESOP's.

The first was the Regional Rail Reorganization Act of 1973 which gives ConRail authority to purchase its common stock through an ESOP for distribution to employees.

Tomorrow, the vice president of the United States Railway Association will be here to discuss why they rejected an ESOP financing vehicle for ConRail.

ERISA, the Employee Retirement Income Security Act of 1974, which my colleague, Senator Javits, did so much fine work on, exempts ESOP's from prohibition on certain transactions between pension trustees and employees. In fact, the ESOP is singled out as the only employee benefit plan which can be used as a vehicle for corporate borrowing and other debt financing.

Finally, the Trade Act of 1974 gives preference for the Commerce Department loan guarantees to corporations that agree to place 25 percent of the principal amount of the loan into a qualified trust under an ESOP.

So we have congressionally provided incentives, at least thus far, some corporate adoption, a widespread corporate interest, and finally the promises that ESOP's are the key to a dynamic economy in the future. The only thing we have not had here in the Congress is a comprehensive examination of ESOP's which has taken a close and hard look as to just how beneficial they will be, not only for corporations, but also for the employees and the economy as a whole.

I trust we will shed some light on these matters in these 2 days of hearings. Today, we will begin with a panel of four individuals who come to ESOP's from different perspectives and degrees of support.

Mr. Louis Kelso, a lawyer-economist, could be actually described as the founder and father, so to speak, of the ESOP concept. He began writing on the idea back in the mid-1950's and has tirelessly pursued the concept through today. He, more than any other proponent, has placed ESOP in a broader economic context by relating it to the future economic growth of this country, employment, and inflation.

Helping us to judge the broader economic merits of ESOP's or some other form of broadened employee stock ownership are two academic economists. Prof. Hans Brems, from the University of Illinois, has done extensive research on these types of plans, especially as they have been debated and practiced in Europe. He is truly one of America's few experts on the European experience in this area. We look forward to his insights on what we can learn from that experience.

Professor Brannon of Georgetown University is a well-recognized tax authority who has taken a critical look at the tax aspects and implications of ESOP's.

The final panel member will be Richard Fay, a lawyer, who has just recently left the employment of the Senate Labor and Public Welfare Committee. While with the committee in the past few years, he was heavily involved with ERISA, particularly its ESOP-related provisions.

Before getting to this panel, we will hear, however, from Charles Walker, Assistant Secretary of the Treasury for Tax Policy. The administration, I understand, has been examining the ESOP concept for some time now, primarily in the Commerce and Treasury Departments.

Mr. Walker will be presenting today the current administration thinking on ESOP's and, also the Treasury analysis of the tax implications.

We have a lot of ground to cover, as there are so many unanswered questions concerning the broader economic ramifications of widespread ESOP adoption. In fact, many of the questions have not really been asked yet. I know that they will be asked in part today; I hope many will be answered.

Mr. Walker, we welcome you and thank you for your patience. We ask you to proceed.

Senator JAVITS. Mr. Chairman, I have an opening statement I would like to present.

Chairman HUMPHREY. Yes.

OPENING STATEMENT OF SENATOR JAVITS

Senator JAVITS. We are here today to investigate the practical economic viability of the employee stock ownership concept for the mutual benefit of American labor and management and the ultimate benefit of the domestic economy. For some time now it has been my belief that the employee stock ownership concept, if properly developed, provides a mechanism to improve the financial condition of working Americans and at the same time improve the productivity of American industry. It is my firm belief, and I believe with Senator Humphrey, that these laudable goals can and must be achieved by providing the opportunity for American workers to share in the fruits of our economic system by way of employee stock ownership.

To the extent that the Joint Economic Committee favorably assesses the concept of employee stock ownership, Congress should be in the position to encourage, by way of legislative initiatives, an appropriate ESOP model. While I note that the Joint Economic Committee hearing schedule contains a number of extremely knowledgeable economists and government representatives it is my hope that these hearings will lead to legislative hearings before the Senate Labor and Public Welfare Committee, of which I am a member, for a practical assessment of the legislative program which I am formulating. I am drafting legislation which will provide a mechanism for encouragement of the ESOP concept for the benefit of labor and management. I would expect that we would receive substantial input from the American labor movement before the Labor Committee. I expect that the Senate Labor and Public Welfare Committee will conduct extensive hearings in order to review this concept in comprehensive fashion for the benefit of labor and management, who will bear the major responsibility for the successful adoption and administration of ESOP's.

I firmly believe that employee stock ownership plans, voluntarily negotiated and administered by labor and management, for the American workers, may provide part of the answer to the current productivity problems we have been experiencing in America. Indeed this entire concept may have a beneficial effect on many of the other economic and social problems which face the Nation and at the same time benefit and improve the quality of our entire industrial output.

While I fully endorse the concept of voluntarily negotiated employee stock ownership plans, I have serious reservations about the Joint Economic Committee endorsing any one program that is currently being utilized in America. As a practical matter we are just beginning to develop useful models which may in fact accomplish the beneficial goals which I believe we can achieve through the use of employee stock ownership plans. It is premature at this point to choose any one of the currently popular models for potential endorsement as the road to future success in this field. While I have serious reservations about certain features of the Kelso plan, which in my opinion must be refined and corrected as we strive to formulate a model plan, I applaud Mr. Kelso's efforts to direct attention to these plans in general. I I will briefly summarize the reservations I have with respect to the Kelso plan, which in my opinion render it less than appropriate for legislative endorsement.

First and foremost, the Kelso type plans fail to provide adequate safeguards for affected employees. Although workers are assigned the role of detached "bystanders" who receive stock for which they pay nothing, there is no assurance that they will not have to pay for the stock with lost wages. In this regard it should be recognized that Congress saw fit to pass the Employee Retirement Income Security Act which imposes many specific and far-reaching safeguards for vesting, funding, participation, and reporting and disclosure which are applicable to pension plans. I suggest that comprehensive safeguards will need to be applied to ESOP's as well in order to protect future participants in employee stock ownership plans from being the recipients of illusory benefits.

My apprehensions with regard to employee safeguards were compounded significantly when I read the following in a New York Times article of October 5, 1975, on ESOP's and I quote verbatim:

> Some investment bankers are advising companies that in exchange for the value of the stock that they are putting into the ESOP they should try to get something back from other fringe benefits. They recommend, for example, reducing hospital benefits or vacation, or holding back on salary increases.

If ESOP's are to receive legislative encouragement it must be by way of an approach which applies the safeguards and protection of both ERISA and the NLRA by way of appropriate amendment of these statutes. Finally ESOP's must not be viewed as a way of diluting wages and other fringe benefits.

With specific regard to the Kelso model I am as yet unable to perceive how workers suddenly can become more productive upon the receipt of stock by an encumbered trust, in which they have no voting right and no financial relationship.

I am also concerned about an ESOP trust device being utilized to enable owners of financially troubled companies, particularly closely held companies to "cash in" their stock via an ESOP when it is especially difficult to determine a fair market value for their stock. This device appears to be a convenient vehicle for owners who need buyers for their stock. Were this possibility to be prevalent on a large scale, workers would be placed in a vulnerable financial position; that is, being in debt to the lender of stock purchase funds.

I would not wish to see the Kelso plan being used as a gimmick to benefit everyone at no one's expense. I have a reservation about the possible inequities inherent in a proposal that, in effect, would allow corporations to deduct the principal component of amortization payment. Julius W. Allen, senior specialist in price economics, Congressional Research Service, has noted that there would be a sizable loss of tax revenue upon wide adoption of this device. The loss in revenue would necessitate either a reduction in government services or an increase in taxes.

I am also very interested in knowing how workers who move from employer to employer can obtain some portability of equity under such a plan. Little has been written on this essential aspect.

Finally, I am concerned about the downside risks of an ESOP for a typical worker, especially when his later working years and/or retirement coincide with a marked decline in the share price of his company's stock. It seems to me that a reliance on the Kelso leveraging technique places the worker's job and retirement future under the same set of risks.

In conclusion, I ask unanimous consent to place in the permanent record of this hearing, the prepared statement of Professor Musgrave on ESOP's; the Congressional Research Service's publication entitled "Employee Stock Ownership Plans: Current Status and Proposed Legislation"; "A Technical Review of the Employee Stock Ownership Trust," by the consulting firm of Towers, Perrin, Forster, and Crosby; "The Hidden Costs of ESOP's," by Triad Financial Reports; "Evaluation of the Use of an Employee Stock Ownership Plan as a Method of Capital Formation for ConRail," by the E. F. Hutton Co.; an analysis of the Kelso plan by Julius Allen of the Congressional Research Service; and a background report on ESOP's by Don Sullivan of the firm of Towers, Perrin, Forster, and Crosby.

I should like to direct special attention to the prepared statement on ESOP's written especially for the record of this hearing by the distinguished professor of economics at Harvard University, Richard Musgrave. Professor Musgrave responded to my personal request to study this question and has provided us with a lucid and enlightening economic analysis. I believe that these articles raise those areas of concern which need to be considered by the committee and by the legislative committees concerned.

Thank you, Mr. Chairman.

Chairman HUMPHREY. Thank you, Senator Javits. Without objection, the material referred to by you for the hearing record will be included at this point.

[The material follows:]

PREPARED STATEMENT OF RICHARD A. MUSGRAVE, H. H. BURBANK PROFESSOR OF POLITICAL ECONOMY, HARVARD UNIVERSITY, ON EMPLOYEE STOCK OWNERSHIP PLANS

I have been requested to comment on the Kelso plan and am pleased to do so. The debate over this proposal is difficult to disentangle, as it involves a number of more or less related issues, including the appropriate tax treatment of employee stock ownership plans, the case for broadened ownership of corporate wealth and for profit sharing, as well as provision for increased availability of equity capital. To see the plan in its proper perspective and to cut through the vastly exaggerated claims which are made on its behalf, let us see how this plan differs from other and more conventional pension and financing arrangements.

Kelso Plan and Alternatives

For this purpose, let me compare four procedures, all of which cost the same to the company in trust fund contributions and involve the same expansion of real assets.

Alternative I. We begin with the Kelso procedure which involves these steps: (*a*) The company establishes a qualified, tax exempt employee pension trust; (*b*) the trust borrows $1 million from a bank and invests this in shares of the company; (*c*) the company uses these funds to increase its real assets, thereby expanding earnings; (*d*) the company makes tax-deductible payments to the trust in the amount of $1 million, which amount is used to service (pay interest and amortize) the debt; (*e*) ownership of the shares accrues to the employees in proportion to their wage receipts; (*f*) if the employees receive their shares or cash equivalent upon retirement and become taxable at that time. Assuming a tax rate of 20 percent, they will pay $200,000 in tax.

Alternative II. Next, suppose that the trust fund does not engage in contracting debt. Rather, (*a*) the company borrows $1 million directly, an expands its capacity; (*b*) the company makes a tax deductible contribution of $1 million to the trust; (*c*) the trust invests these proceeds in the shares of the company; (*d*) the company uses the proceeds to pay off its debt; (*e*) as before, the employees are taxed at the time of distribution.

Alternative III. This alternative is similar to II except that the trust fund invests in the general capital market and the company continues to carry the debt.

Alternative IV. Under this alternative, the trust invests as in III but the company sells shares in the capital market rather than debt finances.

All these procedures can be followed under present law. How do they differ? Alternatives I and II are equivalent for all parties concerned. The company finds its real assets expanded, the debt has been paid off and the trust is in the possession of additional shares. Employees clearly have gained through ownership of these shares if the company's contribution was in addition to normal wages. But even if the contribution is in lieu of wages, they have obtained some gain because their tax is deferred and may be payable in the future at a lower bracket rate. The treasury has incurred a corresponding loss. In short, the outcome of the Kelso procedure is precisely the same as for direct borrowing, provided that trust-fund receipts are reinvested in the company. Under alternatives III and IV the position of wage earners remains the same as under I and II, except that their

equity investment is outside the company. The position of the company differs in that the financing is by debt under III and the shares are held by outside investors under IV. Finally, how is the position of the "old" shareholders affected? If we assume that the company's contribution to the trust is in lieu of wages, there is no effect at all; but the value of their equity is reduced if the contribution is additional. Such is the case under all four plans, the Kelso approach being no exception.

Evaluation of Kelso Procedure

Viewing the Kelso procedure on this comparative basis, what are its advantages and disadvantages?

1. It is argued that the Kelso approach results in a gain to the company because ownership in the work place renders labor more productive. This gain in productivity and the resulting reduction in labor cost is said to offset the cost of the company's contribution to the trust, so that the value of shareholder's equity is not reduced thereby. As has been pointed out repeatedly, this is a very dubious argument. A favorable productivity effect may well result with regard to management personnel and small companies, but it is more questionable with regard to the average worker in a large corporation. The romance of worker-ownered companies, while attractive in Yugoslavia or Peru, is not readily adaptable to the U.S. setting of giant corporations. In any case, the situation would be the same under alternative II, provided that the trust is required to invest its proceeds in the same company. However, such productivity advantage as is gained thereby must be weighed against the disadvantage to the employees as investors, which results from thus limiting their portfolio.

2. Assuming perfect capital markets, all four approaches would lead to similar results, but markets are not perfect. The company may have no access to the equity market and an arrangement with the trust fund to reinvest may provide the only way to obtain equity funds, or to obtain them at lower cost. Note that this result could be accomplished under alternative II as well as I. In either case it is questionable whether the employees should provide this service to their company, and in particular to companies which are not sufficiently strong to have access to the capital market.

3. Under the Kelso approach, as under alternative II, investible funds are obtained through the advancing of bank credit, a feature which would not be available under III and IV. Within the context of a given monetary policy which permits a set total of credit expansion, this expansion must be offset, however, against a similar reduction in available funds somewhere else in the sytstem. Moreover, even if a net expansion occurs, this is a once and for all increase only, as the debt comes to be paid off later on.

4. But is not alternative I superior from the company's point of view to alternative II because, by channelling its borrowing through the trust, it is able to deduct for purposes of the corporation tax not only interest (as under II) but also debt retirement? This seems a powerful advantage at first sight, but at closer consideration the argument proves spurious. Assume that $100 are raised at 10 percent and, to simplify, consider the loan to be repaid in one year. Under the Kelso plan, the company pays $100 to the trust, with a net cost of $52+$5.20=$57.20. Under alternative II, the payment to the bank equals $100, at a net cost of $100+$5.20=$105.20. In addition, a $100 contribution to the trust is made at a net cost of $52, making for total payments of $157.20. At the same time, the company's equity is increased as the debt is repaid (real assets are added and the liability is liquidated) by $100, leaving a net cost of $57.20, the same as under I.

Policy Issues

The special feature of alternative I (the Kelso approach) is its linkage of the trust fund arrangement with trust fund borrowing and the reinvestment requirement. Note that the reinvestment requirement can also be linked with direct borrowing, but that borrowing through the trust must go with reinvestment. The policy issues which emerge are as follows:

1. Should additional tax support be given to pension plans in general?
2. Should special support be given to reinvestment?
3. Should special support be given to contributions to the trust fund if these are used to amortize trust fund debt incurred on behalf of the company?

The first objective might be implemented by increasing the present limit of 15 percent of wage payments to say, 30 percent, as has recently been proposed.

The question here is whether this form of investment is most desirable from the point of view of the small investor, and whether such incentives as are given should be restricted to the pension fund arrangement. Moreover, if such an approach is followed it should be limited to contributions made in relation to wages as distinct from salaried personnel. The second objective might be implemented by relating the limit of deductible contributions to the degree of reinvestment in the company, but I doubt the wisdom of giving a special incentive of this sort. If the employee is to be made a capitalist, let him have the same option which is available to other investors of choosing his investment where it seems most advantageous. The third objective might be achieved by permitting deduction at above 100 percent (say 150 percent as recently proposed) of corporate contributions which are used to repay trust fund borrowing. Such a move appears to be advocated by the proponents of the Kelso plan, but it would be undesirable. I consider it such for two reasons. (1) I do not favor giving the trust a special incentive for reinvestment in its own company, a move which becomes necessary if the trust serves as borrowing agent. (2) I see no advantage in this round-about procedure. If the company is to obtain funds through borrowing, it can do so directly and without drawing a magical veil over what actually goes on. The so-called "leverage" provided by the Kelso arrangement is equally available, and more simply and visibly so, by direct borrowing; and employee ownership in the company, if held desirable, may be obtained more simply and directly by reinvestment of trust proceeds without involvement in borrowing.

In concluding, I would note that this discussion has dealt with the question of trust fund contributions (deferred wages) made in lieu of direct wage payments or, in any case, independent of company profits. These proposals therefore do not address themselves to the issue of profit sharing, where company contributions are linked directly to profits. Shared profits may be paid out currently, or they may be held in a pension trust arrangement. The further question arises whether the employees' profit share should depend on profitability at his place of employment or on the profitability of companies at large. Under the latter approach, part of corporation tax revenue could be set aside for investment in an employee owned mutual fund, the type of approach now under discussion in European countries. In short, there are a large number of possibilities to be examined, but the particular arrangement proposed by the Kelso plan does not rank among the more attractive ones.

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EMPLOYEE STOCK OWNERSHIP PLANS: CURRENT STATUS AND PROPOSED LEGISLATION

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EMPLOYEE STOCK OWNERSHIP PLANS: CURRENT STATUS AND PROPOSED LEGISLATION

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EMPLOYEE STOCK OWNERSHIP PLANS: CURRENT STATUS AND PROPOSED LEGISLATION

Introduction

The concept of employee stock ownership has long been debated as a method of achieving greater productivity for the employing firm and greater income for the employee. It is one of several proposals, including profit-sharing, labor-management productivity committees, and productivity-sharing arrangements, that have been adopted in various situations to provide greater worker participation in business.[1/]

Many different types of employee stock ownership plans (ESOP's) can be found today throughout American industry. One traditional type is the stock purchase plan designed to encourage employees to utilize their own funds to acquire company stock while remaining an employee. Typically, the company concerned contributes to the plan in various ways including establishing a system of payroll deduction for employee stock purchase, arranging for reduced or no brokerage fees in stock purchase, or making a company contribution (often 20-25 cents for each dollar contributed by the employee) to supplement employee funds. Sometimes stock purchase plans are part of a more general employee retirement or savings plan.

1/ For a broader discussion of employee stock ownership plans as well as other methods of achieving greater worker participation and ownership in business, see "Worker Participation and Ownership in American Business" by Peter Henle, Congressional Research Service Multilith No. 74-192E, Nov. 1, 1974.

For a number of leading American industrial firms, including American Telephone and Telegraph, an employee stock-purchase plan dates back to the early 1900's. These plans became more popular during the 1920's, although some of these did not survive the depression of the 1930's. A 1966 survey indicated that one-fifth of the firms whose securities were listed on the New York Stock Exchange had an employee stock purchase plan. In addition such plans were also well represented among banks and insurance companies.[2/] However, the practice is far more prevalent among the larger than the smaller size firms.

In addition to such stock purchase plans for all employees, many firms as part of their executive compensation program have adopted stock option plans for higher levels of management under which the employee is offered an option to purchase company stock at the current market price without actually making payment until sometime in the future. Later, if the price of the company's stock should rise, the employee can exercise his option to purchase the stock and thus benefit from the appreciation in value. Moreover, for a qualified option the gain in the value of the stock is not taxed until the stock is sold, and gain will be taxed at capital gains rates (typically half the usual rate) when sold if certain conditions are met. (The difference between the option price and fair market value at the time of the option

2/ Mitchell Meyer and Harland Fox, "Employee Stock Purchase Plans", National Industrial Conference Board, Studies in Personnel Policy, no. 206, 1967.

may, however, be subject to the minimum tax). The rationale behind such stock option plans is that this type of favorable treatment is necessary to assure the firm of retaining the valued experience of individuals with high managerial ability.

More recently an increasing number of firms have been adopting a somewhat different type of stock ownership plan, in the nature of a stock bonus plan, one in which a separate trust is created to receive contributions from the employer in the form of shares of stock to be held and allocated among the individual employees. Stock allocated to an employee accumulates over a period of years, to be distributed whenever employment is terminated, normally upon retirement. In this form, the stock ownership plan is a form of compensation to the employee having somewhat similar characteristics as an employee pension or deferred profit-sharing retirement plan. (Corporations are allowed to deduct the fair market value of contributed stock, just as they are allowed to deduct contributions to pension and profit sharing plans.)

In fact, no clear demarcation exists between a deferred profit-sharing plan and an employee stock ownership plan. Both types of plans utilize the device of a fund or trust to receive employer contributions and both represent a form of supplementary compensation to the employee, aimed primarily at providing a source of income at retirement. The central characteristic of a deferred profit-sharing plan is that the employer contributions to the plan are based on profit---no profit, no

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contribution. The central characteristic of an ESOP is that the individual employee can acquire title to shares of stock in the firm for which he works. Thus, one plan (profit-sharing) focuses on the formula for the employer's contribution while the other (ESOP) focuses on the granting of ownership rights to the employee. However, the difficulty of classifying plans is illustrated by the plans which relate the employer's contribution to profits and also provide a fund to purchase shares of the firm's stock to be allocated to individual employees.

One variant of this type of stock ownership that has gained special attention in recent years represents the work of Louis O. Kelso, San Francisco lawyer-economist. The "Kelso Plan" is a broad proposal to improve economic performance by giving employees a share in ownership of their firms. The key element in a Kelso Plan is a method of utilizing an employee stock ownership plan to help the employer borrow money from the capital market.

Here is the way the plan operates. The company establishes a qualified tax-exempt trust under the Internal Revenue Code. When the corporation requires funds for expansion, instead of going directly to the money market, the trust borrows the necessary funds which in turn are invested in shares of stock of the corporation, the shares being sold at their fair market price. The corporation has the use of the borrowed funds and guarantees to the lenders that it will make sufficient annual payments into the trust to meet principal and interest payments on the loan. The stock is owned by the trust on behalf

of participating employees and as the principal and interest payments are made, the shares of stock become free of any lien and are allocated to each employee's individual account. An important question is whether the stock is to have voting privileges and, if so, who will exercise those voting rights.

Dividends may be treated a variety of ways depending on the plan. Under some plans, the dividend payments on stock are used to reduce the amount the corporation must pay into the fund. In other cases dividends on allocated stock are additional payments into the trust or paid directly to the employees. As will be seen later, the level of dividends paid and the use of these dividends has a significant impact on the tax benefits and the net cost of the plan to the corporation.

A vesting requirement is typically included under which the employee becomes entitled to his allocated stock only as he meets certain service requirements. Most employees are fully vested by the time they have completed ten years of service.

Typically the employee receives his vested allocated shares of stock or cash equivalent only at retirement or upon termination of employment, although in some cases certain types of emergency distributions are permitted. In case of death, the employee's stock passes to his estate.

Mr. Kelso has written extensively regarding his plan.[3/] His main thesis can be summarized as a belief that (1) increased output depends primarily on increasing inputs of capital and (2) that greater ownership of such capital by a firm's employees will provide a second income to workers enabling them to share more directly in the increased output resulting from the increments of capital input and giving them greater incentives to increase their productivity and their interest in the profitability of the firm. As Kelso has said, "All we're doing is cutting the average worker into the capital gains pie." More information regarding Mr. Kelso's economic views can be obtained from a recent analysis by a Congressional Research Service economist.[4/]

Although these newer types of employee stock ownership plans have attracted greater interest in recent years, they have not yet been widely adopted. Employee stock purchase plans continue to operate in many major corporations. A number of firms, including Hallmark Cards, Inc., whose profit-sharing plans have been built upon a broad

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3/ Louis O. Kelso and Mortimer J. Adler. The Capitalist Manifesto. New York, Random House [1958] 265 p.; Louis O. Kelso and Patricia Hetter. "Corporate Social Responsibility Without Corporate Suicide." Challenge, July/August 1973: pp. 52-57; Louis O. Kelso and Norman G. Kurland. "Financing Economic Growth and Environmental Protection to Strengthen the Market Power of Consumers." Testimony to the Subcommittee on the Environment of the House Committee on Interior and Insular Affairs, January 31, 1974; Louis O. Kelso and Mortimer J. Adler. The New Capitalists, a Proposal to Free Economic Growth from the Slavery of Savings. New York, Random House [1961] 109 p.; Louis O. Kelso and Patricia Hetter. Two-Factor Theory: the Economics of Reality: How to Turn Eighty Million Workers into Capitalists on Borrowed Money and Other Proposals. New York, Vintage Books [1968] 202 p.

4/ "Kelso Plan" by Julius W. Allen, Senior Specialist in Price Economics, Economics Division, Congressional Research Service, October 24, 1974.

diversified portfolio have recently switched investment philosophies to concentrate their funds' investments in the stock of their own company, thus in a sense adding to the ranks of firms with employee stock ownership plans. However, these plans have generally retained their profit-sharing character since employer contributions continue to be related to profits.

There are perhaps 100 Kelso-type stock ownership plans. The first of these in 1957 involved the Peninsula Newspapers, Inc., Palo Alto, Cal., which utilized an ESOP to avoid a takeover by another newspaper chain. Since Mr. Kelso is based in San Francisco, it is not surprising that a large proportion of plans are located in California, including the Brooks Camera Co., a chain of retail photographic stores. Many Kelso plans have developed in special financial situations such as cases where a large firm wishes to divest itself of a subsidiary corporation, where the owners of a closely-held corporation wish to sell their stock, or where the firm is threatened by a takeover action from another company. Although most firms with Kelso-type plans are relatively small, the group does include some larger firms, including E-Systems, Inc., a Dallas electronics and aircraft systems concern with 7,000 employees.

Present Tax Treatment

Employee stock ownership plans receive certain special treatment under the present tax laws, but this treatment is essentially the same

as other benefit programs designed to supplement employee compensation through employer contributions to a trust, such as a funded pension program or profit-sharing plan.

If such an employee stock ownership plan meets the test set forth in Section 401(a) of the Internal Revenue Code, it would benefit from special tax treatment (generally applicable to qualified pension, profit sharing and stock bonus plans), as follows:

1) Contributions to such trusts are deductible by the employer, but not taxable to the employee until actually received.[5] In the case of a Kelso-type financing, employer payments to the trust would be deductible. Since these contributions are used to pay principal and interest, the effect is to allow a deduction for repayment of the loan, which is not allowed in conventional financing.

2) The trust is tax exempt so that earnings of the trust are not taxed currently.

3) Dividends paid to the trust in a Kelso-type plan are not subject to taxation until actually paid out to the employee. While in the trust, they may accumulate earnings tax-free. Any dividends paid to employees are taxable to the recipient; however, the tax law allows an exemption for the first $100 ($200 for a joint return).

5/ The general rule for taxation of an annuity is as follows: if the employee contributed to the plan, he is taxed on the part of the annuity representing the employer's contribution, based on life expectancy. However, if he will recover his contribution within three years, payments are exempt from taxation until his contribution is recovered, and taxable thereafter. If he did not contribute, the annuity is taxable in full.

4) Distributions to employees are eligible for special tax treatment under certain circumstances, including capital gains treatment or averaging for certain lump sum disbributions, and in the case of the death of an employee, certain exemptions of payments from income and estate taxes.

The special rules for taxing distributions do not constitute a feature of major importance. Rather, the benefits from the treatment of pension plans result primarily from two features:

1) Because deductions for contributions are taken before such contributions are taxed to employees, taxes on this income are deferred. A deferral of taxes is like an interest-free loan, with the benefits equal to earnings on the deferred taxes.

2) In the case of retirement plans, an employee is likely to be paying tax at a lower rate when he begins to receive his annuity since his income subject to tax is likely to be lower, not only because he is no longer at work but also because he may benefit from such provisions as the exemption of social security benefits, the retirement income credit, and the additional personal exemption for the elderly.

It has been estimated that this treatment of pension contributions and earnings will cost the Treasury about $5.7 billion in tax receipts in FY 1974, assuming the same level of employer contributions would continue without the special treatment. However, only a small proportion of this sum can be attributed to the limited number of employee stock ownership plans. No specific estimate is available.

Recent Congressional Action

A number of legislators have expressed strong support for employee stock ownership, including in some cases a specific interest in the Kelso Plan. At least in part because of the support of these legislators, the following four recent enactments have made special reference to employee stock ownership plans:

Rail Reorganization: The Regional Rail Reorganization Act of 1973 (P.L. 93-236) includes a provision that could lead to adoption of some type of employee stock ownership plan in the final reorganization of the bankrupt railroads of the Northeast and Midwest. Under the Act. a non-profit Government corporation, the U.S. Railway Association (USRA) will plan the financial and physical structure of a new private business enterprise, the Consolidated Rail Corporation, which will take over the operating assets of the bankrupt railroads. The USRA is responsible for performing certain emergency functions regarding the bankrupt railroads, but the association is also assigned the responsibility of developing a "final system plan" for the new private corporation that will be subject to ultimate review and approval by Congress.

The final system plan, according to the Act, is required to set forth among other things,

> " the manner in which employee stock ownership plans may, to the extent practicable, be utilized for meeting the capitalization requirements of the Corporation, taking into account (A) the relative cost savings compared to conventional methods of corporate finance; (B) the labor cost savings; (C) the potential for minimizing strikes and producing more harmonious relations between labor organizations and railway management; (D) the projected employee dividend incomes; (E) the impact on quality of service and prices to railway users; and (F) the promotion of the objectives of this Act of creating a financially self-sustaining railway system in the region which also meets the service needs of the region and the Nation. (Section 206[e][3]."

Thus, Congress has indicated its interest in utilizing some type of employee stock ownership plan for meeting the capitalization requirements of the new Consolidated Rail Corporation.

Pension Reform: The pension reform legislation (Employee Retirement Income Security Act of 1974; P. L. 93-406) sets standards and regulates activities of all private pension plans in such different areas as vesting (circumstances under which the employee becomes entitled to a pension at retirement), funding, fiduciary standards for administering pension funds, reporting and disclosure to participants and public authorities.

With reference to employee stock ownership plans, the new law provides certain special treatment in the sections setting forth standards of conduct for plan trustees and administrators. Employee stock ownership plans (defined in Sec. 407) are exempted from the following: 1) the requirement for diversification of plan investments (Sec. 404); 2) the requirement that not more than 10 percent of plan assets be invested in employer securities and employer real property (Sec. 407); and 3) the prohibition of party-in-interest transactions as applied to a loan to an employee stock ownership plan providing the loan is primarily for the benefit of participants and beneficiaries and does not carry an excessive rate of interest (Sec. 408). These provisions were designed to permit employee stock ownership plans to continue generally accepted methods of operation.

Trade Act: Title II of the Trade Act of 1974 (P.L. 93-618) establishes various types of Federal programs to alleviate economic hardship caused by import competition. A new feature of the law is provision for adjustment assistance for communities (Title II, Ch. 4), supplementing assistance previously available to workers and firms.

The aim of the new community adjustment assistance program is to create new job opportunities in areas adversely affected by increased imports. Communities meeting specified criteria, as administered by the Secretary of Commerce, will be eligible for a variety of assistance programs, including technical assistance and direct grants for land acquisition and development, public worker, and public services.

As one method of attracting new investment to eligible areas, the Secretary of Commerce is authorized to make loan guarantees to acquire, construct, or modernize plant facilities. In reviewing applications for loan guarantees under the Act, the Secretary is required to give preference to corporations which agree to place 25 percent of the principal amount of the loan into a qualified trust under an employee stock ownership plan providing the plan meets certain criteria set forth in the Act.

1975 Tax Law: The Tax Reduction Act of 1975 (P.L. 94-12) contains a provision to encourage contributions to employee stock ownership plans. The Act increased the investment tax credit from 7% to 10% for 1975 and 1976. However, a corporation may take an 11% credit for the first year if it invests the additional 1% credit in an employee stock ownership trust. Because the investment tax credit reduces the

company's tax liability dollar for dollar, the cost of these contributions will be borne entirely by the Government, i.e. there will be no sharing by the corporation of the costs. There are some special restrictions accompanying this provision, including a requirement that the participants be immediately vested.

The Corporation's View of the Employee Stock Ownership Plan

A number of benefits can accrue to the corporation that initiates an employee stock ownership plan, but at the same time, certain risks can be involved.

The basic benefit claimed by proponents of employee stock ownership plans is improved productivity and greater efficiency as employees gain a greater financial stake in the enterprise. Whether or not an employee stock ownership plan would have this result is difficult to gauge. Probably there is no general rule that can be applied. For large corporations concerned about morale of rank and file production workers, it seems doubtful that dispensing what would have to be a relatively few shares of stock to each employee would mean greater employee loyalty and higher productivity. More important would be the corporation's record over the years in dealing with its employees. On the other hand, if the corporation's workforce is limited and includes a high proportion of white collar or technical employees, the opposite may be true and the distribution of stock through the ESOP may prove to be a meaningful incentive that will enhance employee performance. It seems significant in this respect that the newer types

of ESOP programs seem to have proved more attractive to small rather than large corporations.

Certain very real advantages of utilizing an ESOP do occur as a result of tax law. An ESOP carries with it the special tax treatment accorded all pension, profit-sharing, and stock bonus plans. In addition, if the ESOP is utilized as a Kelso-type plan, any corporate financing through the trust permits the corporation to deduct as a taxable expense payments of both interest and principal on the total amount borrowed (although there are limits on the amount of deductible contributions). With conventional borrowing through a bank loan, only the payment of interest would be deductible.

In addition to this general tax advantage, the ESOP might appear attractive for several other reasons. For example, if the ESOP served as the corporation's major retirement plan, it would have many of the advantages of a profit-sharing retirement plan, but in addition, greater flexibility in that the company's contributions need not be profits in each year. Moreover, similar to profit-sharing, an ESOP plan would not be subject to certain restrictions regarding investments recently enacted in the Employee Retirement Income Security Act of 1974. Of course, corporations already heavily committed to supplementary compensation programs would find an ESOP less attractive unless it were willing to drop or modify its existing programs. It should also be noted that the Internal Revenue Code places a ceiling of 15% of compensation (as well as specific individual ceilings) on the amount that a corporation can contribute to qualified trusts and still receive special tax treatment.

Another advantage of the ESOP system for a corporation might be its use as an executive compensation plan or as supplement to an existing such plan. It should be noted that benefits under an ESOP are allocated in proportion to individual compensation. Thus, the plan, like most deferred compensation plans, will tend to favor the more highly compensated employees, or as one proponent of ESOP indicated, "Since the ESOT (Employee Stock Ownership Trust) enables employees to acquire stock ownership with pre-tax funds, requires no employee contributions, avoids the necessity for employees to use accumulated savings or individually borrowed funds in order to purchase stock, and enables the corporation to deduct the full cost of the benefits, the ESOP is frequently superior as an executive compensation device to stock option plans, stock purchase plans, restricted stock purchase plans and other similar plans which reduce employees' take home pay." 6/

Finally, for closely held corporations, the ESOP can be utilized to provide a buyer for the purchase of company stock from controlling shareholders, minority shareholders or outside investors, thus eliminating one of the possible reasons why a company might be forced to "go public" and issue publicly available shares of stock.

Despite these clearcut financial advantages, certain costs or risks accompany any ESOP. To begin with, when a corporation takes the step of involving its employees in a stock ownership arrangement, it is not only demonstrating its faith in the enterprise but also expressing

6/ John D. Menke. "The Employee Stock Ownership Trust: A New Trend in Employee Benefits and Corporate Finance." Chartered Life Underwriter's Journal, v. 29, Jan. 1975: 31-36.

some confidence that in the future the price of the stock will rise. Otherwise, the gains to the employees are likely to be quite limited (see next section). If this does not occur, the adverse employee reaction is likely to more than offset the benefits that may have followed adoption of the plan.

Moreover, the special tax advantages under a Kelso-type plan of financing required new capital through the ESOP trust also involves a certain cost. That cost occurs because this method of financing establishes a continuing obligation for a company, the issuance of additional shares of stock which will have a continuing claim on any dividends long after the particular capital venture for which the funds will be raised has been fully repaid.

Under an ESOP the tax deduction for principal acts to offset the additional cost of dividends during the term of the loan. Depending on the level of dividends paid and the way the plan is set up, the tax saving may or may not completely offset the additional costs incurred in paying dividends on outstanding stock. The following are ways in which dividends might be treated:

(1) Dividends could be used to reduce the corporation's payments to the trust until the loan is paid off.

(2) Dividends on unallocated stock could be used to substitute for principal and interest payments with dividends on allocated stock paid to employees.

(3) Dividends paid on the stock could be paid over to the trust or passed through to employees, with the dividends in addition to payments for principal and interest.

The level and treatment of dividends affect cost to the corporation for two reasons. First, any dividends paid in addition to principal and interest represent an additional cost. Second, even when dividends are substituted for principal and interest, they are not deductible to the corporation and tend to offset the benefit to the corporation of deducting payments of principal.

Thus, the least advantageous arrangement for the corporation is a plan where high levels of dividends are paid in addition to principal and interest while the most advantageous situation is one in which no dividends are paid.

These features can be illustrated by an example from corporate finance chosen to exemplify the type of borrowing for which a Kelso-type ESOP could have been utilized. One such example involves the Santa Fe Railway Company (part of Santa Fe Industries) which regularly borrows funds from the capital market to finance the purchase of new equipment. In March 1975 it offered $15 million worth of equipment trust certificates to mature over the next 15 years at the rate of $1 million a year, with interest rates ranging between 6.25% and 8.20%.

Let us assume that instead of asking for competitive bids on this offering, the Santa Fe had set up an ESOP trust which in turn would have borrowed the $15 million and purchased $15 million in Santa Fe stock with the Santa Fe agreeing to place into the ESOP trust each year the funds necessary to pay all interest charges plus redemption of $1 million annually in principal.

Table 1 compares the net (after tax) cost to the corporation under four alternative financing situations and illustrates the impact of the plan set-up and the level of dividends. Alternative 1 is a conventional borrowing arrangement. Alternative 2 is a plan where dividends substitute for principal and interest (using the 6.7% dividend rate being paid by Santa Fe at the time). Alternative 3 is a plan where dividends on unallocated stock are used to substitute for principal and interest, while dividends on allocated stock are additional payments to employees. Alternative 4 shows net costs if no dividends were paid.

This table suggests the following:

1) The tax benefits for ESOP under present law would not have been sufficient to make ESOP attractive from a corporate financing standpoint for Santa Fe if net costs alone were considered. The same would be true of other publicly-held corporations where dividend levels are relatively high.

2) The tax benefits make ESOP attractive as a corporate financing plan where a very low level or no dividends are being paid.

3) One can easily establish the break-even points for dividend levels under certain alternative plan set-ups (for the loan repayment period). In this example, if all dividends are paid in addition to principal and interest, the break-even point would be where annual dividends do not exceed the annual tax savings from deducting principal ($.48 million) or 3.2%. If dividends are substituted for payments, they cannot exceed the amount of the principal repayment ($1 million) or 6 2/3%. It would also be possible to determine the break-even point for substituting dividends on unallocated stock for principal and interest while

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TABLE 1

NET (AFTER-TAX) COST OF CORPORATE BORROWING UNDER FOUR ALTERNATIVE PLANS

(Based on Financial Data from Recent Borrowing of Santa Fe Railroad)

Basic Information

Amount Borrowed - $15 million

Term of Borrowing - 15 years, $1 million to mature at the end of each year, with each issue carrying a separate interest rate ranging from 6.25% (for a one-year issue) to 8.20% (for a fifteen year issue).

(In Millions)

Year	Total Principal and Interest Payments Before Taxes	Net (After Tax) Costs: Conventional Borrowing Without Using ESOP (1)*	Kelso Plan 6.7% Dividends Paid to Trust, Substitute for Principal and Interest (2)*	Kelso Plan-6.7% Dividends Paid to Employees When Stock is Allocated (3)*	Kelso Plan-No Dividends (4)*
1	$2.130	$1.5876	$1.590	$1.590	$1.1076
2	2.0675	1.5551	1.5575	1.59234	1.0751
3	2.0025	1.5213	1.5237	1.59338	1.0413
4	1.9335	1.48542	1.48782	1.59234	1.00542
5	1.862	1.44824	1.45064	1.59	.96824
6	1.788	1.40976	1.41216	1.58636	.92976
7	1.713	1.37076	1.37316	1.5822	.89076
8	1.637	1.33124	1.33364	1.57752	.85124
9	1.560	1.2912	1.2934	1.57232	.8112
10	1.4825	1.2509	1.2533	1.56686	.7709
11	1.404	1.21008	1.21248	1.56088	.73008
12	1.325	1.169	1.1714	1.55464	.689
13	1.245	1.1274	1.1298	1.54788	.6474
14	1.164	1.08528	1.08768	1.5406	.60528
15	1.082	1.04264	1.04504	1.5328	.56264
Total Years 1-15	$24.396	$19.8859	$19.92172	$23.58012	$12.68592

*Explanation of Columns (1)-(4) on following page.

Explanation of Columns (1)-(4)

(1) Net after tax cost is equal to principal plus interest minus 48% (the corporate tax rate) of the interest payment.

(2) Net after tax cost is equal to principal and interest payments reduced by 48% of the sum of these payments minus total dividends. For example in the first year the net cost equals $2.130 minus .48 ($2.130 minus .067 [$15]); in the second year $2.0675 minus .48 ($2.0675 minus .067 [$15]).

(3) Alternative 3 is similar to Alternative 2 except that dividends on allocated stock (equal to the amount of principal repaid) are paid directly to employees and are in addition to principal and interest payments. The effect is to increase the before tax cost each year. At the same time, the tax savings are increased each year because more of the principal and interest is deductible since the amount of dividends substituting for principal and interest payments becomes smaller with each succeeding year. However, the additional tax savings are not sufficient to offset the increase in gross costs. Under this alternative, the net cost would be the same as Alternative 2 in the first year since all stock is unallocated. In the second year the cost would be $2.0675 plus .067 ($1) minus .48 ($2.0675 minus .067 [$14]). In the third year, the cost would be $2.0025 plus .067 ($2) minus .48 ($2.0025 minus .067 [$13]).

(4) Net after tax cost equal to principal and interest minus 48% of principal and interest payments (.52 times principal and interest payments).

paying dividends on allocated stock although a discounted value would have to be used.

Of course, all these comparisons do not include the cost of dividends paid after the loan is repaid nor do they deal with any cost of diluting the company's stock. This dilution would be offset in some cases by additions to equity through the tax savings realized. However, there is also the question of voting power of the stock held by employees. Under the ESOP system, there is no requirement that the shares held by the trust be voted by the individuals to whom the stock has been allocated. However, if voting rights on vested shares are passed through to the employees, the company must be prepared to recognize the employee interest involved.

The Employee's View of the Employee Stock Ownership Plan

Since, under ESOP, the individual employee is not asked or required to make any contribution in order to receive his shares of company stock, it would seem that he cannot possibly lose and therefore should be a strong supporter of the proposal. In a number of cases, this has been true. Some employee stock ownership plans (with or without profit-sharing) have helped to enhance employee loyalty to the firm and have yielded participants substantial payments upon retirement. Employees of Sears Roebuck, for example, are noted for their support to their profit-sharing, stock ownership plan which has paid out handsomely as the Sears stock appreciated.

However, the chief beneficiaries under these plans are typically the longer-service managerial employees whose level of compensation

entitled them to significant stock accumulations under the plan. Employees as a group, especially those holding manual jobs, do not seem very interested in pushing for an ESOP, and a number of union organizations have declared themselves as strongly opposed to ESOP. Recently, the labor unions in the railroad industry, including both operating and non-operating groups, after hearing a detailed presentation of the "Kelso Plan" in connection with the provisions of the Regional Rail Reorganization Act adopted a resolution rejecting the proposed ESOP as "contrary to basic trade union principles and not in the best interest of railroad workers or the unions which represent them." 7/

What reasons might there be for this employee and union skepticism regarding ESOP? The following points are suggested:

1) The employee and his representative are naturally suspicious of getting "something for nothing." The employee may wonder whether the employer in fact will be expecting something in return - perhaps greater effort at the workplace, perhaps reduced employee pressure for a wage increase or benefit liberalization the next time the company's bargaining agreement comes up for renewal. Under such circumstances, the employee might reason, he is not so certain that he would prefer ownership of company stock if in return the employees were denied certain improvements in wages or benefits.

2) As a basic retirement plan, the ESOP system has certain deficiencies from the standpoint of the employee. Payments into the fund,

7/ "Labor" (weekly newspaper of railroad labor unions), March 30, 1975.

for example, are entirely dependent upon employer decisions. There is no actuarially determined full funding goal to be achieved, nor is the employer required, as in profit-sharing retirement plans, to provide a certain portion of each year's profit. Moreover, investments of the trust are typically confined to one type of security, the employer's stock. The trust is not subject to the normal fiduciary standard of diversification that was written into the Employee Retirement Income Security Act of 1974. Consequently, there would be considerably greater risk of fluctuations in value for the retirement fund than would be found in the typical employer-financed and funded retirement plan.

3) The employee may also wonder whether the shares of company stock that he will receive will actually represent a substantial addition to his earnings. This of course will depend upon the details of the particular plan the company has established and corporate action under the plan. If the ESOP has been instituted as a form of retirement, the individual employee is credited periodically with his share of the stock accumulated in the trust. The rate at which the employee accumulates stock depends on the amounts that the corporation places in the ESOT.

If the trust has been established to assist in corporate financing, the process of accumulating stock in individual employee accounts becomes more complicated. If the trust has borrowed funds for corporate use, the stock deposited in the trust by the corporation remains the property of the trust and is allocated to individual employees only as the corporation each year pays into the trust sufficient funds to

pay off the loan that the trust has obtained from banking sources. In addition, entitlement to shares may be dependent upon the employee's completion of required years of service. Under these circumstances, accumulation of stock by the individual employee can be relatively slow.

This can be illustrated by the Santa Fe Railroad example. The figures in the attached Table 2 indicate the annual payments which the Santa Fe would make year-by-year and the value of these payments to the average employee in terms of company stock.

Several points can be made about these figures:

a) The value allocated to the average employee in terms of company stock is not impressive. It is hardly likely that an extra \$30-\$60 a year can affect the individual worker's attitude toward his job or his firm.

b) Allocations are typically made under an ESOP according to total compensation received. Thus each individual employee over the 15 years would be receiving more or less than the average \$739 depending upon his wage or salary level. More employees would be receiving less than the average, some perhaps as low as \$500 while others might be receiving as high as \$2,000.

c) Dividend payments would alter these figures to the employee's advantage. In March 1975, Santa Fe Industries stock was selling at about \$27 and paying \$1.80 annually in dividends (6.7%). Typically under an ESOP, dividends on unallocated stock are paid to the trust, but once the stock is allocated to the individual employee, dividend payments typically are made directly to the stockholder; this would

TABLE 2

VALUE TO EMPLOYEES OF USING KELSO-TYPE FINANCING
(Based on Financial Data From Recent Borrowing of Santa Fe Railroad)

Basic Information

Amount Borrowed	-	$15 million
Term of Borrowing	-	15 years, $1 million to mature at the end of each year.
Number of Employees	-	33,000 (Est.) (34,192 average during 1973) with each issue carrying a separate interest rate ranging from 6.25% (for a one-year issue) to 8.20% (for a fifteen year issue).

Year	Payments by Santa Fe (in Millions) Interest	Principal	Total	Value to Average Employee
1	$1.130	$1.0	$2.130	$64.54
2	1.0675	1.0	2.0675	62.65
3	1.0025	1.0	2.0025	60.68
4	.9335	1.0	1.9335	58.59
5	.862	1.0	1.862	56.42
6	.788	1.0	1.788	54.18
7	.713	1.0	1.713	51.91
8	.637	1.0	1.637	49.61
9	.560	1.0	1.560	47.27
10	.4825	1.0	1.4825	44.92
11	.404	1.0	1.404	42.55
12	.325	1.0	1.325	40.15
13	.245	1.0	1.245	37.73
14	.164	1.0	1.164	35.27
15	.082	1.0	1.082	32.79
Total	$9.396	$15.0	$24.396	$739.26

add to his income although the amounts would be quite slight in the early years and even after the fifteenth year would average only about $46.

d) These figures relate only to a single offering of equipment trust certificates. If the ESOP system were maintained over a series of years, and similar certificates were offered at frequent intervals, the employees of course would accumulate stockholdihgs more rapidly based on all outstanding issues of certificates. Assuming an issue each year identical to the specific one cited, after 15 years the average employee would be allocated annually a total of $739 in company stock.

4) The employee may well be concerned about the possible up and down fluctuations in the price of company stock. Under a number of successful ESOP arrangements, the price of the company's stock has risen over the long run, thus adding to the value of the participants' holdings (on which taxes are deferred). However, stock prices fall as well as rise, and the 1973-74 drop in the stock market gives special emphasis to this homespun truth. In many ESOP situations, the major attraction for the employee is the expected increase in the value of his shares with the company's continuing success and the consequent rise in the price of each share. An employee less optimistic about the future may be concerned that the stock that he seems to be getting as a gift may end up being less valuable after several years than it was at the time it was originally given to the ESOP trust. In this connection it is worth noting that under a typical ESOP the employee does not have the option of withdrawing his stock and selling

it on the market in order to make a different investment. Normally a withdrawal of stock cannot be made under an ESOP until the individual severs his connection with the firm either by quitting or retiring.

5) Finally it should be noted that labor unions have traditionally opposed management initiated profit-sharing or stock ownership plans, particularly if introduced outside the scope of the collective bargaining agreement. While many local unions have cooperated in various profit-sharing or stock ownership plans, most unions have argued that such plans benefit only a small minority of employees at the expense of across-the-board increases in pay or other benefits. Also involved in union thinking is the belief that such plans represent management attempts to win employee loyalty outside union channels and thus undermine employee support for union collective bargaining efforts.

Proposed Changes in the Tax Law

Although employee stock ownership plans have been adopted under current tax law, certain tax incentives have been proposed which are designed to encourage the adoption of these plans. These tax changes would be an extension of present tax benefits for pension, profit sharing and stock ownership plans. As noted earlier these benefits are the deductibility of employee contributions, the exemption of income earned by the trust and the delay in taxability to the employee until benefits are actually received.

Proposals have been made to increase the tax benefits allowed to ESOP's primarily by liberalizing certain restrictions in present tax

law and by increasing allowable deductions for the corporation. Although the proposals take various forms, this discussion will focus on two bills: S. 1370, introduced by Senator Fannin in the 93d Congress, and H. R. 462 introduced by Representative Frenzel in the 94th Congress. No hearings were held on either of these bills.

S. 1370 proposed the following changes:

1) An employee's pension, profit sharing or stock bonus trust would be considered a charitable organization so contributions made to it as gifts will be tax deductible.

2) Corporations could deduct any dividends paid on the stock in the trust which are currently distributed to employees.

3) The current annual limitation on tax-deductible contributions of 15% of compensation would be increased to 30%.

4) An additional special deduction would be provided of one-half of all contributions to a trust which repay the principal on the loan.

H. R. 462 would make changes similar to those contained in S. 1370. However, this bill would not allow the extra 50% deduction for payments of principal and would completely remove the 15% limit on contributions. Dividends would be deductible if distributed to employees or used to pay indebtedness. In addition, it would (1) establish a cutoff on tax deductible contributions when the value of an employee's assets in the fund exceeds $500,000, (2) add to the options available to the corporation for distributing to an employee his allocated share of the trust, (3) permit a repurchase option for stock wholly owned by employees, (4) exempt lump sum distributions in an estate from any tax

unless liquidated and not reinvested, (5) enable advance opinions from IRS on various features of ESOP plans, and (6) make distributions to employees exempt from any wage ceilings which may be in force.

Thus a major feature of both bills is allowing a deduction for dividends paid. S. 1370 is more advantageous to the corporation because it allows the extra 50% deduction for payments of principal. However, H.R. 462 allows a deduction for dividends used to pay indebtedness, as well as for dividends distributed to employees.

Both under present law and under the proposed changes, tax benefits reduce the net cost of financing, assuming that the corporation is profitable enough to pay taxes. Assuming a corporation pays tax at 48%, then for any item which is deductible the Government contributes 48% of the cost. In the case of the principal in S. 1370, the Government would pay 72% of the cost.

These proposed changes would alter the relative attractiveness of employee stock ownership plans as a means of corporate financing. Table 3 illustrates this effect assuming that all dividends are distributed to employees, beginning with the first year. The table shows the net cost to the corporation after adjusting for tax benefits over a 15 year period using the Santa Fe Railroad example. The treatment of dividends in this example is the one which would be least attractive to corporations under present law and was not used in the earlier table.

The five alternatives compared are:

1) Conventional borrowing of $15 million to be repaid over 15 years

2) Setting up an ESOP under present law;

3) Setting up an ESOP under S. 1370;

4) Setting up an ESOP under H. R. 462;

5) Selling $15 million in stock to the public.

The table compares the yearly net (after-tax) costs for each of the first 15 years, and the total costs for these years, including the present value of these costs.

On a long run basis, conventional borrowing would be the least costly since there are no on-going obligations after the 15-year loan is repaid. The other long-term alternatives in order of rising costs would be ESOP financing under S. 1370, ESOP financing under H. R. 462, selling stock, and ESOP financing under present law.[8/] For the first fifteen years, however, the least costly alternative is selling stock, followed by ESOP financing under S. 1370, conventional borrowing, ESOP financing under H. R. 462 and ESOP financing under present law.

The treatment of dividends used in this example was chosen to simplify the example and illustrate the fullest reflection of the tax benefits under the proposed legislation. In addition, the example illustrates the case of a corporation paying a relatively high rate of dividends. The relative cost of the various ESOP plans would be reduced compared to borrowing and selling stock if the plan concerned used

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8/ Over the long run ESOP financing under S. 1370 and H. R. 462 would be less costly than selling stock (even though selling stock is cheaper initially) because of the tax deduction for dividends.

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NET (AFTER-TAX) COST OF CORPORATE BORROWING UNDER EXISTING AND PROPOSED LEGISLATION

(Based on Financial Data from Recent Borrowing of Santa Fe Railroad and Assuming Dividends of 6.7%)

Basic Information

Amount Borrowed - $15 million

Term of Borrowing - 15 years, $1 million to mature at the end of each year. With each issue carrying a separate interest rate ranging from 6.25% (for a one-year issue) to 8.20% (for a fifteen year issue).

Dividend Policy - Distribute 6.7% dividend payments to shareholders on the $15 million of stock beginning with year one.

(In Millions)

Year	Conventional Borrowing Without ESOP (1)	ESOP Present Law (2)	ESOP S. 1370 (3)	ESOP H. R. 462 (4)	Selling $15 million Stock (5)
1	$1.5876	$2.1126	$1.3902	$1.6302	$1.005
2	1.5551	2.0801	1.3577	1.5977	1.005
3	1.5213	2.0463	1.3239	1.5639	1.005
4	1.48542	2.01042	1.28802	1.52802	1.005
5	1.44824	1.97324	1.25084	1.49084	1.005
6	1.40976	1.93476	1.21236	1.45236	1.005
7	1.37076	1.89576	1.17336	1.41336	1.005
8	1.33124	1.85424	1.13384	1.37384	1.005
9	1.2912	1.8162	1.0938	1.3338	1.005
10	1.2509	1.7759	1.0535	1.2935	1.005
11	1.21008	1.73508	1.01268	1.25268	1.005
12	1.169	1.694	.9716	1.2116	1.005
13	1.1274	1.6524	.93	1.17	1.005
14	1.08528	1.61028	.88788	1.12788	1.005
15	1.04264	1.56764	.84524	1.08524	1.005
16+(Ongoing Costs)	0	1.005	.5226	.5226	1.005
Total First Fifteen Years Total Payments	$19.88592	$27.76092	$16.92492	$20.52492	$15.075
Present Value of Total Payments (8% Discount Rate)	$12.8	$17.6	$10.9	$13.2	$9.3

dividends to substitute for or accelerate payments of principle and interest, particularly in the latter case where H. R. 462 provides tax benefits.

Similarly with a lower dividend rate, the relative cost of utilizing ESOP financing would be reduced when compared to conventional borrowing, but increased when compared to selling stock.

This example also assumes a constant dividend rate based on the initial value of the stock. If the value of the stock, and the dollar level of dividends, increases, then ESOP financing would become relatively more costly compared to conventional borrowing (although yielding a greater benefit to employees).

It might also be noted that the changes in S. 1370 and H. R. 462 which allow deductions for dividends distributed to employees may result in a conflict between the corporation and the employees, since employees may prefer to have dividends paid to the trust to be accumulated tax free while the corporation may prefer dividends paid to employees to qualify for a deduction.

This example is a simplified one and only reflects the quantifiable costs and benefits of various alternatives. From the corporation's point of view, if significant increases in productivity are expected to follow the adoption of ESOP and lead to higher corporate earnings, the attractiveness of the plans may change. On the other hand, the corporation may be concerned about the dilution of stock occuring with the adoption of an ESOP which may weigh against such plans.

These examples and those presented earlier suggest that without further changes in the tax law, ESOP is likely to be beneficial to limited types of corporations. The typical large, publicly owned corporation paying a relatively high level of dividends would find the tax advantages substantially outweighed by the additional costs of ESOP financing. Thus, any ESOP plan adopted under these circumstances would be expected to substitute partially or completely for other forms of labor compensation, whether wages or other benefit plans, unless substantial gains in productivity are realized.

In evaluating these proposals to provide additional tax incentives to encourage ESOP's, several questions may be asked. The first is whether the benefits expected to be gained from encouraging these plans are sufficient to offset the revenue costs incurred. Any tax subsidy affects the distribution of income, with income shifting from taxpayers and consumers of Government services to those who benefit from the specific subsidy. In this case, the benefits may be expected to accrue to corporations who have adopted or will adopt the plan and their employees. If the proposed changes in tax law lead to adoption of additional ESOP's and greater productivity for the economy as a whole, higher output and income may result. However, depending on their magnitude, the resulting benefits may still not outweigh the costs. Moreover, the distribution of benefits from adopting the proposed changes raises another issue: are these benefits likely to be confined to those corporations with ESOP's and their employees or will they be more widely distributed throughout the economy?

Another question is whether the present tax provisions relating to deferred compensation, which are relatively neutral as to the type of employee benefit, should be revised to create an advantage for ESOP's compared to such other benefit programs as funded pension plans or profit sharing programs. While investments in a company stock may have certain advantages for its employees, concentration of fund assets in one company's stock as a basis for longterm retirement income increases the danger that employees would lose benefits if the company should fail.

Finally, these special tax provisions raise questions of equity in the general context of the present tax structure. Should ESOP trusts, for example, be treated as organizations which can receive charitable contributions or should only dividends paid on this type of stock be deductible for tax purposes?

The Treasury Department has commented on S. 1370 and touched on many of these points in its discussion of the bill.[9/] Among its objections to the proposal were:

1) ESOP financing decreases the security of funds held by employee trusts, and the tax laws should at least be neutral with respect to ESOP financing rather than providing an incentive for its use.

2) Allowing the treatment of an ESOP trust as an organization which can receive charitable contributions is contrary to the general purpose of allowing this treatment only for organizations which benefit the public in general.

9/ Letter from Frederick W. Hickman, Assistant Secretary, Department of the Treasury to Russell B. Long, Chairman, Senate Finance Committee, dated April 30, 1974.

3) If dividends are to be exempt from the corporate income tax, this exemption should apply to all dividends.

4) The removal of the current 15% limitation on corporate contributions is contrary to present trends in pension treatment which are designed to limit benefits for highly compensated executives.

5) The 150% deduction for principal in the bill would place a substantial premium on deferred compensation.

The Treasury report also noted that the provisions of the bill would apply to plans other than ESOP's.

The revenue costs of the bills would depend on the degree to which eligible plans are adopted. The Treasury has estimated the cost of S. 1370 at $1.5 billion annually.

The Treasury report concluded, "In any event, we do not believe that any advantages that may result from ESOP financing are sufficient to justify the significant revenue loss that would be incurred under S. 1370."

A Final Word

Current economic conditions reenforce a continuing interest in employee stock ownership plans. Productivity in the private non-farm economy has been declining for two years. The combination of the major recession through which the country is going as well as continuing increases in living costs naturally stimulates a search for improvement in the basic structure of American industry that might help to facilitate sustained economic recovery.

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Employee stock ownership is not a new idea. Stock purchase and stock option plans have been in existence for over 50 years largely as an incentive for more effective performance by management and executive personnel. More recently, employee stock ownership has been put forward as a method of giving greater stimulus to the job peformance of a much wider group of employees. It also has the attraction of being able to serve as a basic employee retirement plan and as a tax-saving device for obtaining additional capital. The proposal has won considerable support and has been specifically recognized in four major recent congressional enactments.

This paper has attempted to explore some of the implications of employee stock ownership plans from the viewpoint of both management and the employees. From management's viewpoint, the value of an ESOP in improving productivity may depend on the type of firm involved: it is likely to prove more successful in a smaller enterprise with professional and technical employees than in a larger corporation operating with thousands of production and maintenance workers. As a retirement plan, an ESOP may be more useful as a supplementary program than as the firm's basic employee retirement plan since the concentration of plan investments in the employer's stock may involve greater risk than a diversified portfolio. Finally as a method of raising outside capital, it would appear that an ESOP provides clearcut advantages only in certain specialized situations. The savings in taxes available under an ESOP financing because the corporation can deduct payments of both principal and interest (rather than interest alone as in

conventional borrowing) are often offset by the cost of providing dividend payments on the newly issued shares of stock. These additional dividend payments, unlike interest and principal payments on a loan, will continue long after the loan itself has been repaid.

This is perhaps one reason why proponents of ESOP have proposed additional changes in tax law, the most important of which is the suggestion that the payment of dividends on stock held by an ESOP trust would be deductible to the corporation along with the interest and principal payments. This step would indeed alter the relative attractiveness of using ESOP financing rather than conventional methods of borrowing. Whether such changes should be adopted raises important policy questions since a significant loss of revenues to the Treasury may be involved.

However, this report has not reached any definitive conclusions regarding the advisability for firms to adopt employee stock ownership plans or for the Congress to enact the proposed changes in tax law. The reason for this is simple: no definitive studies have yet been undertaken which evaluate the practical results of adopting ESOP. A number of firms have adopted it in recent years but no impartial studies have been completed to assess, for example, the effect of ESOP on the firm's costs, output, and productivity or on employee compensation, attitudes, and motivation. Until the results of such studies are available, it is obviously impossible to evaluate the relative cost and benefits of adopting ESOP either to an individual firm or to the economy

as a whole. Furthermore no evaluation of the tax changes is possible unless there is some basis for estimating the benefits to the economy from adopting ESOP that could offset the obvious loss of tax revenue. Until the value of employee stock ownership plans can be more specifically demonstrated, it would seem appropriate to maintain a skeptical attitude toward the proposed changes in tax law.

A Technical Review of the Employee Stock Ownership Trust

(Submitted by Towers, Perrin, Forster & Crosby to the United States Railway Association, February 24, 1975)

I. INTRODUCTION

The Regional Rail Reorganization Act of 1973 created USRA as the agency responsible for developing a plan for the reorganization of the six bankrupt railroads covered by the Act. Among the areas which the plan must specifically address are motivation of railroad employees and capitalization of the new Consolidated Rail Corporation (ConRail). In this regard, the Act states that the final system plan shall outline the manner in which an Employee Stock Ownership Trust may, "to the extent practicable", be utilized for the dual purpose of capitalization and employee motivation. USRA must determine whether such an approach is feasible under the circumstances.

TPF&C was retained for the purpose of evaluating the appropriateness of an Employee Stock Ownership Trust for ConRail. This report is intended to present sufficient background information to enable USRA to understand exactly how the concept operates. A more detailed study of its possible application to ConRail will then be conducted with assistance from outside experts in the fields of corporate finance and employee motivation. The results of this study will be presented in a final report in May of this year.

II. BASIC DESIGN OF AN EMPLOYEE STOCK OWNERSHIP TRUST

The Employee Stock Ownership Trust (ESOT) has been legally possible for over thirty years, but has attracted attention only recently largely through the efforts of Louis O. Kelso, a San Francisco attorney. While the Internal Revenue Service does not keep precise figures on ESOT's, estimates of the number currently in existence range from about 200 to 500.

Essentially the ESOT is designed to place employer stock in the hands of employees, while at the same time providing the corporation with a ready source of investment capital. These goals are accomplished at the outset by the establishment of a "qualified" employee stock bonus and/or money purchase pension plan in accordance with the provisions of the Internal Revenue Code. Under the terms of the plan, the employer agrees to make annual contributions (according to a pre-determined formula) for the express purpose of transferring ownership of company stock to eligible employees. The contributions for this purpose represent a tax deduction to the corporation and are not taxable to the employees until actually distributed from the plan in the form of employer stock. All income and appreciation are also tax-sheltered until the time of distribution.

The corporate financing objective is accomplished through a loan negotiated by the trust with an appropriate lending institution. The trust applies the loan to the purchase of employer stock and pledges the stock as collateral for the loan. This places the necessary capital in the hands of the employer, who then amortizes the loan (through the trust) with his annual contributions to the plan. As the loan is retired, an amount of stock equal to each year's payment of principal is allocated to the accounts of all eligible employees. A special amortization schedule is adopted to avoid the usual imbalance between debt service and principal payments in the early years.

III. ESTABLISHMENT OF AN EMPLOYEE STOCK OWNERSHIP TRUST

In order to establish an ESOT, the following basic steps must be performed:

1. The employer creates a stock bonus plan and trust (and/or money purchase pension plan) qualified under Sections 401(a) and 501(a) of the Internal Revenue Code with a fixed formula for determining annual contributions and a fixed formula for allocating them among employees.

2. The employer applies to the Securities and Exchange Commission for a ruling on whether the employer stock earmarked for the plan must be registered. (While the employer stock generally does not require registration under a qualified plan, some authorities have expressed concern on this point and recommend this step as a precaution.)

3. The employer establishes the fair market value of the earmarked stock. (An outside firm may be called upon to assist in the evaluation in order to insure impartiality.)

4. The employer appoints a trustee who applies to a lending institution for a loan with the earmarked employer stock as collateral. (The employer will also be asked to co-sign the loan.)

5. The trustee applies the borrowed funds to the purchase of the earmarked employer stock.

Once an ESOT has been established, the following steps must be taken in each succeeding year:

1. The employer makes a contribution to the stock bonus and/or money purchase pension plan in accordance with the pre-determined formula (usually a percentage of eligible payroll).

2. The trustee uses the employer's contribution to make the required payment on the loan.

3. The trustee credits each participating employee's account with company stock equal to his share (based on the allocation formula) of the employer's payment of principal.

4. The employer claims the entire contribution as a tax deduction up to 15 percent of eligible payroll (25 percent if a money purchase pension plan is included).

5. The trustee (at the employer's direction) votes all shares held under the trust. (Employees may be granted voting rights for shares in which they are vested.)

IV. USE OF AN EMPLOYEE STOCK OWNERSHIP TRUST

An ESOT is typically applicable to corporations in a rather narrow range of circumstances. A corporation contemplating the adoption of an ESOT should meet all of the following requirements:

1. The company should have an eligible payroll of at least $500,000 and be in the maximum corporate income tax bracket.

2. The company should have a good credit rating.

3. The prospects for future earnings should be well above average.

4. The company should be fairly closely-held, whether publicly or privately owned.

5. There should be a preference for equity over debt financing.

6. There should be a real desire to place substantial ownership in the hands of employees.

The size of a company is important because the loan to the trust must be amortized with annual payments equal to a maximum of 25 percent of the payroll of eligible employees. A payroll of less than $500,000 is not adequate to produce loan payments over the customary number of years. A company which is not in the maximum corporate income tax bracket is unlikely to be in a strong earnings position and moreover would not gain the same tax advantages from an ESOT because of its lower tax bracket.

The company must have a good credit rating and good prospects for future earnings for two reasons. First, the lending institution will require that the corporation co-sign the loan with the trustee. A weak credit rating will jeopardize the plan right from the start and will also raise Internal Revenue Service questions concerning the company's true intentions. Second, and perhaps more important, an ESOT represents a major commitment to an employee benefit plan which should not be undertaken by a company in a weak earnings position. No firm should *ever* resort to an ESOT to raise capital when its credit position us the traditional money markets is unsound.

It is vitally important that any corporation considering an ESOT weigh carefully the pros and cons of equity versus debt financing. Since an ESOT often involves a new issue of employer stock and future allocation to participants at less than fair market value, there is bound to be some dilution of shareholders' equity. While this may be justified in management's eyes when compared to the current cost of debt financing, there is the possibility of a backlash from shareholders. Private, closely-held firms appear to be the most likely candidates for an ESOT because the employee group represents a "captive market" which makes an equity issue possible and thus presents an alternative to the usual debt financing.

Finally, the importance of a genuine management commitment to the idea of employee stock ownership cannot be over-emphasized. While the corporate financing aspect of the ESOT approach often commands the most attention, management must view employee ownership of the firm as a positive goal in itself. Because of the ongoing nature of a qualified stock bonus plan, employees will come to expect an opportunity to participate in company ownership beyond the time when the loan to the trustee is repaid. If this ongoing commitment is not present, an ESOT may ultimately become a source of employee dissatisfaction.

V. INTERNAL REVENUE SERVICE REQUIREMENTS

Internal Revenue Service requirements are a major factor in the consideration of an ESOT because the employee stock bonus plan must be "qualified" in order to ensure that employer contributions (and employee accounts) are exempt from taxation. The basic requirements which a stock bonus plan must meet in order to obtain "qualified" status are the following:

1. The plan must be permanent in nature (duration of the plan cannot be linked to the repayment period of the loan).
2. The plan must not discriminate in favor of officers, shareholders, or highly compensated employees.
3. The plan must be for the "exclusive benefit" of eligible employees.
4. All distributions from the plan must be in the form of employer stock, although dividends can be paid annually in cash on a non-tax-favored basis. (Money purchase pension plan distributions can be in any form.)
5. Annual employer contributions cannot exceed 15 percent of eligible payroll. (25 percent if a money purchase pension plan is included.)

The first three of the above requirements are imposed by the Internal Revenue Service on all employee benefit plans intended to provide retirement income. The fourth is directed specifically at stock bonus plans and is the one distinguishing feature of these plans in the IRS' eyes. The fifth is applicable to stock bonus, profit sharing and thrift plans alike. Generally speaking, a stock bonus plan is viewed by the IRS as a variant of the profit-sharing approach. However, there is no requirement that employer contributions be made from corporate earnings, and the employer is thus committed to make a contribution even in a loss year.

The requirement that the plan be permanent in nature deserves emphasis in light of the tendency to view an ESOT largely in terms of corporate financing. While plans of this nature can sometimes be terminated for business reasons without dire tax consequences, they should nonetheless be viewed as a fixed commitment. As noted previously, termination of a plan after if has become established and accepted can have an adverse impact on employee morale.

The requirement that the plan not discriminate in favor of key personnel is basic to IRS qualifications. While this mandates the use of uniform eligibility, vesting, and retirement rules, it does not prevent the allocation of stock in relation to salary. As long as there is a fixed allocation formula, there is nothing to prevent an employee earning $50,000 from receiving five times the amount of stock that a $10,000 employee receives. In fact, most stock bonus plans make allocations on precisely this basis.

The "exclusive benefit" requirement poses perhaps the greatest obstacle to qualification of an ESOT. In order to meet this requirement, the Internal Revenue Service has ruled that employer stock must be valued at no more than "fair market value" at the time of purchase by the trust and that the employer must have been able to borrow an equivalent sum in the regular money markets at that time. The requirements concerning liquidity, diversification, and fair return on investments are waived for a stock bonus plan.

The difficulties with the "exclusive benefit" rule center around a situation in which the employer stock declines in value after the date of purchase by the trust. Under these circumstances, there is a legitimate question as to whether the plan is indeed operating for the "exclusive benefit" of the employees, since the trust will be allocating shares at a value higher than their current market value. Lending institutions have recognized this possibility, which explains their usual insistence that the employer co-sign the loan with the trustee. The Internal Revenue Service is increasingly concerned with this problem, and a number of District Offices around the country have delcared a moratorium on the approval of new ESOT's. This policy will probably remain unchanged until the National Office issues some clear guidelines in this area. At the present time, it appears unlikely that this will happen prior to 1976.

Another potential problem concerning IRS requirements involves the definition of "unrelated business income" under an ESOT. Such income is taxable to the trust in the year earned. While there are no clear guidelines in this area either, some authorities have voiced the opinion that increases in the value of the employer stock may result in a ruling that any increase attributable to the *unallocated* portion of the stock is "unrelated business income" and therefore taxable. While no such ruling has come down, concern will remain until clearer guidelines are forthcoming from the National Office.

On a more positive note, IRS rules are quite clear and generally favorable with regard to distributions from an ESOT. As noted above, distributions from a qualified stock bonus plan must be in the form of employer stock, with the sole exception of annual dividend payments. At the time of distribution, the employee is taxed on the original purchase price of the stock in his account. This is considered ordinary income, subject to ten-year forward averaging. Any increase in the value of the stock above its original purchase price is taxed as a capital gain to the employee at the time he actually sells it. Since there is rarely a broad market for the stock, especially with a privately-held firm, the trustee is usually granted a "right of first refusal" to repurchase the stock from the employee. This does not violate the "exclusive benefit" rule since the employee is not required to sell and may hold the stock as long as he wishes.

VI. IMPACT OF EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

The Employee Retirement Income Security Act of 1974 (ERISA) specifically recognizes the ESOT and includes it in the category of "eligible individual account plan". Such plans, if they are specifically designed for investment in employer stock, are exempt from certain requirements of the new law. Most important among these is the limitation on investment in employer stock to 10 percent of total plan assets. While the law thus appears to treat such plans as a separate class, there are certain specific provisions which tend to raise some doubts about their exact status.

ERISA continues the exemption of stock bonus plans from the IRS requirements concerning liquidity, diversification and fair return on investments. It clearly includes them, however, under the new "prudent man" rule and the old "exclusive benefit" rule. This raises some serious questions for plan trustees, who are now classified as "fiduciaries" under the law. As such, they are subject to civil suit by employees for failure to ensure that investments are made with the care a "prudent man" would normally exercise and are for the "exclusive benefit " of employees. What, for example, is a trustee's responsibility if he believes that investment in employer stock is not "prudent" at a given point in time? While he is technically bound by the provisions of the plan (and the loan agreement), he could be exposing himself to possible legal action by employees in the event of subsequent depreciation in the employer stock. Hopefully, this question will be resolved when regulations implementing ERISA are issued sometime in mid-1975. In the meantime, it presents at least a temporary problem, although insurance is now available to cover the potential liability of fiduciaries.

Other provisions of ERISA affect the design of qualified plans in such areas as vesting and eligibility. Under the new law, no employee may be excluded from a qualified plan once he has attained age 25 and completed one year of service. This requirement obviously serves to broaden the plan base and allows employees to participate sooner than the employer might otherwise wish.

The vesting requirements of ERISA also serve to expand the benefits of a qualified plan by limiting the number of years that may be required before an employee gains a vested right to his benefits. The new law provides three alternate minimum vesting schedules, along the following lines:

1. 100 percent vesting after 10 years of service
2. 50 percent vesting when age plus service equals 45, with 10 percent additional each year thereafter
3. 25 percent vesting after 5 years of service, with additional amounts each year until vesting is 100 percent after 15 years.

While all of these schedules provide more rapid vesting than is currently found in many pension plans, stock bonus plans have traditionally allowed employees to gain vested rights at an earlier date in order to reinforce the motivational aspect of these plans.

One final ERISA provision chich is worthy of note authorizes the Department of Labor to act it if receives objections from the requisite number of emp'oyees concerning establishment of a qualified plan or financial transactions conducted under the plan. While this is unlikely to occur in practice, it further emphasizes the importance of viewing an ESOT as an employee benefit plan as well as a corporate financing vehicle.

VII. EMPLOYEE BENEFIT DESIGN CONSIDERATIONS

Any evaluation of the ESOT approach must attempt to place it in its proper perspective among employee benefits. When, for example, does an ESOT represent a sound benefit program, and when is it either excessive or inadequate? The answer

generally lies in the attitude of the employer and in the existence of other benefit plans at the same location.

A major reason for adoption of an ESOT is to improve employee motivation by tying employee fortunes more closely to those of the employer. An ESOT should never be viewed as a traditional pension plan because it offers no guarantees of retirement security. In fact, the basic design of an ESOT precludes recognition of an employee's service prior to inception of the plan. This serves to emphasize the point that an ESOT should not be utilized as a company's sole retirement vehicle, but should rather be considered in conjunction with a bona fide pension plan.

While an ESOT may thus be inadequate in some situations, there are others in which it may be unnecessary or overly generous. For example, a firm which already has a good pension plan and well-motivated employees would appear to have little need for an ESOT. This would be double true if there were also some sort of bonus and/or profit-sharing plan in effect. Under these circumstances, an ESOT would clearly be superflous, unless it served to replace the existing profit-sharing plan.

Perhaps the most logical situation in which to consider an ESOT would be one in which there is an existing pension plan providing modest benefits, but employee productivity and overall motivation are low. The threat of unionization might also be a further inducement to management to take some decisive action. Under these circumstances an ESOT could be very valuable, provided, of course, that the prospects for future growth were promising. If the prospects for future growth were not promising, or if the stock were publicly traded at a low price-earnings ratio, some non-profit-related incentive would be more appropriate.

One further consideration in this regard is the determination of which employee classifications should be included. In a smaller firm, all employees would normally participate once they had fulfilled the eligibility requirements. In a larger firm, while all salaried employees would normally be eligible, some or all of the hourly workers might be represented by a bargaining unit. Labor unions have traditionally been unreceptive to any sort of profit sharing or stock bonus plan, and a union might well use the introduction of an ESOT for salaried personnel as an excuse for new wage demands at the next round of contract negotiations. This possibility would have to be weighed against the advantages of introducing the plan for salaried and non-union hourly personnel.

VIII. SUMMARY OF ADVANTAGES AND DISADVANTAGES

Advocates of the ESOT have advanced a number of arguments in its favor. A company that meets the criteria outlined earlier may gain the following advantages from an ESOT:

1. Create a market for the corporate stock which might otherwise be unavailable.
2. Preserve management voting rights in newly-issued stock.
3. Provide an alternative to debt financing that allows repayment with pre-tax dollars.
4. Improve employee motivation through closer identification with the success of the company.

In addition to the above, there are some advantages to an ESOT which apply only in special situations. For example, a company which wishes to divest itself of a division or subsidiary may utilize an ESOT to avoid the problem of finding a buyer. Large shareholders in a closely-held company may find an ESOT appealing in that it provides them with a ready market for estate planning purposes without the sale of the firm to an outside interest. It is estimated, in fact, that the majority of ESOT's now in existence were created at least in part to facilitate the estate planning of key shareholders.

Perhaps the most important advantage of an ESOT lies in providing the option of equity financing to smaller, closely-held corporations which would otherwise have no choice but traditional debt financing. While a loan is still involved, the company repays both principal and interest with pre-tax dollars and at the same time provides a significant benefit for its employees. With traditional debt financing, only the interest is tax deductible, and repayment of the loan does not improve overall employee benefits. An ESOT thus provides some of the basic advantages of equity financing to the employer who is willing to pay the price inherent in an ongoing stock bonus plan.

The primary disadvantages of the ESOT approach are the following:

1. The employer stock may depreciate in value and leave the employees dissatisfied.

2. Existing shareholders may react against the dilution of their equity.

3. Bargaining units may reject coverage and view introduction of the plan as an excuse for increased wage demands.

4. Continuation of the stock bonus plan may become a liability to the firm once the original loan is repaid.

There are also the technical problems involving IRS requirements and the new pension legislation. With regard to the new law, regulations must clarify whether fiduciaries under an ESOT are responsible for deciding whether investment in employer stock is always "prudent". More importantly, until the IRS National Office clarifies whether an ESOT is for the "exclusive benefit" of employees, the District Offices which have placed a freeze on new applications are unlikely to change their position. Thus in some areas of the country an ESOT is for the moment not a viable option.

Perhaps the most important drawback to an ESOT is the possibility of a decline in company fortunes. Not only would this reduce the value of employee accounts, and make the corporate tax advantage less significant, but it would also seriously jeopardize the company's ability to continue the stock bonus plan beyond the period of the loan. Termination of the plan with only marginal gains for employees might convince them that they had been deceived. The end result would then be the exact opposite of what was intended by the establishment of the ESOT in the first place.

Taken together, the advantages and disadvantages tend to confirm above all the importance of a company's growth potential in the consideration of an ESOT. A firm which does not have both a solid earnings record and a good opportunity for expansion should probably explore other avenues of corporate financing and employee motivation. Where these requirements are met, the ESOT offers unique opportunities for certain corporations. Where they are lacking, it can prove to be both costly and ineffective.

IX. POSSIBLE APPLICATION TO CONRAIL

Concerning the possible application of the ESOT approach to ConRail, there appear to be a number of potential problem areas which will be explored in depth in the final report.

Perhaps the most important question concerns the potential profitability of ConRail; this is significant for a number of reasons. If profits are generally low, the value of ConRail stock is not likely to increase substantially and may decline. With today's uncertain stock market, it is also possible that ConRail might show reasonable profits and still be traded publicly at a low price-earnings ratio. In either event, a stock bonus plan would be of doubtful value to employees and could result in the type of employee backlash mentioned earlier.

From the corporation's standpoint, one of the primary advantages of an ESOT lies in the fact that contributions to the qualified stock bonus plan are made with pre-tax dollars. If ConRail were to find itself in a non-profit situation, this advantage would disappear. Moreover, the contributions to the plan would be more burdensome than if made from profits.

Another basic question is whether there exists a need for a new benefit plan for employees of the railroads comprising ConRail. All their employees are covered under the Railroad Retirement Act, which provides generous benefits up to annual pay levels of about $15,000. All of the railroads provide additional retirement benefits to certain groups of employees, and health and welfare benefits are also quite generous. A stock bonus plan might thus represent an unnecessary addition to the overall benefits program.

It may be premature at this point to consider new benefits prior to the consolidation of the existing benefit plans, since the consolidation may involve some increase in benefits. On a more basic level, there may be some reluctance to provide additional benefits in view of the present financial condition of the covered railroads. ConRail may not wish to assume another fixed payroll cost of this magnitude, especially if additional investment capital can be raised through a regular equity issue and/or government sources.

Another potential drawback to adoption of an ESOT involves the relationship between the railroads comprising ConRail and the rest of the railroad industry. If an ESOT were introduced for ConRail employees, this would probably encourage employees at the other railroads to press for some equivalent benefit. In particular, this could have an impact on national bargianing with union employees.

With ConRail, as with any other corporation, the key factor in the consideration of an ESOT is the potential for growth and earnings. While other factors such as labor relations and overall benefit design are important, the primary concern must be the potential profitability of the new corporation. If the financial prospects are good, the ESOT *may* be a viable alternative. If they are not, other approaches to both employee motivation and corporate financing will probably be more effective.

THE HIDDEN COSTS OF ESOP's (EMPLOYEE STOCK OWNERSHIP PLANS)

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INTRODUCTION

In recent months, the business community has been presented with a series of articles, books, seminars, newsletters, and consultants, all extolling the virtues of ESOPS—Employee Stock Ownership Plans. This publicity is reminiscent of previous "business fads," which served to sell numberless books and conferences, but provided little in the way of hard benefits to business. The publicity on ESOPS differs from that of previous fads largely in that it is more extreme and misleading.

Although the Internal Revenue Service requires that ESOPS be created for the "exclusive benefit" of the participan5s, the publicity on ESOPS concentrates almost exclusively (and understandably) on the claimed benefits to the company and the owners. It is claimed, for example, that:

ESOPS improve employee productivity
ESOPS improve cash flow
ESOPS can be used to borrow, with the principal repaid in pre-tax dollars
ESOPS can be used to acquire other companies, and pay for them in pre-tax dollars
ESOPS are ideal for the closely-held company

This report examines these major claims and demonstrates that, while they may be "literally" true in the narrow sense, they create negative side effects which more than cancel the claimed benefits. In order to demonstrate what actually happens in using an ESOP, the same hypothetical company is used as an example throughout the report. The methods used in the analyses are readily adaptable to other real or hypothetical companies.

Using the example and the analyses, the report demonstrates that what happens, in brief, is that while an ESOP can provide modest improvements to cash flow, it does so at the expense of:

Reduced profits.
Dilution of prior ownership.
Reduced earnings on equity.
Reduced earnings per share.
Reduced stock values, as a potential secondary effect.

The proponents of ESOPS contend that these negative effects (if they even admit to them), are overcome by the operation of three factors:

Improved employee productivity.
Earnings on the additional cash.
Participation of the prior owners in the ESOP.

The first two points are dealt with in the body of the report. In regard to the third, it should be apparent that if the prior owners participate in an ESOP to a degree which substantially offsets the negative effects, then there would necessarily be very few non-owner participants in the ESOP. IRS qualification in such a case would be extremely questionable, since the ESOP would be an obvious tax dodge for the benefit of the owners.

It is assumed throughout that the ESOP is investing in common stock, although an ESOP can invest in any class of stock. If preferred stock were used, the negative effects demonstrated in the examples would be reduced somewhere during years in which the earnings on equity exceeded the return on the preferred, but they would be increased in the converse situation. If a class of preferred stock with an abnormally low return were used, IRS qualification may be questionable as a result, and there would probably be negative effects on employee morale and productivity.

Chapter I

ESOPS BRIEFLY DEFINED

The following summary is offered for those readers who have not yet had an an opportunity to become familiar with the general characteristics of ESOPS, and for those who desire a quick review. As the points below demonstrate, an ESOP is in many ways similar to a Profit Sharing Plan, but with several very significant differences.

1. When the ESOP is qualified by the Internal Revenue Service, company contributions to it are tax deductible.
2. ESOPS are limited to investing in employer stock, unless none is available, in which case they may make other investments, much like Profit Sharing Plans. An ESOP may invest in any class of employer stock.
3. The company contribution may be made in stock instead of cash. The fair value of such stock is deductible.
4. The ESOP may purchase stock from the company or from an existing shareholder.
5. All stock transactions must be at market value for traded stock, or at (appraised) fair market value for non-traded stock.
6. Requirements for employee eligibility to participate, vesting, distribution, etc. are much the same as for Profit Sharing Plans. A major exception is that distributions must be made in employer stock.
7. Employee contributions are not normally required with ESOPS, to avoid problems involved in selling stock.
8. The participants' ESOP accounts share in the company's contribution in proportion to salary for the year. Forfeitures of unvested portions of the accounts of employees who terminate are similarly allocated.
9. Participants share in ESOP earnings in proportion to the values of their accounts.
10. The shares held by the ESOP are voted by a committee appointed by the Board of Directors of the company. Control is thus retained.
11. A participant first develops income tax liability when he receives his distribution of stock at retirement or termination. At that point, he becomes liable for ordinary income tax on the cost (to the ESOP) of the stock he receives. When he sells shares, he becomes liable for capital gains tax on any increase in value over the cost to the ESOP.
12. ESOPS often include provisions encouraging a participant who has received his distribution to sell his stock back to the ESOP, to the company, or to a major shareholder.
13. ESOPS, unlike Profit Sharing Plans, can borrow (usually with the note guaranteed by the company and secured by stock), or may purchase shares on an installment basis.

Chapter II

CONVERTING A PROFIT SHARING PLAN TO AN ESOP

One of the advantageous features the proponents of ESOPS frequently point out is that an existing Profit Sharing Plan may be converted to an ESOP, thus obtaining more rapidly the "benefits" of an ESOP. However, just as with the "benefits" discussed in later chapters, the conversion possibility has disadvantages.

Some of these disadvantages have been pointed out in the typical publicity on ESOPS—the fact that plans which require employee contributions may encounter problems with the SEC, and the fact that the IRS may permit such conversions under conditions which may be burdensome, and which may vary from district to district. But there are more important disadvantages.

To illustrate, we will use the example of a company with a net worth of $3,000,000, common shares outstanding of 30,000, pre-tax earnings of $635,000 (after contributing to the Profit Sharing Plan), and a 53% tax rate. Assume the company has a Profit Sharing Plan (not requiring employee contributions), and that the Plan has assets of $1,000,000. The Plan is one of those fortunate ones—it has been earning a steady 10% each year. Initially, we will assume that the Plan's assets are invested in company real estate, which it leases back to the company.

The conversion of the Profit Sharing Plan to an ESOP conceptually involves transferring the Plan's assets to the company in exchange for stock in the company. Assuming that the fair market value of the stock is the same as book value ($100), the ESOP would receive 10,000 shares in exchange for its previous assets.

The company would become owner of the real estate, and would have a post-conversion equity of $4,000,000. The creditors may consider the increase in equity an improvement, but let's look further.

The previous owners have been transformed as a result of the conversion, from 100% owners to 75% owners. It is true, as the ESOP proponents point out, that 100% of $3,000,000 is the same dollar value as 75% of $4,000,000. But what they tend to ignore, is that the previous owners have given up their rights to 25% of all future profits of the company.

But the impact of the conversion goes even further. The $100,000 annual earnings of the Profit Sharing Plan were tax-free to the Plan. After conversion, that $100,000 becomes taxable income to the company (since the company must no longer make rental payments to the Plan), and is subject to the 53% tax rate. As a result, there are effects on earnings as a percent of equity and on earnings per share. To summarize:

	No conversion	Conversion
Pre-tax earnings	$635,000	$735,000
Tax (53 percent)	(336,550)	(389,550)
Net income	298,450	345,450
Equity	$3,000,000	$4,000,000
Earnings on equity (percent)	9.95	8.64
Shares outstanding	30,000	40,000
Earnings per share	$9.95	$8.64

Since conversion reduced the previous owners' position from 100% to 75%, the net income of the company applicable to the previous owners' shares has been reduced from $298,450 (without conversion) to $259,087 (after conversion), a loss to them of $39,363.

In order for the previous owners' income position to remain the same, the company would need to earn the same pre-tax yield on the additional $1,000,000 equity that it was earning previously on the original $3,000,000 equity, or 21.17%. In the above case, the company could not earn that yield (at least initially), because the Profit Sharing Plan's assets consisted of company real estate. Thus the immediate contribution to company profits was the reduction in rent.

If the Profit Sharing Plan in the above example had invested its funds in something other than company real estate, the initial results could be improved. In this case, the assets transferred from the Profit Sharing Plan would presumably be more liquid, and it may be that the company could invest them to obtain the same pre-tax yield (21.17%) that it had previously been earning, thus protecting the previous owners' position.

This required yield of 21.17% is dependent, of course, on the effective tax rate and the previous return on equity provided by net income. For example, assuming a 53% tax rate, a previous net income yield of 12% would mean that the additional $1,000,000 equity would need to yield 25.3% pre-tax income. Similarly, if the previous net income yield were 15%, the required pre-tax earnings would be 31.91%.

The above assumes that the stock issued in exchange for the assets of the Profit Sharing Plan was issued at a market value which was equal to book value. If the market value were less than book, then the dilution is increased, and to protect the position of the previous owners would require a higher yield on the additional equity than that stated above. The converse, of course, is also true.

Therefore, in order for the conversion to avoid working to the immediate detriment of the previous owners:

Pre-tax earnings on the additional equity must be as high as previous pre-tax earnings.

Shares must be valued at book (or earnings must be higher to compensate for shares issued at less than book).

Once the conversion has taken place, however, there will be additional effects resulting from the subsequent contributions to the ESOP. For example, assume that sufficient additional income was earned to avoid impairing the previous owners' position, as outlined above. We will compare two alternatives, one assuming that the company makes a $50,000 contribution to the ESOP during its first year, and one assuming no contribution.

Pre-tax earnings (not considering the contribution) would need to be $846,800 (21.17% of the $4,000,000 equity) to protect the previous owners' position. Net income without the contribution would be $397,996. With the contribution, the pre-tax income would be reduced by $50,000, and net income would be $374,496.

The contribution would enable the ESOP to purchase 500 shares (assuming market value equals book value at the year's start). Thus the position of the previous owners is reduced to 74.07%. The results of the two alternatives are summarized below:

	No contribution	Contribution
Pre-tax income	$846,800	$796,800
Tax	(448,804)	(422,304)
Net income	397,996	374,496
Contribution		50,000
Start equity	4,000,000	4,000,000
End equity	4,397,996	4,424,496
75 percent share	3,298,497	
74.07 percent share		3,277,224

Thus the contribution of $50,000 would cause a loss to the previous owners of $21,273. To avoid this loss, an additional $61,107 in pre-tax income would be required (the loss divided by 74.07% to obtain the net income required, which is divided by 47% to obtain the pre-tax income required).

The average additional cash available during the year as a result of the contribution would be approximately $13,250. (The $50,000 contribution times the tax rate of 53% equals the year-end cash incretse as a result of the tax savings. Average additional cash during the year would be approximately half that, or $13,250.) Thus, to avoid the loss to the previous owners as a result of the contribution, the company would need to earn $61,107 (pre-tax) on the average additional cash of $13,250, or a yield of 461%.

Additional contributions in subsequent years would further erode the position of the previous owners, and in order to avoid financial loss to them, would require continued high yields from the modest amounts of additional cash.

It should be noted that in some instances, the Internal Revenue Service does not permit the existing assets of a converted Profit Sharing Plan to be invested in company stock. In effect, such assets are segregated, and continue to be treated much as they were under the Profit Sharing Plan, with only the subsequent contributions being invested in company stock. The effects of this are much the same as in starting a new ESOP (without converting), and are described in the next chapter.

In summary, conversion of an existing Profit Sharing Plan can improve the company's cash position (*if* the existing assets are liquid and can be transferred to the company in exchange for stock). The balance sheet can be improved by the increased equity. The cost of conversion to the present owners can be high, by diluting their claim on future profits. To avoid this, earnings on the transferred assets must be equal to the previous pre-tax earnings on equity (or higher if the stock is issued at less than book value). Subsequent contributions to the ESOP further dilute the previous owners' position and make it increasingly unlikely that they will escape financial loss as a result of the ESOP. Side effects can impair earnings on equity, earnings per share, and potentially reduce the value of the stock.

Chapter III

THE NEW ESOP IN OPERATION

The previous chapter discussed the effects of converting an existing Profit Sharing Plan to an ESOP. Creating and operating a new ESOP (without converting) also have detrimental effects, as outlined below.

First, consider a closely held company in which the ESOP receives its contribution from the company in cash, and uses the funds to buy out an existing shareholder. Since the stock is being purchased by the ESOP from an existing shareholder, the percentage ownership position of the remaining previous owners is unchanged. However, earnings, equity and book value are reduced (from what they would be without an ESOP).

To illustrate, assume the company previously used as an example. Equity is $3,000,000, there are 30,000 shares outstanding, pre-tax earnings are $635,000, and the tax rate is 53%. Assume that the company created an ESOP, and in the first year contributed $200,000, which is used by the ESOP to purchase 2,000 shares from a shareholder at a market value equal to book value. The table below summarizes the results from the first year of operation and compares them to the results had the company purchased the shares directly instead of using an ESOP:

	No ESOP	ESOP
Normal pretax earning	$635,000	$635,000
Contribution to ESOP	0	(200,000)
Pretax earnings	635,000	435,000
Tax (53 percent)	(336,550)	(230,550)
Net income	298,450	204,450
Purchase of shares	(200,000)	0
Net cash effect	98,450	204,450
Start equity	3,000,000	3,000,000
Purchase of shares	(200,000)	0
Net income	298,450	204,450
Ending equity	3,098,450	3,204,450
Earnings on start equity (percent)	9.95	6.82
Shares outstanding (after purchase)	28,000	30,000
Remaining previous owner's position (percent)	100	93.3
Earnings per share (after purchase)	$10.66	$6.82
Book value (year end)	$110.66	$106.82

Thus, by purchasing through the ESOP, the company's cash position is better, but the position of the remaining previous owners, net income, earnings as a percent of equity, earnings per share and book value are all impaired, and market value of the stock would likely be impaired as a secondary effect.

As a second example, assume that the ESOP receives its contribution from the company in stock (or in cash which it uses to purchase stock from the company). The company contribution is $50,000, and the stock's market value is the same as book value at the start of the year ($100). Thus the ESOP would receive 500 shares for its $50,000.

Based on these assumptions, net income for the company would be (compared to $298,450 without an ESOP):

Normal pre-tax income	$635,000
Contribution to ESOP	(50,000)
Adjusted pre-tax	585,000
Tax (53 percent)	(310,050)
Net income	274,950

The company's equity would be increased, however, not only by the net income, but also by the contribution to the ESOP, since it was used to purchase stock from the company. Thus:

Start equity	$3,000,000
Net income	274,950
Shares sold ESOP	50,000
Year-end equity	3,324,950

With the additional shares issued to the ESOP, there would be 30,500 shares outstanding at year end, and the book value would be $109.01. With the background of this example, we will look further at dilution (of the previous owners' position), and at cash flow.

Without an ESOP, the year-end equity would be $3,298,450, with an ESOP it would be $3,324,950. But the previous owners would own 30,000 of the 30,500 shares outstanding, or approximately 98.4%. Thus their share of the equity would be $3,271,751, for a loss of $26,699 from their position if an ESOP had not been formed. Not a vast amount in comparison to their total equity in the company, but even if the company never makes another contribution to the ESOP, the first year of operation has caused the previous owners to lose their rights to approximately 1.6% of all future earnings.

If the company does make further contributions to the ESOP in subsequent years, as is likely, then the previous owners' position continues to erode, the speed depending on the size of the contributions and the market value of the stock in relation to book.

What of the claims that this dilution is compensated for by earnings on the additional cash available and on improved employee productivity? In order for the previous owners to maintain the same dollar equity position with the ESOP as without (at the end of the first year), the company would need to earn an additional $57,730 (pre-tax) during the year. (Their loss of $26,699 divided by 98.6% to obtain the net income required, which is then divided by 47% to obtain the pre-tax earnings required.) As shown in the next chapter, very little of this increase in earnings is likely to be obtained due to increased employee productivity.

As for earnings on the additional cash flow, the average additional cash available to the company during the year would be approximately half the difference between the year-end equity without an ESOP and the year-end equity with one (depending on the timing of the payment to the ESOP). On that basis, the average additional cash available would be $13,250. If the earnings requirement described above were to be obtained entirely from the additional cash, an investment yielding 436% would be required. (As shown in the tables at the end of this chapter, the yield required to compensate for dilution reduces in subsequent years. But it does not become low enough to be a realistically obtainable yield.)

What of cash flow in subsequent years? Assuming continued contributions of $50,000 each year, the company would have additional cash of $132,500 at the end of the fifth year, or an average of $119,250 during the fifth year (not considering earnings on the additional cash). This is obviously still not an impressive improvement in cash flow for a company of this size, even if earnings on the added cash were considered (as described in chapters V and VI).

The cost of this modest improvement in cash position is a progressively eroding ownership position for the previous owners, reduced earnings, reduced earnings on equity, and reduced earnings per share. If the cash flow were increased by having the company make larger contributions to the ESOP, then the negative effects would also take place at a faster pace.

The secondary effects (on the value of the company's stock and its ability to attract lenders) of the reduced earnings, reduced earnings on equity, and reduced earnings per share require serious consideration.

The following tables carry the above example further, to demonstrate the results of the operations with an ESOP over a period of five years.

TABLE A.—ESOP APPROACH—DILUTION OF PRIOR OWNERS' EQUITY

Year	Ending equity	Shares issued	Shares out year end	Prior owners share	Ending book value
0	$3,000,000	0	30,000	100.0	$100.00
1	3,324,950	[1] 500	30,500	98.4	109.01
2	3,649,900	[1] 459	30,959	96.9	117.89
3	3,974,850	[1] 424	31,383	95.6	126.66
4	4,299,800	[1] 395	31,778	94.4	135.31
5	4,624,750	[1] 370	32,148	93.3	143.86

[1] $50,000 worth at book value, prior year end.

TABLE B.—PREVIOUS OWNERS' LOSS OF EQUITY POSITION

Year	Share without ESOP	Share with ESOP	Cumulative loss	Annual ESOP loss
1	$3,298,450	$3,271,751	$26,699	$26,699
2	3,596,900	3,536,753	60,147	33,448
3	3,895,350	3,799,957	95,393	35,246
4	4,193,800	4,059,011	134,789	39,396
5	4,492,250	4,314,892	177,358	42,569

TABLE C.—YIELDS REQUIRED ON ADDITIONAL CASH (TO MAINTAIN PRIOR OWNERS' POSITION)

Year	Year-end cash increase	Average cash increase	Year's ESOP loss	Pretax income required [1]	Yield required (percent) [2]
1	$26,500	$13,250	$26,699	$57,730	436
2	53,000	34,750	33,448	73,443	211
3	79,500	66,250	35,246	78,443	118
4	106,000	92,750	39,396	88,794	96
5	132,500	119,250	42,569	97,076	81

[1] Pretax income required equals years ESOP loss divided by prior owners' year-end share (table A), the result then being divided by 47 percent.
[2] Field required on average cash increase during year (percent).

TABLE D.—EFFECTS ON EARNINGS PER SHARE

Year	No ESOP, Earning per share	With ESOP		
		Year-end shares out	Net income	Earnings per share
1	$9.95	30,500	$274,950	$9.08
2	9.95	30,959	274,950	8.87
3	9.95	31.383	274,950	8.61
4	9.95	31,778	274,950	8.65
5	9.95	32,148	274,950	8.55

TABLE E.—EARNINGS AS A PERCENT OF EQUITY

Year	No ESOP			With ESOP		
	Start equity	Earnings	Percent	Start equity	Earnings	Percent [1]
1	$3,000,000	$298,450	9.9	$3,000,000	$274,950	9.2
2	3,298,450	298,450	9.0	3,224,950	274,950	8.3
3	3,596,900	298,450	8.3	3,649,900	274,950	7.5
4	3,895,350	298,450	7.7	3,974,850	274,950	6.9
5	4,193,800	298,450	7.1	4,299,800	274,950	€.4

[1] Would be slightly increased if earnings on additional cash were considered.

CHAPTER IV

EMPLOYEE PRODUCTIVITY

One of the main arguments against the negative points brought out in the previous chapters is that the ESOP will improve employee productivity sufficiently to compensate, at least in part. When the Employees own a "piece of the action", it is felt, they will tend to view the company from an ownership position, and their attitude, morale, and productivity will improve as a result. But will they?

Management often tends to look at ownership from the viewpoint of control, because if they can control things, then they can strongly influence earnings (their own, as well as the company's). But the stock held by the ESOP on behalf of the participants affords them no control, since it is voted by a committee appointed by the Board of Directors. Even after he retires and receives his distribution in stock, the participant has no real control. His tax liability provides strong pressure to sell the stock, and even if he keeps it, it will be only a very minor part of the shares outstanding.

In fact, what the participant in the ESOP has, is a vague prospect of economic gain, uncertain in size, (uncertain even if it will continue to exist,) and payable at some far future date. Once the initial public relations effort surrounding the new ESOP wears off, the participants will understand exactly what they have. Is this a motivator toward increased poductivity?

When the participant is gaining economically (or thinks he is), his morale may be improved and his productivity may be higher. But it is the perceived economic gain which (may) cause increased productivity from the participant, not the other way around. In other words, with the possible exception of very small companies, the participants are not likely to believe that additional exertion on their parts will improve their economic position through the ESOP.

Further, the volatility of the stock market will at times cause the value of the participant's ESOP account (even for non-traded companies) to decline. If anything, there will be a negative impact on productivity at these times, especially if the participant feels that the "slackers" are sharing more or less equally in the ESOP.

The proponents of ESOPS make claims of actual cases in which morale and productivity have improved. In at least one such case, the improvements should not be surprising. It relates to a company in which the ESOP was adopted by the altruistic owner of the company for the primary purpose of turning the business over the employees.

To summarize, there may well be an initial improvement in productivity, expecially if there is a good, competent public relations effort. Following that, however, the employees will begin to perceive that their ownership of shares is meaningless from the standpoint of control, and the sole advantage the ESOP offers them is economic. The employee will soon realize that the economic reward is of unknown size, unknown certainty, subject to random factors over which neither he nor the company has control, and in event, the gain is remote in time.

From that point on, the ESOP is a "part of the package", and perhaps a not too dependable part, at that. The odds are, that over the lifetime of the ESOP, the downturns in stock values will prove of more significance in impairing morale and productivity than the upturns will in improving them.

CHAPTER V

BORROWING THROUGH AN ESOP

Another of the major advantages claimed for ESOPS is that they can be used to borrow money, with the principal amount being repaid in tax-deductible dollars. The ESOP borrows the money and uses it to purchase stock from the company, pledging the stock as collateral, with the company usually guaranteeing the loan. The company agrees to make future cash contributions to the ESOP sufficient to repay the loan and interest. Since the principal (as well as the interest) is deductible, it is claimed that an "ESOP loan" costs the company approximately half as much to repay as compared with a direct loan.

Unfortunately, the proponents normally carry the argument only as far as that described above. When the analysis is carried further, into subsequent years some interesting facts are brought to light.

We will assume the same company as before; equity of $3,000,000, 30,000 shares outstanding, pre-tax earnings of $635,000, and a tax rate of 53%. Assume the company wants to borrow $300,000, repaying $100,000 each year, plus interest. Assume that the loan is a matter of necessity, and creates no additional income for the company. Which is the better alternative—borrowing directly from the lender, or borrowing through an ESOP? (A loan which is used to create additional income is described in the following chapter.)

The following two tables describe the two approaches. Table A depicts the direct-borrowing approach. The upper part of the table (to the fifth line) shows the calculation of post-tax income for each of the three years of the loan. However, the existence of the loan creates a cash flow effect, which requires estimating an additional adjustment to obtain net income for the three years.

The cash-flow adjustment is described in the second part of Table A. (Depreciation is ignored since it would be the same in either alternative.) The cash flow factors are summarized by year on the fourth line. The fifth line shows the cumulative cash flow effect. (A refinement, which does not affect the conclusions, would be to recognize that the additional cash flow takes place cumulatively *during* each year, calculate the average increased cash availability for each year, and "cum" the resulting figures.)

Since the cash flow effect is positive, it is assumed that the funds will be used to reduce current bank borrowings, and will contribute 10% to pre-tax income. That figure is shown on line six. The post-tax effect of the additional income is 47%, and is shown on line seven. That figure, for each year, is carried up to the upper part of Table A as an estimated Cash Flow Adjustment, to obtain the Net Income for each year.

Table B depicts in a similar manner, the approach whereby the funds are borrowed through an ESOP. In the upper portion of the table, the full amount of principal and interest is deducted as a contribution to the ESOP.

The lower portion of Table B describes the cash-flow estimate related to the ESOP approach. The net cash flow effect for each year is summed on line four, and the cumulative amount shown on line five. The income on the additional cash

is again assumed to be 10% (line six), and the post-tax effect is calculated at 47% and shown on line seven. That figure, for each year, is carried up to the upper part of Table B as an estimated Cash Flow Adjustment, to obtain the Net Income for each year.

While this method of estimating the impact of the cash flow effect is not absolutely precise, it has the advantage of relative simplicity and in no way changes the conclusions to be drawn.

TABLE A.—DIRECT BORROWING APPROACH

	Year I	Year II	Year III	Total
Normal pretax	$635,000	$635,000	$635,000	
Loan interest	(30,000)	(20,000)	(10,000)	
Adjusted pretax	605,000	615,000	625,000	
Tax (53 percent)	(320,650)	(325,950)	(331,250)	
Post-tax	284,350	289,050	293,750	
Cash flow adjustment	8,664	17,550	26,656	
Net income	293,014	306,600	320,406	$920,020
Cash flow effect:				
Normal pretax	635,000	635,000	635,000	
Tax (as above)	(320,650)	(325,950)	(331,250)	
Loan payment	(130,000)	(120,000)	(110,000)	
Yearly cash increase	184,350	189,050	193,750	567,150
Cumulative cash increase	184,350	373,400	567,150	
Earnings at 10 percent	18,435	37,340	56,715	
Post-tax effect	8,664	17,550	26,656	

TABLE B.—BORROWING THROUGH AN ESOP

	Year I	Year II	Year III	Total
Normal pretax	$635,000	$635,000	$635,000	
Contributed to ESOP	(130,000)	(120,000)	(110,000)	
Adjusted pretax	505,000	515,000	525,000	
Tax (53 percent)	(267,650)	(272,950)	(278,250)	
Post-tax	237,350	242,050	246,750	
Cash flow adjustment	11,155	22,532	34,129	
Net income	248,505	264,582	280,879	$793,966
Cash flow effect:				
Normal pretax	635,000	635,000	635,000	
Tax (as above)	(267,650)	(272,950)	(278,250)	
Contributed to ESOP	(130,000)	(120,000)	(110,000)	
Yearly cash increase	237,350	242,050	246,750	726,150
Cumulative cash increase	237,350	479,400	726,150	
Earnings at 10 percent	23,735	47,940	72,615	
Post-tax effect	11,155	22,532	34,129	

As the tables show, the direct borrowing approach provides net income over the three years of $920,020, and an increase in cash available of $567,150. The ESOP borrowing approach provides net income over the three year period of $793,966, and an increase in cash available, of $726,150. Thus, borrowing through an ESOP increases available cash by $159,000 over what it would have been on a direct borrowing basis, but does so at the cost of a reduction in net income of $126,054.

And, as in previous examples, the effects do not stop there. If the $300,000 had been borrowed through an ESOP, the company would be obliged to issue 3,000 shares of stock to the ESOP (assuming market value equals book value), in return for the funds contributed. At the outset of the three year loan period, the previous owners' position would thus have been reduced from one of 100% to one of 90.9% ownership. These effects, plus the impact on earnings, on earnings as a percent of equity, and on earnings per share are summarized in Table C at the end of the chapter.

Proponents of ESOPS sometimes claim that one advantage of borrowing through an ESOP is that the loan is easier to obtain. Obviously, that would depend on the individual lender's evaluation of the situation, but it is doubtful that many lenders would consider a loan through an ESOP significantly more desirable than a direct loan. On the positive side the lender would need to consider the increase in the company's net worth and the slight improvement in liquidity. On the negative side he would need to consider the reduced net income, reduced earnings on equity, and reduced earnings per share. He would also need to consider the likely impact these factors would have on the value of the ESOP's stock, which is serving as collateral for the loan.

In summary, the claim that you can borrow through an ESOP and repay the loan in tax-deductible dollars is true only in the narrowest literal sense. Considering the side effects, the ESOP approach is a very expensive one.

TABLE C.—EFFECTS ON EARNINGS ON EQUITY AND EARNINGS PER SHARE

Year	Net income	Previous owner share	Earnings/equity percent	Earnings/share
No ESOP:				
1	$293,014	$293,014	9.8	$9.77
2	306,600	306,600	9.3	10.22
3	320,406	320,406	8.9	10.68
Total	920,020	920,020		
With ESOP:				
1	248,505	225,913	7.5	7.53
2	264,582	240,529	7.5	8.02
3	280,879	255,345	7.4	8.51
Total	793,966	721,787		

CHAPTER VI

ESOPS AND ACQUISITIONS

Another of the major advantages claimed by the proponents of ESOPS, is that an ESOP can be used to acquire another company, "paying for it in pre-tax dollars." There are several means by which this can be done.

In many examples, the ESOP purchases the stock of the company to be acquired, paying for it on an instalment basis (or through the use of borrowed funds). The ESOP then makes an exchange of stock with the parent company, the acquired company's stock being transferred to the parent, and stock in the parent company being given in return. Cash contributions from the parent company to the ESOP in subsequent years are used by the ESOP to pay for the acquired company's stock. Other approaches achieve the same end result.

It should be apparent that this is not greatly different from the example used in the previous chapter, in which an ESOP was used to borrow funds. In that example, however, we assumed that the borrowed funds generated no additional income. In the case of an acquisition, there would hopefully be some additional income.

To illustrate the use of an ESOP in acquiring another company, we will use the same hypothetical company used in previous chapters. A comparison will be made between the "ESOP" method of acquisition and the "direct" method, in which an ESOP is not used.

To reiterate the example—equity is $3,000,000, there are 30,000 shares outstanding, pre-tax income is $635,000 and the tax rate is 53%. Assume that the cost of the stock in the company to be acquired is $300,000, and that borrowed funds are used which must be repaid at $100,000 each year plus 10% interest. The company being acquired earns $80,000 pre-tax.

Table A describes the results of three years of operations after acquiring the company directly (without an ESOP). Pre-tax income is $715,000, the total of the parent's $635,000 and the acquired company's $80,000. The example follows the pattern described in the previous chapter on borrowing through an ESOP, including the cash flow adjustment, which is described in the second half of the table.

Table B describes the results of three years of operations after financing the acquisition through an ESOP. Comparing the two approaches, it is apparent that the ESOP approach improves available cash during the three years by $159,000

as compared with the non-ESOP approach. But, as in the previous example, this modest improvement is achieved at the expense of a reduction in profits of $126,054.

And, as in previous examples, the problems created by using an ESOP for acquisitions do not end there. The ESOP approach would reduce the previous owners' position from 100% to 90.9%, so that the previous owners would own a reduced share of the profits for the three year period. In addition, earnings, earnings as a percent of equity and earnings per share are adversely affected, with potential effects on market value for the stock. These effects are summarized in Table C.

TABLE A.—FINANCING ACQUISITION DIRECTLY (NO ESOP)

	Year I	Year II	Year III	Total
Normal pretax	$715,000	$715,000	$715,000	
Loan interest	(30,000)	(20,000)	(10,000)	
Adjusted pretax	685,000	695,000	705,000	
Tax (53 percent)	(363,050)	(368,350)	(373,650)	
Posttax	321,950	326,650	331,350	
Cash flow adjustment	10,431	21,084	31,958	
Net income	332,381	347,734	363,308	$1,043,423
Cash flow effect:				
Normal pretax	715,000	715,000	715,000	
Tax (as above)	(363,050)	(368,350)	(373,650)	
Loan payment	(130,000)	(120,000)	(110,000)	
Yearly cash increase	221,950	226,650	231,350	679,950
Cumulative cash increase	221,950	448,600	679,950	
Earnings at 10 percent	22,195	44,860	67,995	
Posttax effect	10,431	21,084	31,958	

TABLE B.—FINANCING ACQUISITION THROUGH AN ESOP

	Year I	Year II	Year III	Total
Normal pretax	$715,000	$715,000	$715,000	
Contributed to ESOP	(130,000)	(120,000)	(110,000)	
Adjusted pretax	585,000	595,000	605,000	
Tax (53 percent)	(310,050)	(315,350)	(320,650)	
Posttax	274,950	279,650	284,350	
Cash flow adjustment	12,922	26,066	39,431	
Net income	287,872	305,716	323,781	$917,369
Cash flow effect:				
Normal pretax	715,000	715,000	715,000	
Tax (as above)	(310,050)	(315,350)	(320,650)	
Contributed to ESOP	(130,000)	(120,000)	(110,000)	
Yearly cash increase	274,950	279,650	284,350	838,950
Cumulative cash increase	274,950	554,600	838,950	
Earnings at 10 percent	27,495	55,460	83,895	
Posttax effect	12,922	26,066	39,431	

TABLE C.—EFFECTS ON EARNINGS ON EQUITY AND ON EARNINGS PER SHARE

Year	Net income	Previous owner share	Earnings/equity (percent)	Earnings/share
Acquisition without ESOP:				
1	$332,381	$332,381	11.1	$11.08
2	347,734	347,734	10.4	11.59
3	363,308	363,308	9.9	12.11
Total	1,043,423	1,043,423		
Acquisition with an ESOP:				
1	287,872	261,676	8.7	8.72
2	305,716	277,896	8.5	9.26
3	323,781	294,317	8.3	9.81
Total	917,369	833,889		

Chapter VII

SUMMARY

The foregoing examples and analyses have demonstrated that in the majority of instances, the major advantages claimed for ESOPS are more than outweighed by the disadvantages. There may be a modest improvement to cash flow, but in most situations there are reductions in earnings, reductions in earnings on equity, and reductions in earnings per share. There would likely be secondary effects which would reduce the value of the stock and impair the company's ability to attract lenders.

The Internal Revenue Service insists that ESOPS be "for the exclusive benefit of the participants." It may well be that the Internal Revenue Service understands the workings of ESOPS far better than do those in business, as it is rarely the owners who benefit. Whatever the company's motives in adopting an ESOP, it is almost always for the "exclusive benefit of the employees."

Evaluation of the Use of an Employee Stock Ownership Plan as a Method of Capital Formation for ConRail

(By E. F. Hutton & Co., Inc., May 12, 1975)

INTRODUCTION

In conjunction with a study conducted by Towers, Perrin, Forster & Crosby ("TPF/C") for the United States Railway Association ("USRA") on "The Evaluation of the Employee Stock Ownership Plan ('ESOP') as Applied to ConRail", E. F. Hutton & Company, Inc. has been engaged to evaluate an ESOP as a method of capital formation for ConRail.

This anslysis is based on the information set forth in the USRA's Preliminary System Plan (the "PSP") and especially Part 3 which is entitled "Financial Assessment of the Preliminary System Plan". Inputs in the areas of employee benefit programs and employee motivation will be provided by TPF/C and Dr. Saul Gellerman, respectively.

This report reviews how an ESOP serves to provide capital to a corporation; examines the financial effects of an ESOP on the sponsoring corporation; and considers the advantages and disadvantages to a corporation and to its common shareholders of an ESOP financing as compared with other financing modes. It then considers the applicability of the ESOP method of financing to ConRail and gives E. F. Hutton's recommendations on the use of an ESOP at ConRail.

How an ESOP Operates to Provide Capital

Under an ESOP a corporation sets up a Trust established under a stock bonus plan qualified under Section 401(a) of the Internal Revenue Code. Such qualification is required in order to make the corporation's contributions deductible for tax purposes. The Trust then arranges for a loan from a bank or other lending institution, the proceeds of which are used either to purchase newly-issued stock from the corporation, or to purchase previously-issued stock from existing shareholders. The loan to the Trust is secured by the stock purchased and guaranteed by the sponsoring corporation. In establishing the ESOP the corporation undertakes to make contributions to the plan in an amount related to the size of the plan and the salary and wages of participating employees. Interest and principal payments on the loan to the Trust are made out of these contributions. The contributions, to the extent that they do not exceed 15% of the wages and salaries of the participating employees, are fully tax deductible in a qualified plan. The result of the transaction is to provide the corporation with capital in an amount equal to the loan made to the Trust, or to provide cash to selling shareholders (or their estates).

ESOP Financing—Debt or Equity

By its structure ESOP financing is a hybrid of debt an equity. While equity securities are "sold" to the Trust the ESOP financing does not provide the advantages of true equity financing because the corporation also incurs fixed charge obligations equal to those it would have under a straight debt financing. The advantage is that the debt can be retired through tax deductible contributions. For all practical purposes the loan to the Trust must be viewed as having been made directly to the corporation. The contributions are in fact interest and principal payments made directly by the corporation. The ESOP's stock is validly issued and outstanding in spite of the fact that it has not yet been allocated to the accounts of participating employees. No contributions are made by the participating employees; as the loan is retired and they achieve vesting, they receive stock essentially free of any cost to them.

Basically, the ESOP is a loan to the corporation the amortization of which creates an equity interest for the corporaiion's employees in the capitalization of the corporation. The reason for viewing it as a loan made directly to the corporation is the fact that any lending institution providing the funds to the Trust looks through the Trust vehicle to the source of the funds required to amortize the loan. The loan is made on the credit worthiness of the corporation and thus an ESOP does not create the opportunity to borrow in amounts significantly greater than the corporation could otherwise have borrowed. In the event of a default by the Trust the lenders could sell the stock. If the proceeds are inadequate, the corporation is obligated to repay the balance of the loan. However, this security interest is not meaningful because the Trust's default would have been occasioned by a prior default by the corporation. In the event of such a default the equity securities would have only a nominal value. This problem is further compounded by the fact that most ESOP financings are done for either private companies or companies with extremely thin trading markets, making realization upon sale of large amounts of equity difficult.

The equity interest represented by the stock held in the Trust, while not immediately vested to the accounts of participating employees, is recognized from the inception of the plan. The stock has the same rights as similar stock held by other investors including the right to vote and receive dividends, is such provisions exist. Pending vesting to the accounts of employees, the Trustee votes the stock in accordance with the provisions of the plan.

Comparison of ESOP Financing with Conventional Debt and Equity Financing

A comparison of the effects of ESOP financing, debt financing and equity financing is presented in Table I. It considers the impact of each on income, cash flow, capitalization and existing equity investors. The impact on a hypothetical corporation is demonstrated in Exhibit I. Table I and Exhibit I make the following assumptions:

1. An equal amount of money is raised under each of the alternative financings.
2. The proceeds from each of the alternatives are invested to produce an equivalent amount of revenues.
3. The contributions made by the corporation are equal to the interest and principal payments on the loan to the Trust.
4. The loan to the Trust is guaranteed by the corporation.
5. The corporation has only common stock in its equity capitalization. Therefore, the number of shares sold to the ESOP would be equivalent to the number of shares sold to investors in the equity financing.
6. "t" is the corporation's marginal tax rate.
7. No effect has been given to greater productivity resulting from the plan. See Dr. Gellerman's report for an analysis of the possibilities of such effects.
8. The corporation can avail itself of any of the three alternatives.

TABLE I

ESOP financing	Debt financing	Equity financing
INCOME EFFECTS		
Pretax income is reduced by interest and principal payments on the loan (the contributions).	Pretax income is reduced by the portion of the loan payment representing interest. Principal payments do not directly affect income.	There is no reduction in income relating to the equity financing.
After-tax income is reduced by the amount of the interest and principal payments multiplied by (l—t).	After-tax income is reduced by the amount of the interest portion multiplied by (l—t). Principal payments are not tax deductible.	Any dividends paid on the corporation's stock are not tax deductible.
Any dividends paid on stock issued to the ESOP are not tax deductible.		
CASH FLOW EFFECTS		
Cash flow is reduced by the amount of interest and principal payments multiplied by (l—t). Cash flow is reduced by dividend payments, if any, on the newly issued stock.	Cash flow is reduced by the amount of the interest portion of the loan payment multiplied by (l—t). Cash flow is reduced by the full amount of the principal portion of the loan payment.	Cash flow is reduced by dividend payments, if any, on the newly issued stock.
CAPITALIZATION EFFECTS		
Initially the corporation would reflect the full amount of the trust's loan as a long-term liability. As contributions are applied to repay the trust's loan this liability would decrease. Initially shareholders' equity would not show an increase. As the trust's loan is repaid the decrease in the principal amount would be reflected by an increase in shareholders' equity. The number of shares outstanding would be increased by the shares sold to the ESOP. Retained earnings would be reduced by dividend payments, if any, on the shares sold to the ESOP.	The loan would be reflected as a long-term liability. As the loan is amortized this liability would decrease.	Shareholders' equity would be increased by the proceeds from the sale of the stock. The increased income which derives from not charging income with the costs associated with the ESOP and debt financing will be added to retained earnings. Retained earnings would be reduced by dividend payments, if any, on the newly issued shares.
EFFECT ON EXISTING SHAREHOLDERS		
The proportionate interest of existing shareholders in the corporation's net income and book value is diluted by the percentage relationship which the number of shares sold to the ESOP bears to the total shares outstanding after the sale to the ESOP.	The excess of the income generated from the investment of the funds over the interest costs increases earnings and book value with no dilution in either the shareholders' proportionate interest in earnings or book value.	The proportionate interest of existing shareholders in the corporation's net income is diluted by the percentage relationship which the number of shares sold to investors bears to the total shares outstanding after the offering. The effect on the book value per share of existing shareholders depends on the relationship of the offering price per share to book value per share prior to the offering. If the offering price is greater than book value the financing increases book value; if the offering price is lower than book value the offer decreases book value.

Advantages of ESOP Financing

The ESOP methods of financing can provide certain financial advantages over debt and equity financing in specialized situations. Generally, the most compelling financial advantage is that the principal on an ESOP loan is repaid with pre-tax dollars compared with after-tax dollars under conventional debt financing. This cash flow advantage in dollars is:

$$\frac{P}{(1-t)}-P$$

where "P" is the principal amount of the loan and "t" is the marginal tax rate. P/(l–t) is the pre-tax income which must be generated to repay the conventional loan compared with an amount P of pre-tax income to repay the ESOP loan. *If the corporation does not pay any taxes this advantage is not present.* An offset to this cash flow advantage (relative to debt financing) is the dividend requirements, if any, on newly-issued shares.

The corporation is able to flow pre-tax dollars into its equity account since a portion of the contributions made to the ESOP go to repay the loan to the Trust which translates into an increase in shareholders' equity. For a tax paying corporation the fact that the principal amortization becomes a pre-tax charge rather than an after-tax charge to cash flow can improve the cash flow coverage ratios of total debt service (principal and interest) and thus increase overall debt capacity when contrasted with the debt financing.

At the present time, conditions in the equity securities markets are such that only major corporations can sell equity securities through the traditional underwriting channels. Under such conditions, for many companies the only practical equity financing is through an ESOP. As discussed above, the capital raising advantages of such a sale are limited. However, for estate planning purposes or for "going private" transactions an ESOP can be very useful, because in these cases the shares purchased by the ESOP are previously issued "secondary" shares. The debt capacity of the corporation can thus be used to provide liquidity to an estate or to increase the ownership percentage of inside shareholders.

Disadvantages of ESOP Financing

The principal financial disadvantage of the ESOP method is its impact on income and the dilution of the interests of existing shareholders. Contributions made to the plan are charged directly to income. To the extent that a part of the contribution represents principal payments on the loan to the Thrust, this is an additional charge not associated with a debt financing. The reported income of a corporation using ESOP financing will be reduced by the entire contribution to the Trust whereas only interest payments are charged against earnings in a debt financing. While this charge is not important to a private corporation, it will reduce the value of any shares to be utilized to raise capital for the corporation.

In addition to the earnings impact, the shares in an ESOP will dilute overall earnings per share as they are deemed to be outstanding for computation of earnings per share. This "dilution" will also lower the per share value which could be obtained in a sale of equity to raise capital. Since the shares sold to the ESOP are valued at the same price as shares sold in the equity financing, the same dilution in existing shareholders' interest is created. However, there are no on-going charges to income. Therefore, in the equity financing the offset to the dilution of the newly-issued shares is the additional income which is generated by investment of the proceeds of the financing. If the after-tax rate of return earned on the proceeds is greater than the reciprocal of the multiple of earnings at which the common stock is valued, then the equity financing in non-dilutionary to existing shareholders' proportionate interest in the corporation's earnings. In the case of an ESOP financing the rate of return would have to be proportionately higher to compensate for the increased charges to earnings before such an offering became non-dilutionary.

The earnings generated from the productivity increases stemming from the motivational aspects of the ESOP plan must exceed the contribution costs by the pre-tax rate of return which the corporation could expect on investing the proceeds from the equity financing before the ESOP method would not adversely impact the proportionate interest of existing shareholders both in income and cash flow.

Impact on Financing Alternatives

While ESOP financing has numerous attributes of equity financing it is more properly considered debt financing for the reasons mentioned earlier in the report. There is, however, a difference of opinion as to how to ESOP should be accounted for in the accounting community. The alternatives are to either reflect the ESOP loan directly in the balance sheet, or indirectly as a contingent liability footnote. The form will not affect the analysis performed by members of the financial community. Contributions to the Trust, because of the implications of the default on its loan, should be considered a fixed charge of the corporation and, therefore, such an obligation is properly included in the liability section of the balance sheet for analytical purposes. The equity formation of the ESOP arises from a charge to income which amortizes the loan and occurs over the term of the loan. To include the loan to the Trust's proceeds in the shareholders' equity section of the corporation's balance sheet ignores the fixed obligation of the corporation to indirectly repay the loan through its contributions.

The proper capital structure of a corporation depends on a host of factors, the most important of which is the nature of its business. If a business expects an assured steady demand for its services and has the ability to cover its costs in pricing its product, its capital structure could include a substantial amount of

leverage. A more speculative enterprise argues for less reliance on capital which necessitates fixed payments to avoid jeopardizing its on-going business.

As an ESOP financing is categorized as debt, it limits the borrowing capacity of a corporation. A lending institution or debt investor will consider the fixed nature of the corporation's obligations to the ESOP before lending it additional funds. One mitigating aspect is the tax subsidy on principal payments not available on a conventional loan.

The equity financing has a two-fold benefit to the corporation as it does not utilize existing borrowing capacity, but actually increases the amount a corporation can look to borrow in the debt markets.

It has been assumed that the corporation can avail itself of any of the three alternatives. If such were not the case, the decision to establish an ESOP requires additional considerations, however, the IRS requires that the plan be for the exclusive benefit of the employees. Rulings on this matter require that the stock sold to the ESOP must be valued at no more than fair market value at the time of purchase by the Trust and that the corporation must have been able to borrow an equivalent sum in the regular money markets at the time.

This requirement should not be confused with the timing on the establishment of an ESOP. The maximization of the value received for the equity interest sold should be an important consideration to the corporation. If short-term uncertainties are reflected in a low valuation of the corporation's equity securities, then management should resort to debt financing, if available, to avoid a sale of equity which would unnecessarily dilute the interests of existing shareholders.

THE APPLICABILITY OF AN ESOP AS A METHOD OF CAPITAL FORMATION TO CONRAIL

ConRail's Projected Financial Results and Funding Requirements

This analysis uses as a basis for examining the applicability of ESOP financing to ConRail the data presented in Chapter 14 of the PSP entitled "Financial Analysis of the Preliminary System Plan", and no assessment is made on the accuracy of such projections as E. F. Hutton took no part in their preparation.

The ability of ConRail to obtain capital from private sources independent of Federal guarantees depends on the credence placed by the financial community on the projections developed and in their assessment of the treatment of the creditors of the existing bankrupt railroads. It is our opinion that without a Federal guarantee ConRail as presently conceived will be precluded from raising funds (other than direct mortgage indebtedness) in the private sector until it has an operating history which demonstrates a capability of profitable operation. We believe that the USRA has reached the same conclusion as the inference drawn from a reading of Chapter 14 of the PSP, is that ConRail's ability to obtain funds from the capital markets will be quite limited. Of the $3.5 billion budgeted for external financing by 1985, approximately $3 billion is expected to consist of Federal notes. The balance is projected to consist of equipment obligations. If, in fact, ConRail will have no independent ability to achieve debt financing then the creation of an ESOP will not increase the ability of ConRail to raise capital. The necessary Federal guarantees will not be increased or decreased.

ConRail's Probable Tax Position

The advantages of the ESOP method of financing over alternative methods stem primarily from the provisions of the Internal Revenue Code which enable a corporation to deduct contributions made to the plan from taxable income. Consequently, ConRail's expected tax position is a key consideration.

The PSP indicates that based on expected results and the opportunities for favorable tax treatment, ConRail will be in a position to eliminate or defer taxes for most of the ten year planning horizon (1975–1985).

Therefore, the tax advantages to ConRail of the ESOP financing are nonexistent until ConRail becomes a tax-paying entity. Traditional debt financing will provide an equivalent amount of capital at the same cost without the concomitant dilution and higher charges to earnings brought about by the ESOP.

Impact on Income

The ESOP financing, as previously indicated, requires charging to income the contributions made to the ESOP Trust. These costs exceed any of the charges

related to the other financing modes. In its projections USRA does not foresee ConRail becoming profitable until 1978. The establishment of an ESOP would decrease the profit potential and possibly lengthen the time before ConRail becomes a profitable entity. The magnitude of these effects would be in direct proportion to the size of the ESOP plan utilized.

Effects on Future Capital Formation Through Sale of Equity

The establishment of an ESOP dilutes the interest of existing shareholders in earnings as shown in the forepart of this report, and it will also reduce the reported earnings. Consequently, the creation of an ESOP will reduce the ability of ConRail to obtain equity capital through the sale of equity to the public. Again, further sales to the ESOP would be limited by the debt capacity of ConRail in the absence of Government guarantees, and the IRS requirement that the corporation have the ability to borrow equal amounts in the capital markets.

Structure of an ESOP

There are many conceivable alternatives that could be considered in establishing an ESOP for ConRail, most of which depend upon a prior determination of how existing, unsecured creditors are to be handled in the recapitalization. If they are to receive common stock (or common stock equivalents such as convertible debentures, convertible preferreds, or warrants) then this would preclude 100 percent ownership by the employees. In such a case, the sale to the ESOP, which must be at "fair market value", would have to be the same price utilized in determining the value of the shares given to the creditors. If this value were to be reduced by subsequent adjudication it would presumably have to be lowered for the ESOP. At the very least, the plan would lose its IRS qualification. Distributions to the creditors, or distributions to trustees in bankruptcy which subsequently flow through to former creditors and shareholders, could presumably result in ConRail becoming a public, reporting company under Section 12G of the Securities & Exchange Act of 1934. This would occur if more than 300 shareholders resulted. This early existence of a "market" could lead to the same complications.

If no equity securities are given to creditors then all or any portion of the common shares could be placed in an ESOP. In our opinion, the loan utilized would have to be guaranteed by the U.S. Government, as previously discussed. The amount would be limited to the "fair market value" of the equity. E. F. Hutton has not been engaged to determine this value, however, it is possible to say that in view of the facts that (1) the structure of ConRail has not yet been determined, (2) currently railroad related equities sell at very low price earnings multiples, (3) the projections prepared by USRA do not show achievement of profitability before 1978, and (4) many persons, groups, corporations and even governmental agencies have questioned the attainability of these projections, any valuation arrived at would be extremely low relative to the value such equities would have when ConRail becomes a viable, profitable entity.

Since in the early years ConRail's viability will require massive Federal guarantees of debt, it is clear that the U.S. Government will have provided the means by which ConRail might ultimately achieve profitability. When profitable, the equity of ConRail could conceivably be worth many billions of dollars. For example, if ConRail were to earn the $381,736,000 it is projected to earn in 1985 (page 202 of the PSP) and have a market price of five times earnings, the value of the equity would then be $1.9 billion. This would clearly be an enormous windfall for the 70,000 to 100,000 employees of ConRail, who would never have contributed toward the purchase of the shares, even at the low price levels which would currently be required.

Conclusion

Due to the unique nature of ConRail, in our opinion, there is no present financial advantage to ConRail in the establishment of an ESOP. No enhancement of capital formation results because ConRail will not pay taxes for many years and the Federal Government will be required to guarantee all unsecured debt. Future capital formation through the sale of common stock will be made more expensive due to the higher than necessary charges to earnings and the dilutive effects of having issued common shares without a corresponding contribution. In the absence of a clearly defined ConRail structure and uncertainty over the future earnings prospects of ConRail we believe that any "sales" to an ESOP would

have to be at inordinately low prices relative to what the value may prove to be after the Government's efforts at restructuring, and the Government's guaranteeing of billions of dollars of indebtedness, prove successful.

At the present time it is our opinion that the only financial reason for creation of an ESOP now would be as an experimental model, to be expanded when the Board of Directors of ConRail determined that conditions then existing make it appropriate.

EXHIBIT I—COMPARATIVE EFFECTS OF ESOP, DEBT AND EQUITY FINANCING

[Schedule traces the effects on a hypothetical corporation of a $10,000,000 financing within the framework of table I (see assumptions to table I, p. 3)]

[Dollar amounts in thousands]

	Before financing	ESOP financing (A)	Debt financing (A)	Equity financing
Income effects:				
Pretax income before financing costs (B)	$9,000	$10,800	$10,800	$10,800
Financing costs:				
Interest		(800)	(800)	0
Principal		(690)	(1)	0
Adjusted pretax income	9,000	9,310	10,000	10,800
Taxes at 50 percent	4,500	4,655	5,000	5,400
Net income	4,500	4,655	5,000	5,400
Pretax financing costs charged to income		1,490	800	0
Aftertax financing costs charged to income (C)		745	400	0
Cash flow effects:				
Cash flow before financing costs	18,000	21,600	21,600	21,600
Financing costs before dividends:				
Interest		400	400	0
Principal		345	690	0
Adjusted cash flow before dividends	18,000	20,855	20,510	21,600
Dividends—$2.50 per share (5 percent)	2,500	3,000	2,500	3,000
Cash flow after dividends	15,500	17,855	18,010	18,600
Cash financing costs (C)		1,245	1,090	500
Capitalization effects:				
Debt	50,000	60,000	60,000	50,000
Shareholders' equity	50,000	50,000	50,000	60,000
Total	100,000	110,000	110,000	110,000
Effect on existing shareholders:				
Shares outstanding	1,000,000	1,200,000	1,000,000	1,200,000
Dilution in proportionate interest (percent)		16.7	None	16.7
Earnings per share	$4.50	$3.88	$5.00	$4.50
Increase (decrease) (percent)		(13.8)	11.1	None
Book value	$50.00	$41.67	$50.00	$50.00
Increase (decrease) (percent)		(16.7)	None	None

[1] Not deductible.

(A) The loans under the ESOP and Debt alternatives are made on the following terms:

Term: Ten years
Interest Rate: 8%
Amortization Schedule: 14.90% of the principal amount per annum

(B) The corporation earns an 18% pre-tax return on the investment of the proceeds from each of the financings

(C) The charges to net income and cash flow relating to the ESOP and Debt financing over the life of the loan differ because of the varying portion of the loan payments allocated to interest. The schedules below show the impact of each over the full term of the loan. In Case 1 a 50% tax rate was assumed while in Case 2 the corporation is assumed to pay no taxes.

[Dollar amounts in thousands]

	Charge to net income		Charge to cash flow	
	ESOP financing	Debt financing	ESOP financing before dividends of $500 per annum)	Debt financing
Case 1—50 percent tax rate (year):				
1	$745	$400.0	$745	$1,090.0
2	745	372.5	745	1,117.5
3	745	342.5	745	1,147.5
4	745	310.5	745	1,179.5
5	745	275.5	745	1,214.5
6	745	238.0	745	1,252.0
7	745	197.5	745	1,292.5
8	745	153.5	745	1,336.5
9	745	106.5	745	1,383.5
10	745	55.0	745	1,435.0
Case 2—No taxes (year):				
1	1,490	800.0	1,490	1,490.0
2	1,490	745.0	1,490	1,499.0
3	1,490	685.0	1,490	1,490.0
4	1,490	621.0	1,490	1,490.0
5	1,490	551.0	1,490	1,490.0
6	1,490	476.0	1,490	1,490.0
7	1,490	395.0	1,490	1,490.0
8	1,490	307.0	1,490	1,490.0
9	1,490	213.0	1,490	1,490.0
10	1,490	110.0	1,490	1,490.0

THE KELSO PLAN

(By Julius W. Allen, Senior Specialist in Price Economics, Congressional Research Service, Library of Congress, Washington, D.C., Oct. 24, 1974)

At least since 1958, when "The Capitalist Manifesto" by Louis O. Kelso and Mortimer J. Adler was published, a so-called Kelso plan to encourage stock ownership by employees has received considerable attention. Kelso's plan has evolved with some variations in two subsequent books, "The New Capitalists, a Proposal to Free Economic Growth from the Slavery of Savings," co-authored with Mortimer Adler, and published in 1961, and "Two-Factor Theory: the Economics of Reality: How to Turn Eighty Million Workers into Capitalists on Borrowed Money and Other Proposals," co-authored with Patricia Hetter and published in 1967, and in numerous articles and statements submitted to Congressional committees. Among the most recent are "Corporate Social Responsibility Without Corporate Suicide," by Louis O. Kelso and Patricia Hetter, Challenge, July/August 1973, pp. 52–27, and "Financing Economic Growth and Environmental Protection to Strengthen the Market Power of Consumers," testimony to the Subcommittee on the Environment of the House Committee on Interior and Insular Affairs by Louis O. Kelso and Norman G. Kurland, January 31, 1974.

Kelso sees his program as being beneficial in numerous ways, in particular (1) making it possible for a corporation's employees to become owners of stock in their own corporation, and thereby increasing worker motivation and productivity, and (2) providing cheaper financing for capital improvements, as a result of tax advantages that could be derived by corporations utilizing the plan. It should be recognized at the outset that there are already in operation other employee stock ownership plans that have a similar motivation of providing greater incentives to employees to identify themselves with the successful operations and profitability of their companies.[1] They are not however, as sweeping in their obligatory aspects of employee participation and management financing procedures.

Kelso's two-fold thesis might be summarized as a belief that (1) increased output depends primarily on increasing inputs of capital and (2) that greater ownership of such capital by a firm's employees will provide a second income to workers enabling them to share more directly in the increased output resulting from the increments of capital input and giving them greater incentives to increase their productivity and their interest in the profitability of the firm. As Kelso has said, "All we're doing is cutting the average worker into the capital gains pie." [2]

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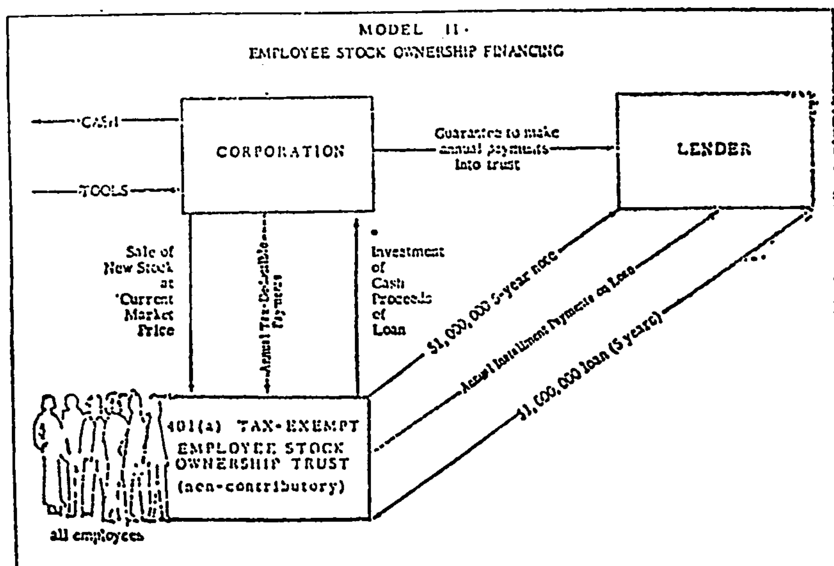
[1] A memorandum, dated April 18, 1974, outlining the basic characteristics of most employee stock ownership plans is attached.

[2] Business and Government "Insider" Newsletter. V. 1, No. 50, November 13, 1972.

In making his explanation of his plan, Kelso postulates the customary procedure of a corporation desiring to make a capital investment in the following terms. The normal financing procedure has the firm go to a lender, take out a loan, make the improvement and eventually pay back the loan plus interest. No net new capital owners are created in the process. Use of internal financing sources involves the same limited ownership and does not expand the number of new owners of capital.

Kelso's alternative is illustrated in the following diagram, titled Model II, in contrast to the traditional method of financing described above, which he refers to as Model I. This so-called Employee Stock Ownership Plan (ESOP) involves the use of a tax-exempt Employee Stock Ownership Trust (ESOT). Principal aspects of the ESOP financing techniques are described by Kelso as follows:

The basic building block for bringing about such change in the pattern of ownership of capital in the U.S. economy is ESOP financing (the possible variations are numerous). Using the assumptions referred to in connection with the discussion of traditional financing, Model I, it may described as follows:



The most important aspects of the ESOP financing techniques are:

The loan in made not directly to the corporation, but to a specially-designed pension trust designed to be invested in employer stock, under Section 401(a) of the Internal Revenue Code. Such trusts normally cover all employees of the corporation; their relative interests are proportional to their relative annual compensation (however defined) over the period of years that the financing is being paid off. The trusts are normally under the control of a committee appointed by management and its membership may include labor representatives.

The committee invests the proceeds of the loan in the corporation by purchasing newly issued stock at its current market value.

The trust gives its note to the lender, which note may or may not be secured by a pledge of the stock. If it is so secured, the pledge is designed for relaese of proportionate amounts of the stock each year as installment payments are made on the trust's note to the lender and the released stock is allocated to participants' accounts.

The corporation issues its guarantee to the lender assuring that it will make annual payments into the trust in amounts sufficient to enable the trust to amortize its debt to the lender. Within the limits specified by the Internal Revenue Code, such payments are deductible by the corporation as payments to a qualified employee deferred compensation trust. Thus the lender has the general credit of the corporation to support repayment of the loan, plus the added security resulting from the fact that the loan is repayable in pre-tax dollars.

Each year as a payment is made by the corporation into the ESOT there is allocated proportionately among the accounts of the participants in the trust a number of shares of stock proportionate to the participants' allocated shares of the payment. Special formulas have been designed to counteract the relatively high proportion of early amortization payments used to pay interest and the relatively high proportion of later amortization payments used to repay principal.

As the financing is completed and the loan paid off, the beneficial ownership of the stoci accrues to the employees. Most trusts are designed to permit the withdrawal of the portfolio in kind, subject to vesting provisions, either at termination of employment, or at retirement. However, it is desirable to so design the ESOT that any dividend income on shares of stock that have been paid for by the financing process and then allocated to the employees' accounts be distributed currently to the employee-participants, thus giving them a second source of income.

Diversification of the trust can be achieved after a particular block of stock has been paid for by exchanging the stock, at fair market value, for other shares of equal market value. Since the trust is a tax-exempt entity, such diversification is without tax impact.

While there is temporary dilution of the equity of existing shareholders at the outset, due to the fact that both stock and a limited and special type of loan obligation are outstanding, each year as the corporation repays its debt in pre-tax dollars through the trust, a cash accumulation is set aside that eventually, either within the financing period or thereafter, taken in conjunction with the considerations mentioned in the following paragraph, restores the dilution because of the yield on invested net worth of the tax saving.

When all factors are considered, including the cost and relative inadequacy of most alternative private retirement systems (for which the ESOP becomes a substitute), the probable costs and losses to the corporation resulting from (i) the inevitable demands of employees for progressively more pay in return for progressively less work input where they have no opportunity to accumulate significant capital ownership over a reasonable working lifetime; (ii) the shrinkage of markets for the corporation's products or services from the otherwise inevitable inflation of its product prices; and (iii) the added costs to the employer from alienation and demotivation of employees not enabled to acquire capital ownership in an economy where capital is a chief productive factor, etc., the cost of capital under Model II ESOT financing over the long term, i.e., beyond the financing period, is no greater, and will normally be less than the cost of capital resulting from any of the techniques discussed under Model I above.[3]

As yet, the adoption of the Kelso plan has been limited. According to a 1972 statement, "the San Francisco investment-banking firm of which Kelso is a principal, Bangert and Company, has some twenty clients formally in the process of adopting ESOT, nine more will be by the end of the year, and forty more are in the works." We have no independent assessment as to the success of any of the cases where it has been adopted.

It should be noted that the plan has received some attention in the 93rd Congress. The Regional Rail Reorganization Act of 1973 (P.L. 93–226) contains a provision mandating the study, but not necessarily the adoption, of employee stock ownership financing in connection with the establishment of a Consolidated Rail Corporation to provide rail service in the northeastern United States. The Employee Retirement Income Security Act of 1974 (P.L. 93–406), the pension reform law, contained provisions favorable to employee stock ownership plans as one form of pension plans.

Two bills were introduced in the 93rd Congress aimed directly at facilitating the establishment of employee stock ownership plans, primarily by increasing the amount of annual deductible contribution to a qualified employee profit sharing trust from 15 to 30 percent of employee compensation. The other three main provisions may be summarized as follows: (1) a qualified employee profit sharing trust shall have the tax characteristics of a charitable organization so contributions made to it as gifts will be tax deductible; (2) a tax deduction to corporations for the amount of dividends which they pay on stock held by qualified employee profit sharing trusts, provided that the dividends are promptly paid over to the employees covered by the plan; (3) an additional tax deduction amounting to 50 percent of the principal amount of the indebtedness paid by the trust

[3] U.S. Congress. House. Committee on Interior and Insular Affairs. Subcommittee on the Environment. National Energy Research. Hearings . . . on H.R. 6602 and related bills, May 16, 1973–February 19, 1974. pp. 356–358.

during the taxable year for a corporation making a contribution to a qualified employee profit sharing trust where the trust pays off indebtedness incurred to purchase stock of the corporation. These were S. 1370, introduced on March 27, 1973 by Senator Fannin for himself, Senator Hansen and Senator Dominick, and H.R. 3590, introduced on June 12, 1973 by Congressman William Frenzel.

Finally, on October 2, 1974, the Senate Committee on Finance approved an amendment to the pending Trade Reform Act which would require a firm, in order to be eligible for a guaranteed loan, to establish an employee stock ownership plan involving stock worth one quarter of the amount of the loan guarantee.

The lack of widespread adoption of, or enthusiasm for, the Kelso plan may be attributed to several factors, including the following.

It may be questioned that wider dispersion of stock ownership is as advantageous as Kelso suggest. Certainly the ownership of "shares" in American industry, widely advocated in recent years, has come to be far less attractive during the past year than it has been in most of the postwar period. The severe drop in the value of securities traded in the New York and other stock exchanges in recent years has robbed stocks of such merit as an antiinflationary hedge they had been assumed to have.

A basic assumption of the Kelso plan in fact is that capital outlays financed directly by new employee-owned stock issues, in turn financed by bank loans, will turn out to be profitable enough to permit repayment of the loan and growing value of the stock. There are, however, a substantial number of instances where such profits fail to materialize. The resulting impact on the value of shares in such a case is bound to be adverse, particularly in the case of a small or new firm where a given capital outlay is a large proportion of a company's capitalization.

Since issuance of stock is tied to capital investment, i.e. the purchase of "tools" as it is described in the accompanying chart, the amount of stock which an employee would accumulate under the plan is dependent on the extent of capital investment planned by the company. This is likely to vary not only among companies but over time in any given company. Thus, both because the price of stock may fluctuate and because the amount to be derived by any given employee is highly uncertain, it is not surprising that in many cases employees are likely to bargain for higher wages rather than a lower level of wages and an uncertain stock bonus.

This uncertainty as to the value of stock holdings in any employee stock ownership trust makes such a trust particularly risky when it is used as a basis for, or alternative to, a pension plan for employees. As the Treasury Department pointed out in its statement in opposition on S. 1370, "the extent to which profit-sharing plans should invest in stock of the employer is itself a much debated question among plan administrators, many of whom believe such plans should hold a diversified investment portfolio." Certainly if a company were to go out of business because of financial losses and/or bankruptcy, the employees' investment in their company's stock would be drastically reduced.

The individual employee has few if any options as to participation in Kelso's stock ownership plan. As noted the stocks are held in an employee stock ownership trust with employees as beneficial owners in proportion to their compensation. Management of the trust is normally under the control of a committee appointed by management; its membership may include labor representatives.

It seems that the attractiveness of the Kelso plan to corporate management derives primarily from the tax benefits accruing to a corporation making payments to an employee stock ownership trust rather than to a credit institution when it decides upon a capital expenditure. It follows that if this plan is widely adopted the revenue loss would be substantial. For example, the Treasury Department has estimated that implementation of S. 1370, described above, which would facilitate establishment of employee stock ownership plans would involve an annual revenue loss of $1.5 billion. It is a serious question of public policy whether the benefits accruing to corporations using this plan and their employees outweighs this loss of revenue, and the resulting consequence of a corresponding reduction in government services, or an increase in alternative sources of revenue.

Although it may be possible eventually to adapt the Kelso plan successfully to non-corporate enterprises, at present the plan is geared entirely to issuance of stock by a corporation and donation by the corporation to its employee stock ownership trust, with ensuing tax advantages. Thus it, at present at least, clearly operates to the advantage of corporate and to the disadvantage of noncorporate businesses.

In summary, employee stock ownership plans have real, albeit limited, advantages in improving productivity, raising employee morale, and raising company profitability. Most such plans are voluntary, which is usually considered a desirable characteristic.

On the other hand, the Kelso plan, which would not be optional on the part of employees of corporations participating in the plan, has been presented so largely as a panacea for multiple economic ills confronting the nation that a considerable degree of skepticism as to its efficacy appears justified. Basically one may question that the alleged benefits adoption of Kelso's plan would achieve for corporations adopting it and their employees would not largely be counterbalanced by offsetting costs to other segments of society. There is certainly no evidence that the plan would per se result in such an increase in productivity as to vitiate this conclusion.

EMPLOYEE STOCK OWNERSHIP PLANS

(By Don Sullivan of the firm of Towers, Perrin, Forster & Crosby, June 1975)

BACKGROUND

A number of recent events, the most significant of which is the passage of the Tax Reduction Act of 1975, has generated renewed interest in Employee Stock Ownership Plans.

In 1968, Louis O. Kelso and Patricia Hetter published a book entitled *Two Factor Theory: The Economics of Reality*. In the book, the authors set forth an economic and social philosophy that is the basis of the Employee Stock Ownership Plan/Trust (ESOP or ESOT). Briefly stated, they believe it is important to:

Spread capitalism through stock ownership by using borrowed funds to distribute stock to all workers.

Provide a "second income" to employees through dividends on stock.

The purpose of this memo is to discuss considerations that are unique or of particular importance to ESOP's and to test the oft-heard claim that an ESOP is an efficient means of raising capital.

DESCRIPTION

Section 407(d)(6) of ERISA defines an Employee Stock Ownership Plan as a qualified stock bonus plan or a combination qualified stock bonus and money purchase plan designed to invest primarily in employer securities. IRS Regulation 1.401-1(b)(iii) defines a stock bonus plan as a "plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company." A working definition of an ESOP, then, is a plan qualified under Section 401 of the Code, the assets of which are invested in and the benefits of which are payable in employer stock.

The Kelso variation introduces debt and, as a result, leveraging into the working definition of an ESOP. It is this variation that is the subject of this memo. Under the Kelso scheme, the trust created under the plan arranges for a loan from a lending institution and uses the loan to purchase employer stock—usually newly issued. The stock is pledged as collateral for the loan. Because the trust cannot generate income on its own, the corporation usually is required to guarantee the loan. The loan (including interest) is repaid by the trust from the contributions of the employer.

The value of stock initially secured by the trust typically exceeds the employer's annual contribution. For example, a trust anticipating an annual employer contribution of $1,500,000 might negotiate a loan for $10,000,000 at 8 percent to be repaid over ten years. Assuming a per share price of $50, the trust would purchase 200,000 shares of stock from the employer.

Normally, the allocation of shares to participants in a given year is based on the ratio of the current debt installment to the total loan cost (principal plus interest). Using the assumptions above, the total debt cost would be $15,000,000 (i.e., principal of $10,000,000 plus an interest cost of $5,000,000). If the first-year contribution to the trust is $1,500,000, 10 percent of the shares, that is

$$20{,}000 \text{ shares } \left(\frac{\$1{,}500{,}000}{\$15{,}000{,}000} \times 200{,}000\right)$$

would be allocated to participants. However, this first-year contribution would be applied partly to repay principal and partly to pay interest. Thus, some of the shares allocated to participants will not have been paid in full because less than 10 percent of the principal has been repaid. Shares credited to the accounts of participants that have not been paid for are contingently allocated and are not distributed to employees before full payment is made.

The Kelso modification is an extreme example of the "all your eggs in one basket" philosophy because future as well as current allocations to participants are committed to investments in the employer's stock. In effect, employees take a long position in the employer's stock.

ELIGIBLE EMPLOYERS

Stock bonus plans, by definition, are limited to corporations. Corporations that elect to be taxed as partnerships (Subchapter S Corporations) are not eligible because one of the requirements for Subchapter S election is that no shares may be held in trust.

PREVALENCE OF PLANS

There are no published statistics on the number of Kelso Plans. In fact, since June 30, 1970, the IRS has not maintained separate statistics for stock bonus plans, but has included them with the tabulation of profit-sharing plans. Between 1955 and 1970, the IRS approved approximately 300 stock bonus plans; in contrast, in the same period the IRS approved applications for more than 190,000 pension and profit-sharing plans.

TAX CONSIDERATIONS

Employer contributions to a qualified stock bonus plan are deductible for Federal income tax purposes up to 15 percent of the participants' covered compensation. The deductible limit is 25 percent for combination stock bonus/money purchase plans. The existence of any other qualified plan could, of course, have an impact on the deductible limit.

Although applicable to all qualified plans, the deferral of tax on unrealized appreciation in employer securities until actual sale is of particular significance to stock bonus plans. If a participant receives a lump-sum distribution from a qualified plan that is eligible for special tax treatment, the amount by which the fair market value of the employer stock exceeds the trustee's cost basis is not taxed until the recipient disposes of the stock. At time of distribution, the participant reports only the cost basis of the securities as taxable income.

Assuming a constantly increasing market value, establishing the cost basis for tax purposes for all shares (including those to be allocated in the future) at the date of the plan's inception maximizes the portion of the distribution that is not taxed at time of receipt and that qualifies for capital gains treatment. Under a conventional stock bonus plan (i.e., without the loan arrangement), and under a profit-sharing plan that purchases employer stock with each year's contribution, the cost basis is, in effect, dollar-averaged.

LEGAL CONSIDERATIONS

ERISA Exemptions: Stock bonus plans and ESOP's, along with profit-sharing and thrift and savings plans, are included in the definition of "eligible individual account plans" under Section 407(d)(3) of ERISA. As such, these plans are:

Not subject to plan termination insurance.

Exempt from the 10 percent investment limitation in employer securities.

Exempt from the diversification requirements of the prudency rule.

In addition, the prohibition against the purchase of employer stock by the plan from a party-in-interest does not apply to an "eligible individual account plan" if the transaction is for adequate consideration and if no commission is charged. Therefore, under an ESOP, employer stock may be purchase not only on the open market but also from the corporation or directly from an individual shareholder.

ERISA also prohibits most plans from engaging in transactions that constitute directed or indirect "lending of money or extension of credit between the plan and a party-in-interest." If this provision were applicable to an ESOP, it would cripple its ability:

To purchase shares from the corporation with borrowed funds (unless the corporation was not obliged to guarantee the loan).

To purchase shares on an installment basis from a controlling shareholder.

However, Section 408(b)(3) of ERISA exempts an ESOP from this prohibition, provided that the loan is made primarily for the participants' benefit and the interest is not in excess of a reasonable rate. The Conference Committee Report notes that these loans and extensions of credit "will be subject to special scrutiny by the Department of Labor and the Internal Revenue Service to ensure that they are primarily for the benefit of plan participants and beneficiaries."

Exclusive Benefit Rule: One of the primary tests of qualification under Section 401 of the Code is the requirement that the plan be for the "exclusive benefit of the employees or their beneficiaries." With respect to the investment of trust assets, the "exclusive benefit rule" will not be violated if the following conditions are satisfied (Rev. Ruling 69-494):

the cost must not exceed fair market value at time of purchase.

a fair return commensurate with the prevailing rate must be provided.

sufficient liquidity must be maintained to permit distribution in accordance with the terms of the plan.

the safeguards and diversity to which a prudent investor would adhere must be present.

Fair market value is established as of the date of actual contribution of shares by the corporation or purchase of shares by the trust. For privately held firms, fair market value is not a readily ascertainable figure. Guidelines for the valuation of closely held stock have been established by the Internal Revenue Service in a series of rulings. Some corporations, however, enlist the assistance of professional appraisal firms.

The requirement of a fair rate of return is not applicable to obligatory investments in employer stock under a stock bonus plan (Rev. Ruling 69-65). The liquidity requirement has no practical application to stock bonus plans because distributions are in stock, not in cash. It would, however, be a consideration for money purchase plans.

Under ERISA, stock bonus plans and other eligible individual account plans are exempt from the diversity requirement, but the prudent man rule applies in all other respects. If the trustee is required under the plan to purchase employer stock, a conflict with the prudency rule could arise—particulaly where purchases of stock are made periodically during the life of the plan. If the trustee is not required to invest in employer stock, then the fair return requirement applies, Also, because the trustee is not required to purchase employer stock, he may have as much, if not more, difficulty in satisfying the prudenced requirement.

In satisfying the "exclusive benefit" requirement, one must be concerned with the employee's ability to convert his distribution to cash or marketable securities. This is of particular importance when an ESOP is being considered by a closely held firm. If there is no public market, how does a participant exchange his certificates for legal tender? The market for a minority interest in a closely held corporation is, at best, thin and, at worst, non-existent.

To overcome this problem, a corporation may have to obligate itself to repurchase shares distributed under the plan. This, in turn, introduces cash flow considerations. Further, in some instances, the repurchase may be considered a dividend under tax laws relating to stock redemptions. Having the trust repurchase the stock avoids the problem of having the repurchase being treated as a dividend; however, the cash flow problem remains.

Allocation of Shares: As previously mentioned, the allocation of shares to participants' accounts includes shares for which full payment has not been made. In effect, some shares are contingently allocated. This presents a possible conflict with ERISA's non-forfeitability requirement because a default on the loan could result in the withdrawal from a participant's account of any shares contingently allocated. However, it can be argued that there is non-forfeitability in the funded benefit (i.e., the shares fully purchased). In the final analysis, consideration of this issue may be an academic exercise in terms of the value of the stock to participants. If there is a default and the corporation cannot fulfill the requirements of the loan, it is probably a case of insolvency, in which event the shares are likely to be without value.

Shares that have not been paid for in full cannot be distributed to participants. Consequently, when a participant terminates, his vested interest may be paid to him over a period of time as the shares are paid for. This raises a question of whether the initial lump-sum distribution to a participant constitutes a total distribution, which is required for favorable tax treatment.

Eligibility for special lump-sum treatment hinges on whether the shares contingently allocated to an employee's account, but not distributed until tax years following his separation from service, are deemed to be:

A part of his total account at the time of initial distribution, which would preclude the initial distribution from being treated as a total distribution, or

Allocated subsequent to the initial distribution, in which case the initial distribution would be eligible for favorable lump-sum tax treatment.

A further consideration is that the contingent allocation of shares might be interpreted as a violation of the non-assignability provisions of ERISA.

Unrelated Business Income: Another problem concerning IRS requirements involves possible application of "unrelated business income" concepts to an ESOP. This income would be taxable to the trust in the year earned. Although there are no clear guidelines in this area, some authorities have voiced the opinion that increases in the value of the unallocated employer stock may be considered to be "unrelated business income" and, therefore, taxable. However, the IRS is unlikely to consider unrealized gains "income." A stronger argument could be made that the excess of dividends paid on unallocated stock over the interest cost represents unrelated business income. However, dividend rate in excess of the interest cost is not likely.

OTHER APPLICATIONS OF ESOP'S

The proponents of ESOP's identify a variety of applications for the plan other than raising capital for the corporation. These include:

Conversion of a public company to a private organization.

Disposition of a division (the selling corporation would establish a new corporation which, in turn, would establish an ESOP; the plan could borrow funds and purchase the division).

Provision of estate liquidity to a major shareholder.

OTHER CONSIDERATIONS

For the corporation whose stock is publicly traded, there are additional considerations, a discussion of which is beyond the scope of this memorandum. There are, for example, the SEC requirements regarding registration, resale restrictions and insider trading. In addition, the Federal Reserve board's borrowing limits may apply when margined stock is held by the lender as collateral.

APPARENT ADVANTAGES

To the employer:

The employer avoids some of the expenses and complexity of selling stock to the public and/or existing shareholders. In effect, employees "buy" the stock through an enforced investment of employer contributions made on their behalf.

The plan creates a proprietary interest on the part of employees through stock ownership.

The plan can supplement existing compensation and benefit programs.

To employees:

Plan is similar to deferred profit sharing, but with greater assurance of employer contributions (especially until trustee has repaid loan).

Net unrealized appreciation on stock is maximized in a rising market. At the time of lum-sum termination distribution, unrealized appreciation is not taxable until the stock is sold.

APPARENT DISADVANTAGES

To the employer:

No portion of the stock held in an unallocated trust account can revert to the employer in the event the trust is terminated prematurely. Because all assets in the trust (net of any remaining loan obligation) technically belong to the employees, the employer will probably be required to furnish collateral against the risk that the trustee will default on the loan.

There may be some risk of plan disqualification due to failure to meet "exclusive benefit" requirements of law.

It is an inefficient compensation tool even if the stock appreciates in value because the company foregoes a tax deduction for capital appreciation on shares that under a typical non-leveraged plan would have been made in future years.

To employees:

Plan members suffer instant depreciation of company contribution if the stock depreciates.

Employees security may be too closely tied to the fortunes of the employer.

ESOPS AND CAPITAL FORMATION

The claim that debt under an ESOP is retired with pre-tax dollars is, at best, a gross oversimplification. Technically, the trust, not the corporation, incurs the debt, with the corporation having contingent liability as the guarantor of the note. The debt is retired by the trust with contributions made by the corportation. The corporation is entitled to a deduction because its contributions are made to a qualified plan.

It is true that the corporation's contingent liability is reduced by payments made by the trust to the lender, so, indirectly, the corporation is retiring a debt obligation with pre-tax dollars. However if the use of pre-tax dollars to retire the debt is perceived as a unique advantage then one must admit to a unique disadvantage in that payment to retire the principal is a charge to earnings.

If, as Kelso Plan proponents claim, the retirement of the debt with pre-tax dollars is a unique advantage, the effects should show in an analysis of the financial data.

In the balance of this section, we take a closer look at ESOP's as a means of raising capital. A comparision of the effects of ESOP financing, debt financing and equity financing on net income, EPS and cash flow is presented in Table I.

Our assumptions are as follows:

in each alternative, $10,000,000 is raised by the corporation.

the corporation obtains a 20 percent pre-tax return on the proceeds.

the loan in the debt alternative is for ten years at 8 percent; repayment is in the amount of $1,490,000 per year (principal plus interest); first year interest is $800,000 and principal payment is $690,000.

the equity offering is 200,000 shares at $50.00 per share.

the per share dividend is $2.50.

TABLE I.—COMPARISON OF ESOP, EQUITY AND DEBT FINANCING

[Dollar amounts in thousands]

	Before financing	ESOP	Equity	Debt
Effect on net income:				
Pretax income before financing costs	$8,000	[1] $10,000	[1] $10,000	[1] $10,000
Financing cost—Interest				800
Required contribution		1,490		
Adjusted pretax income	8,000	8,510	10,000	9,200
Taxes (50 percent)	4,000	4,255	5,000	4,600
Net income	4,0C0	4,255	5,000	4,600
Effect on earnings per share:				
Outstanding shares	1,000,000	1,200,000	1,200,000	1,000,000
EPS	$4.00	$3.55	$4.17	$4.60
Effect on cash flow:				
Cash flow before "financing" costs	$15,000	[2] $15,255	[2] $16,000	[2] $15,600
Financing cost not reflected in net income:				
Principal				690
Dividends	2,500	3,000	3,000	2,500
Cash flow	12,500	12,255	13,000	12,410

[1] Increase of $2,000,000 ($10,000,000 times 20 percent).
[2] Cash flow before "financing" cost adjusted for increase in profit.

IMPACT ON NET INCOME AND EARNINGS PER SHARE

ESOP vs. Equity: An ESOP will result in lower net income because the corporation must expense an amount at least equal to the debt installment of the trust. Because net income is lower and both alternatives have the same share base, an ESOP also results in lower EPS.

ESOP vs. Debt: The ESOP alternative results in lower net income. Under debt financing, only debt service (i.e., interest) is charged to book income. As indicated above, the corporation under an ESOP must expense an amount at least equal to the debt installment of the trust (i.e., principal and interest). All other things being equal, net earnings under an ESOP will be lower by one-half (assuming a 50 percent tax bracket) of the amount attributable to principal repayment.

Earnings per share will be considerably higher under the debt alternative because income is higher and there are fewer outstanding shares.

Note: Over time, the charge to income for interest expense under debt financing will decrease as the outstanding balance declines. The charge to earnings under an ESOP, though, remains the same until the debt is repaid. Thereafter, a charge to earnings continues during the life of the plan.

IMPACT ON CASH FLOW

ESOP vs. Equity: Cash flow under an ESOP is less favorable because a contribution to the trust is required. The difference in cash flow will be the after-tax cost of the contribution.

ESOP vs. Debt: The comparison with debt is somewhat more complicated. If the contribution to the trust under an ESOP equals the trust's debt installment, the ESOP alternative will have a more positive cash flow initially. The full amount is deductible, whereas only the interest cost on the debt alternative is deductible. This advantage is offset by dividends paid on the increase in outstanding shares and the opportunity cost of the increase in market value of the shares sold to the trust.

The example assumes a 5 percent dividend or $2.50 per share, which increases the dividend payment by $500,000 (200,000 × $2.50). This more than offset the $345,000 advantage under an ESOP. If the dividend rate were reduced to 3.45 percent or $1.725 per share, it would be a stand-off before considering the opportunity cost. For the closely held firm, the payment of dividends might be the exception rather than the rule. On the other hand, the dividends are the source of the "second income," which is a fundamental precept of Kelso's philosophy.

Note: Over time, the debt alternative would involve a greater negative cash flow as the portion of the payment attributable to interest (which is tax deductible) declines. However, this would be offset by any increase in dividends.

FINANCIAL OBSERVATIONS

The claim that, under an ESOP, the debt is retired with pre-tax dollars is financial legerdemain. If the sole purpose of establishing an ESOP is to raise capital, it is a financial mistake. If the establishment of an employee benefit plan is also an objective, the same financial results would ensue to the corporation if it sold the same number of shares at the same price to private investors, established a qualified plan and made the same contribution to it. There is no magic in establishing an ESOP to raise capital.

CONCLUSIONS

On balance, an ESOP appears to offer some advantages to the small or medium-sized employer who is:

Unable (or unwilling) to raise capital by the more traditional routes of borrowing or equity financing.

Willing to adopt a qualified plan and able to meet its implied commitment for substantial, recurring contributions.

Desirous of putting stock into the hands of the employees.

By the same token, any company that shies away from a public offering of its stock (or cannot find a lender) because of a poor earnings record will probably find it equally difficult to install the ESOP approach successfully.

PERSPECTIVE

An ESOP should be evaluated strictly as an employee benefit plan. This brings us back to fundamentals. What are the objectives of the employee benefit plan? How does an ESOP compare with other alternatives in meeting the objectives?

TPF&C Letter

Issue 134 United States Edition

a critical look at ESOPs as a financing tool

More companies than ever before are wondering whether an Employee Stock Ownership Plan (ESOP) is an idea whose time has come, a mere fad or something in between. That's because word has gotten around that ESOPs can receive favorable treatment under the Tax Reduction Act of 1975.

The Act, in addition to boosting the investment tax credit from 7% to 10% for 1975 and 1976, allows an additional 1% credit for investing in a qualified ESOP (a defined-contribution employee benefit plan that invests in common stock issued by the employer). For example, a company putting $250 million into capital equipment this year will receive a $25 million investment tax credit. It can obtain another $2.5 million tax credit by placing at least that amount in a new ESOP or adding it to an existing plan. By setting up or expanding its ESOP with tax dollars, a company incurs administrative expenses only. The government provides the financing.

While exploring the 1% tax credit, many companies have discovered the traditional ESOP, which is funded with borrowed capital rather than tax dollars. In this form, the ESOP has the additional objective of raising capital.

'inside' the traditional ESOP

Typically, a debt-funded ESOP works like this: A trust is set up by the company as a funding vehicle for a qualified employee benefit plan. The trust borrows, say, $10 million from a bank for investment in newly issued company stock, pledging the shares as collateral. The company co-signs the loan, then puts the $10 million to work as investment capital, meanwhile making annual contributions to the ESOP trust to repay the loan. These contributions continue throughout the life of the loan – let's say ten years.

Because these contributions to an employee benefit plan are used by the trust to retire the loan, the company indirectly pays off the debt with pre-tax dollars. As the company's annual contributions come in, the trust allocates stock to employees – in proportion to their compensation – for eventual distribution under applicable rules and regulations. After ten years, all the shares are allocated.

Let's compare a hypothetical, debt-funded ESOP as a capital formation tool with equity financing and straight debt. We'll show how each affects net income, earnings per share (EPS) and cash flow, using these assumptions:

- the company raises $10 million and invests it at a pre-tax rate of 20%
- pre-tax income before financing costs, and before the 20% return on investment (ROI), is $8 million; cash flow before financing and financing costs is $15 million
- the loan in the debt financing is for ten years at 8%; repayment amounts to $1,490,000 a year in principal and interest; in the first year interest totals $800,000 and amortization $690,000
- before the conventional equity offering of 200,000 shares at $50 each, one million shares are outstanding, and the dividend rate is $1 a share
- the company's tax rate is 50%; its annual contribution to the ESOP trust is $1,490,000.

effect on net income and EPS

The impact on net income and EPS of the three financing methods is shown on the reverse page.

After financing, the 20% ROI swells pre-tax income to $10 million. Here are the comparisons:
ESOP vs. Equity: Under the weight of the employer's $1,490,000 annual contribution to the trust, the ESOP results in lower net income than the equity offering. EPS with the ESOP are correspondingly lower because the number of outstanding shares is the same in both cases.
ESOP vs. Debt: The ESOP leads to net income below that generated with straight debt because the contribution to the ESOP trust exceeds the $800,000 interest charge. Furthermore, the interest on the conventional loan eventually will decline as the outstanding balance is reduced, but the employer's annual ESOP contribution will remain fixed. Also, because straight debt doesn't involve the issuance of shares and the ESOP does, the latter also results in dilution. Result: EPS with ESOP financing are sharply lower.

	Before Financing	ESOP	Equity	Debt
	(in thousands of $ except for EPS)			
Effect on Net Income				
Pre-Tax Income Before Financing Costs	$ 8,000	$10,000	$10,000	$10,000
Financing Cost—Interest	—	—	—	800
Required Contribution	—	1,490	—	—
Adjusted Pre-Tax Income	$ 8,000	$ 8,510	$10,000	$ 9,200
Taxes (50%)	4,000	4,255	5,000	4,600
Net Income	$ 4,000	$ 4,255	$ 5,000	$ 4,600
Effect on Earnings Per Share				
Outstanding Shares	1,000,000	1,200,000	1,200,000	1,000,000
EPS	$4.00	$3.55	$4.17	$4.60

impact on cash flow

The relative cash flow performances appear below.

	Before Financing	ESOP	Equity	Debt
	(in thousands of $)			
Effect on Cash Flow				
Cash Flow Before "Financing" Costs	$15,000	$15,255	$16,000	$15,600
Financing Cost Not Reflected In Net Income				
—Principal	—	—	—	690
—Dividends	1,000	1,200	1,200	1,000
Cash Flow	$14,000	$14,055	$14,800	$13,910

After financing, the three alternatives show a rise in cash flow equal to their respective gains in net income made possible by the 20% ROI. Before financing costs, the figures are $255,000 with the ESOP, $1 million with equity financing and $600,000 with straight debt. Here are the comparisons:

ESOP vs. Equity: Dividend costs are the same, but cash flow is lower with the ESOP, again mirroring the effect on net income of the employer's contribution to the ESOP trust.

ESOP vs. Debt: Only interest is tax deductible in straight debt financing, so principal repayments are charged in full to cash flow. In the example, even the first-year repayment of $690 000 is enough to give the ESOP a cash flow a[illegible]tage, more than offsetting the effect of the $[illegible].000 in added dividend costs. As time passes, the principal repayments will increase. However, with a dividend rate higher than $1, the ESOP's cash flow edge would be narrower or non-existent.

on balance

What stands out most clearly in the financial comparisons is that the company's contributions to the ESOP trust represent a charge against earnings. Although ESOPs do provide a market for the shares of smaller, closely held companies, the tables suggest it would be a mistake to establish an ESOP *solely* to raise capital. And capital formation and employee benefit plans, *in combination*, are attainable in other ways, with the same financial results.

So even as a joint employee benefit-capital raising technique, there is no magic in an ESOP. And *as a benefit plan*, an ESOP involves a host of considerations, of which the following are only a sample:

What is the effect of regulations governing the registration of newly issued stock? What is the impact on loan-financed ESOPs of margin requirements for the purchase of securities with borrowed funds? What are the implications of the fiduciary responsibility provisions of the Employee Retirement Income Security Act?

Such considerations are important because, in the last analysis, an ESOP must stand or fall on its merits as an employee benefit plan.

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Chairman HUMPHREY. Senator Long.

OPENING STATEMENT OF SENATOR LONG

Senator LONG. I would like to direct attention to the fact that Senator Paul Fannin is here with us. He was a sponsor of the employee stock ownership legislation, even before I became acquainted with this subject, and he has been invaluable in helping us move along legislation to encourage employee stock ownership.

It seems to me that we are trying to move toward a concept here that has broad bipartisan support. I know that it does in the Senate. It is something where the Nation will benefit, and I think that it should be decided now, not on who is right, but what is right. If the concept is right, we ought to implement it.

I believe that it is, and I very much enjoy working with my colleagues here today, and I am most happy to see the Joint Economic Committee, headed by our very able chairman, Senator Humphrey, and assisted by a very dear friend and relative, Gillis Long, who has taken an interest in this matter and has held hearings on the subject, and helped to direct it to the attention of the people.

And, I regret to say, that while we have passed some ESOP proposals by unanimous vote, you might say, in the Senate, there are altogether too many Senators that do not fully understand even now what we have done, and what we are trying to do.

I think the same thing is true in the House of Representatives.

This hearing will help a great deal in helping Members on both sides to understand what it is we are trying to achieve here.

Thank you, Mr. Chairman.

Chairman HUMPHREY. Thank you, Senator Long.

Senator Fannin.

OPENING STATEMENT OF SENATOR FANNIN

Senator FANNIN. I, too, would like to commend the chairman for his action in bringing this subject before the committee, the Joint Economic Committee, and giving an opportunity for others to participate.

I am very proud of what the chairman of the Finance Committee, Chairman Long, has been able to do. He is dedicated to the principle of giving the worker the opportunity to participate and giving management an opportunity to show their desire to have a broad coverage of ownership in the stock of a particular corporation involved.

I think what Senator Javits has said illustrates the tremendous interest that is being developed in this program, and I feel we can go forward with the legislation which will boost the opportunities for the adoption of this program.

Thank you.

Chairman HUMPHREY. Thank you, Senator Fannin.

Congressman Long.

Representative LONG. I will wait until the questions, Mr. Chairman. Thank you.

Chairman HUMPHREY. The whole purpose of this hearing is information. We are not legislative in our authority. We are investigating and being informed.

We had hoped that this hearing would help the work of the Congress and a better appreciation of the plans that are proposed, in terms of stock ownership.

So we will proceed with you, Mr. Walker, and welcome your testimony.

STATEMENT OF HON. CHARLES M. WALKER, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, ACCOMPANIED BY PATRICIA METZER, ASSOCIATE TAX LEGISLATIVE COUNSEL-DESIGNATE; AND GABRIEL G. RUDNEY, ASSISTANT DIRECTOR, TAX PROGRAMING

Mr. WALKER. Mr. Chairman and members of this distinguished committee, I am pleased to appear before you today to testify on the subject of employee stock ownership plans, ESOP's. Your invitation stated that the committee will be analyzing the different forms such plans can take as well as the major advantages and disadvantages of each form. I am glad to provide the committee with material to use in that analysis.

Preliminarily, I think it is important to comment upon a definition of terms. There is a tendency to use ESOP as a definition for all types of employee stock ownership plans. But this obscures the differences among such plans. It also obscures the fact that plans other than ESOP's may be useful in the promotion of broadened stock ownership—one of the objectives of an ESOP.

BROADENING STOCK OWNERSHIP

Before discussing the types of ESOP's, I will comment on the more general subject of broadening stock ownership. Is it a desirable objective? If so, how can it be achieved?

Preliminarily, it should be emphasized that broadened stock ownership is not a panacea. The future well-being of the American public is primarily related to the long-run economic growth of this country, which in turn requires a continuation of high rates of capital formation, continued technical progress, and continual improvement in the skills of the labor force.

It is our contention that the economy will perform best if we can generally restrict the growth of government spending and reduce the extent to which government deficits draw savings away from productive, private capital investments. It is for this reason that the President has proposed a $395 billion spending ceiling and $28 billion in tax cuts from 1974 levels.

Chairman HUMPHREY. Is that a commercial?

Mr. WALKER. I feel it generally myself. [General laughter.]

We believe it is desirable to broaden stock ownership. It furthers the American tradition of private ownership of business. It strengthens the economic, social, and political base of support for the free enterprise system.

It is highly important to do this in order to foster participation by more people in providing growth of the economy and its capacity to satisfy the ever increasing demand for jobs.

It is important also that a tax inducement for broadening the base of stock ownership be neutral in the identification of taxpayers who can benefit from the inducement. Thus the benefit should not be limited to taxpayers who are employees of employers having qualified ESOP's.

The benefit should be extended to all taxpayers, including those who are employees of corporate employers that do not have qualified ESOP's; self-employed invidivuals; employees of governmental

units, nonprofit corporations, and noncorporate enterprises which do not have a qualified ESOP; and members of the Armed Forces.

One way to provide neutrality among benefited taxpayers is to extend the ESOP concept across the board in the same way that the individual retirement account, IRA, concept extended qualified retirement plans; that is, to selfemployed persons or employees of employers who do not have a qualified plan.

The extension could be called an individual stock ownership plan, ISOP, which would be like an ESOP but would not be dependent upon the employer's setting up a qualified plan, and would contemplate investment in portfolio stocks.

Another way to provide neutrality among benefited taxpayers is to drop the ESOP-ISOP concept, contributions to the plans being tax deductible, in favor of a tax credit equal to a specified percentage of the purchase price of stock held for a specified period.

Still another alternative is to drop the ESOP-ISOP concept in favor of an individual stock saving account, ISSA, concept. Both ESOP's and ISOP's are retirement-type mechanisms. An ISSA could be utilized for individual savings motivated otherwise than for retirement.

In deciding among the alternatives, it will be necessary to develop the specifics of the plan to use. Among the items to consider are:

First, the class of individuals who are to benefit from the plan.

Second, the income level an individual must have in order to qualify.

Third, the limit on the amount of contribution that can be tax deductible.

Fourth, the level of tax-deductible contribution available to the employer if he contributes to the plan.

Fifth, the length of time funds must be held in the plan; that is, for a minimum period of time or until reaching a specified age.

Sixth, the nature of the available investment media, for example, common stocks, preferred stocks, bonds, savings accounts, et cetera.

I have listed here six items that need to be specified, and we think there undoubtedly will be more.

DIFFERENCES AMONG ESOP'S

Although there is no single definition of an ESOP, it can be viewed generally as any tax-qualified individual account—also known as a defined contribution—deferred compensation plan which invests a significant portion of its funds in employer stock.

Under the Internal Revenue Code an ESOP is a stock bonus plan or a combination of a stock bonus plan and a money purchase pension plan, which is designed to invest primarily in employer securities.

The term "employee stock ownership plan," ESOP, was added by the Employee Retirement Income Security Act of 1974, ERISA. It was made operative for only a narrow purpose; namely, certain exemptions from ERISA's prohibited transaction and diversification rules.

An ESOP is permitted to borrow from a disqualified person or with the guarantee of a disqualified person if certain conditions are met, and is exempted from rules limiting holdings of employer stock.

A conventional stock bonus plan contemplates annual tax de-

ductible contributions in the form of, or for the cash purchase of, employer stock. A leveraged ESOP, however, contemplates use of funds borrowed by the ESOP to buy a substantial block of the employer's stock. Over the years the employer makes tax-deductible contributions to the ESOP which it uses to amortize the loan and pay interest.

Under the Tax Reduction Act of 1975, an extra 1 percent investment credit—11 percent instead of 10 percent—was made available to taxpayers who contribute the amount of the 1-percent credit to an ESOP. Taxpayers who use the extra 1 percent this way thus realize a dollar-for-dollar tax benefit, as opposed to the tax benefit normally derived from making a tax deductible contribution to the ESOP.

BUSINESS CONSIDERATIONS

Business decisions are required with respect to many aspects of ESOP's: Does adoption of the investment credit ESOP require continued contributions to the ESOP in later years when a similar 100-percent funding by the tax credit is not available? What is the effect on employees, some of whom will not be covered if contributions are not continued? Is dilution of stock interests of existing shareholders under the leveraged type of ESOP acceptable? Can valuations be handled satisfactorily, particularly in the case of closely held stock? Will ESOP holdings and distribution of employer stock involve SEC problems?

CONCLUSION

In conclusion, I would like to emphasize that any program to promote broadened stock ownership should meet these two requirements. First, it should be a broad-based program that would extend the employee benefits of ESOP's to self-employed individuals and employees of employers who do not have an ESOP. Second, employees should have an opportunity to direct that their funds be invested in stock other than stock of the employer.

While opinions may differ on the matter, we do not regard an ESOP, or an ISOP, or ISSA as a tax loophole. Rather, it is a device to achieve the end of broadened stock ownership. Until such time as we can basically reshape the tax law to broaden its base, reduce the tax rates, and substantially simplify it, and in the process encourage business activity, we think that tax incentives to broaden investment, including investment in stock are desirable.

The appendix to this statement contains supplemental material and statistics.

I appreciate the opportunity to appear before your committee, and will be glad to answer your questions.

[The appendix to Mr. Walker's statement follows:]

APPENDIX TO STATEMENT OF HON. CHARLES M. WALKER

The Chairman in his invitation to the Treasury for testimony on Employee Stock Options Plans (ESOP's) requested certain specific information. Most of the requested information has been discussed in the testimony itself. Presented below are further elaborations on the testimony as well as responses to points not covered in the testimony.

ESOP'S AND RELATED PLANS

Employee stock ownership plans as they now exist are within the broad scope of private employee benefit plans. These are plans which are sponsored unilaterally by employers or jointly with employees. These plans provide for financial security at old age and retirement or when certain contingencies arise such as sickness, accident, death, or unemployment.

Employee benefit plans include profit-sharing plans which enable employees to participate in the profits of employers. Distributions to employees from these plans may be made for a variety of reasons (discussed later). Employee benefit plans also include savings or thrift plans which may be directed toward use for retirement or for certain contingencies, and stock bonus plans which provide benefits to employees (not unlike profit-sharing in timing of distribution) payable in employer stock.

Stock ownership is permitted in individual account plans including defined contribution, profit-sharing and stock bonus plans; and such plans are, in general, exempted from the diversity requirement applicable to other plans, which prohibits more than 10 percent of a plan's assets being invested in stock of the employer.

The so-called "Kelso" type employee stock ownership plan is a special utilization of a stock bonus (or money purchase) plan which permits the plan (or trust) to be used to provide financing for the employer by purchasing the employer's stock with borrowed funds. Typically the employer guarantees the debt and undertakes to make annual payments (contributions or dividends) sufficient to service the debt.

The structure of most employee benefit plans is affected by tax law because a plan must be qualified under the law in order for employers to obtain income tax deductions for contributions to the plan, for employees to defer income tax on employer contributions made in their behalf, and for the plan or trust itself to obtain tax-free treatment of investment earnings.

We shall examine each of these pension plans, profit-sharing plans, thrift plans, stock bonus plans, and employee stock ownership plans as to their similarities and differences.

A *pension* plan is established and maintained by an employer to provide systematically for payment of definitely determinable benefits to his employees over a period of years after retirement. Contributions and benefits under a pension plan must not depend on profits. Forfeitures of benefits by terminating employees may not increase the benefits of the remaining employees; instead they must reduce future employer contributions.

There are roughly 420,000 pension plans in existence covering approximately 27 million employees. The preferential tax treatment of pension plans costs the Government $4.1 billion in revenues in 1975.

A *profit-sharing* plan is established and maintained by an employer to enable his employees to participate in his profits on a deferred basis according to a definite formula for allocating contributions and distributing accumulated funds. Distributions from the plan may be made prior to retirement, for various reasons: after a fixed number of years, the attainment of a stated age, or the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance from employment. The term "fixed number of years" means at least 2 years. Thus, profit-sharing plans receive preferential tax treatment but are not necessarily retirement plans.

In order to be a qualified profit-sharing plan, contributions must come *"out of profits."* Such a plan need not provide retirement benefits, and it may contain a number of provisions prohibited to pension plans. For example, benefits may be distributed before retirement, forfeitures may be applied to increase benefits, the contribution formula may be discretionary, and accident or health insurance may be provided for employees and their families.

A modification of profit-sharing plans is the *"thrift" plan.* It is a tax-qualified plan under which each employee has the option to contribute a percentage of his salary to the plan. The employer then contributes an amount equal to a percentage of the employees' contributions. Amounts contributed under a thrift plan usually may be withdrawn before retirement in the case of emergencies, such as large medical expenses. Because benefits may not be paid prior to retirement under pension plans, "thrift" plans are drafted to meet the requirements applicable to profit-sharing plans. Where employers have profits, however, the limitation that contributions be paid out of profits has no real impact.

There are roughly 310,000 profit-sharing plans in existence covering approximately 9 million employees. The revenue loss for preferential treatment of profit-sharing plans is $1.4 billion in 1975.

Another tax qualified plan—the *stock bonus* plan—is one established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer do not necessarily depend upon profits and benefits must be distributed in stock of the employer company. An employer who wishes to adopt a tax-qualified plan that requires fixed contributions independent of profits and permits distributions prior to retirement can do so only through a stock bonus plan.

Stock bonus plans now number roughly 7,250 covering about 400,000 employees. The revenue loss of stock bonus plans is $40 million for 1975.

Another category of tax-qualified plan is the so-called *"employee stock ownership plan,"* a classification that was introduced with the enactment of ERISA in 1974 in connection with the rules relating to plan investments and prohibited transactions.

Basically, an employee stock ownership plan (ESOP) is a stock bonus plan, although it may be coupled with a money purchase plan. In an ESOP, contributions are ordinarily not based on profits, but rather are fixed (money purchase). In the case of the "Kelso" leveraged financing variety of ESOP, this insures that the loan can be repaid with tax deductible dollars even though the employer may be without profits in a particular year.

The 1974 Act limits the investment by certain plans in securities of the employer corporation to 10 percent of plan assets, but these limitations do not apply to stock bonus or stock ownership plans.

The Act prohibits plan fiduciaries from engaging in certain transactions and imposes a special excise tax on other persons who are parties to such transactions. Among the prohibited transactions are a sale or exchange of any property between the plan and a "party in interest" and the lending of money or other extension of credit between a plan and a "party in interest." A "party in interest" includes the employer corporation and its principal stockholders and officers. Under the Act, however, an exception is made for stock bonus and stock ownership plans. This was necessary to permit employers to guarantee loans obtained by such a plan or to sell stock to the plan. Borrowing by a plan in order to invest in securities of the employer corporation does not affect the tax qualification of the plan.

It is estimated that no more than 300 ESOP's are presently in existence. However, the plans are now being considered rather widely because of the investment credit incentive in the Tax Reduction Act of 1975.

The 1975 Act provides a special incentive for the establishment of ESOPs. In addition to the 10 percent investment credit, an additional 1 percent credit is provided if a corporate taxpayer agrees to transfer, to an ESOP, cash or securities of the employer corporation which are equal in value to the 1 percent credit. If cash is contributed, it must be used to purchase the employer's securities.

ESOPs under the 1975 Act must meet the following requirements.

(1) The stock contributed to the plan, or purchased by it, must be allocated among participants substantially in proportion to compensation. Allocations must be made to all employees who were plan participants at any time during the plan year, whether or not they are participants at the close of the plan year. Compensation in excess of $100,000 is not taken into account in making allocations.

(2) The employees' rights to the stock allocated to them must be nonforfeitable.

(3) Except in the case of separation from service, death, or disability, stock allocated to an employee's account may not be distributed to him before the expiration of 84 months (7 years).

(4) Employees must be given the right to direct the manner in which shares allocated to their accounts are to be voted.

The Act provides the 1 percent ESOP investment credit for tax years 1975 and 1976. The current House passed tax bill, H.R. 10612, extended the 10 percent investment credit 4 additional years—through 1980—but did not extend the special ESOP incentive beyond 1976.

AGGREGATE SAVINGS, CAPITAL FORMATION, AND ECONOMIC GROWTH

The Administration's proposal to integrate corporate and personal taxes is designed to encourage additional savings by increasing the rate of return to savers. This would be accomplished by reducing or eliminating the double tax burden on corporate earnings which, in turn, would induce more people to hold their

savings in the form of coporate stocks. Since the corporate sector is so large in the U.S. economy, increasing the rate of return to corporate investment would have the effect of increasing the average rate of return across the entire economy. Therefore, to the extent that savings is responsive to higher rates of return, the proposal would have the effect of increasing savings in the economy as well. In this case, broadened stock ownership would occur as a natural by-product of the more favorable rates of return that would be available on corporate equities.

Furthermore, the increase in the rate of return would be relatively greater for lower- and middle-income taxpayers who are most penalized by the double taxation of corporate earnings. A taxpayer in the 20 percent marginal tax bracket, for example, finds that under current arrangements his total tax on corporate source income results from a combination of the 48 percent corporate tax rate and his personal tax rate of 20 percent of the 52 cents available for distribution by the corporate. This gives a total tax of over 58 percent. Thus, the corporate tax has the effect of increasing his tax burden by almost 300 percent over what it would be if such income were taxed only at the individual shareholder level. For the high-income shareholder, on the other hand, the relative increase in taxation brought about by the double tax on corporate earning in much less. The 70 percent shareholder pays total taxes on the margin equal to 48 percent plus 70 percent of the remaining 52 percent for a total of 84 percent. The extra burden in this case is only about 20 percent over what it would be if such income were taxed only at the individual shareholder level. Thus, integration of corporate and personal taxes, to prevent the double tax on corporate earnings would provide the greatest gain to those income groups where the opportunities for broadened stock ownership are greatest. In fact, the double taxation of corporate earnings may be one of the most important factors restricting ownership at present.

STOCK OWNERSHIP TODAY

The New York Stock Exchange gives the following figures on share ownership These estimates are derived from occasional NYSE surveys of the population.

	Thousand
1952	6, 490
1956	8, 630
1959	12, 490
1962	17, 010
1965	20, 120
1970	30, 850
1975	25, 206

The frequency of share ownership has risen from 1 in 16 adults in 1952 to 1 in 4 adults in 1970. Although this growth in share ownership has slackened somewhat to about 1 in 5 adults since 1970, this dispersion of share ownership is the more remarkable given that persons have been being is placed in relative aggregate share ownership by institutional holders, especially pension plans.

Nonetheless, only a small percentage of lower income families have invested directly in publicly-traded stock. (See Table 1) Their demand for this type of illiquid asset has been low. However, lower income classes do invest in stock through their pension plans. Employer and employee contributions to retirement plans are currently about 4 percent of wages and salaries in private industry and about 8.5 percent of wages and salaries of covered workers. Possibly one-half of the assets of private pension funds are held in the form of common stock. Only about 45 percent of wage and salary workers are covered by employee benefit plans, and, of these, a fair proportion only have a limited amount of coverage.

For families as a whole, pension fund reserves are a significant proportion of total wealth. Currently, private pension fund reserves comprise approximately 8.3 percent of the total financial assets of families, while the current annual flow of funds into private pension reserves comprises approximately 13.6 percent of the net acquisition of financial assets by families.

In summary, there is substantial savings for retirement in the form of pension plans. For lower income families, then, stock may be indirectly saved through ownership of pension reserves, but the demand for more direct ownership has been quite small.

TABLE 1.—PERCENTAGE DISTRIBUTION OF FAMILIES,[1] DIVIDEND INCOME, AND VALUE OF STOCK BY FAMILY INCOME LEVEL, 1958–71

Family income [2]	1958	1960	1964	1969	1970	1971
Number of families:						
Under $5,000	48.75	43.9	37.2	26.9	23.9	22.0
$5,000 to $9,999	37.9	39.4	38.6	32.7	31.9	31.4
$10,000 to $14,999	8.5	10.6	16.0	21.8	23.1	23.5
$15,000 to $24,999	3.5	4.6	6.0	15.2	15.9	17.3
$25,000 to $49,999	1.1	1.2	1.7	2.3	4.3	4.8
$50,000 to $99,999	.2	.25	.4	.7	.7	.8
$100,000 and over	.05	.05	.1	.2	.2	.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
Aggregate dividend income:						
Under $5,000	4.6	5.0	4.0	3.0	2.9	2.8
$5,000 to $9,999	10.5	10.7	10.6	9.9	8.6	8.2
$10,000 to $14,999	12.9	11.7	11.0	9.4	9.4	9.3
$15,000 to $24,999	17.4	18.2	15.1	14.6	14.1	13.8
$25,000 to $49,999	20.7	21.8	20.5	20.2	19.7	18.9
$50,000 to $99,999	15.5	13.5	17.2	19.8	20.1	20.0
$100,000 and over	18.4	19.1	21.6	23.1	25.2	26.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
Aggregate market value of stock:						
Under $5,000	4.4	4.8	3.9	2.6	2.5	2.4
$5,000 to $9,999	10.2	10.3	10.3	8.6	7.4	7.0
$10,000 to $14,999	12.6	11.2	10.7	9.0	8.4	8.9
$15,000 to $24,999	17.2	17.6	15.0	13.7	13.2	12.8
$25,000 to $49,999	20.6	21.9	20.4	19.2	18.8	17.8
$50,000 to $99,999	15.8	14.0	17.4	20.7	21.2	20.9
$100,000 and over	19.2	20.2	22.3	26.2	28.5	30.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

[1] Definition of families includes unattached individuals.
[2] Family personal income before income taxes.

Source: Survey of Current Business, November 1974.

PARTICIPATION IN AND REVENUE EFFECTS OF ESOP'S AND RELATED PLANS

Attached is Table 2 which gives current estimates of the number of plans, number of participants, and expected revenue loss of ESOP's and related plans. Accurate statistics on ESOP's themselves are hard to obtain. The term "employee stock ownership plan" has only been given more specific meaning through acts passed recently. As can be seen from the table, it appears that few such plans existed before this year.

The future participation and revenue costs of ESOP's are also unclear. Because the 1 percent additional investment tax credit was only applicable to the years 1975 and 1976, and because it has been unclear whether similar incentives will continue into the future, many companies have adopted a wait-and-see attitude toward the adoption of ESOP's. Based upon current investment eligible for the investment tax credit, the maximum annual revenue cost of the special 1 percent incentive is in the range of $600–700 million for 1975 liabilities if all corporate employers elect to establish ESOP's and claim the extra credit.

If adoption of ESOP's becomes widespread through the economy and if employers make substantial contributions to such plans in addition to the contributions already being made to tax qualified employee benefit plans, the revenue costs could be substantial. For example, if the total additional contributions equalled 1 percent of total wage payments by employers, the revenue cost would be about $1 billion.

TABLE 2.—ESTIMATES OF RETIREMENT PLANS, 1975

	Plans	Participants (millions)	Revenue loss (millions)
Employer pension plans	420,000	27.0	$4,100
Profit-sharing plans	310,000	9.0	1,350
Stock bonus (other than ESOP) plans	7,250	.4	40
ESOP plans	250	.1	[1] 10
Total, employer plans	737,500	[2] 36.5	5,500
Keogh plans	500,000	.5	450
Individual retirement accounts	1,300,000	1.3	300
Total, individual plans	1,800,000	18	750

[1] Estimate excludes the cost of the additional 1-percent investment tax credit that may be claimed by emplo ers investing in qualified ESOP plans under provisions of the Tax Reduction Act of 1975.
[2] Total about 32,000,000 after allowance for dual coverage.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Chairman HUMPHREY. Mr. Walker, I understand you have an appointment at the White House, is that right?

Mr. WALKER. I do.

Chairman HUMPHREY. I was going to suggest that we have the panel immediately after you. We had better ask our questions of you now, and permit you to leave.

Mr. WALKER. I would appreciate that.

Chairman HUMPHREY. Therefore, I am going to start right off by asking Congressman Long if he has any questions that he wants to ask, then we will come to Senator Javits. We will keep our questions limited. Each member may take a few minutes, if you would.

Representative LONG. Thank you, Mr. Chairman.

In your statement, Mr. Walker, you say that: "Both ESOP's and ISOP's are retirement-type mechanisms. An ISSA could be utilized for individual savings motivated otherwise than for retirement."

Are both of these other programs necessarily restricted to being retirement-type mechanisms?

Mr. WALKER. An ESOP builds on the retirement mechanism that is in the statute now, which is a retirement mechanism.

Representative LONG. It does not necessarily have to be restricted to that, although the statute at the present time might so prescribe, is that correct?

Mr. WALKER. It will require statutory change to provide a plan that is not built on retirement, that is not an augmentation of a retirement plan.

Representative LONG. On the question of broadening stock ownership, I saw in the Wall Street Journal, or one of the publications within the last few days, that stock ownership was down, I believe, in 1972.

As you know, a few years ago, the major investment banking firms made a major effort to get stock ownership in the hands of the public and spread it out. I remember Merrill Lynch's advertising program in that regard, particularly.

It seems to me that if my recollection of that news story is correct, we are really going in the opposite direction. Again, the pattern is that stock ownership is really being more concentrated in the hands of more people.

Mr. WALKER. The appendix to my statement I supplied to the committee tells the story as published by the New York Stock Exchange, with these numbers. The last figure that we have is the 1975 figure which does reflect, as you say, Congressman Long, the reduction now in total stock ownership.

I believe it is down over 5 million people since the last published item.

This was reported in the last few days.

Representative LONG. That is all the questions I have, Mr. Chairman. Thank you.

Chairman HUMPHREY. Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

Mr. Walker, I have just two questions at this time, and we will have an opportunity to deal with Treasury views later.

I find your cardinal point very interesting, that there should be a neutrality between various types of the employed population, such as for ERISA.

What do you consider the role of organized labor and the trade unions in respect to these employee stock ownership plans? In this way, I have always conceived these plans as a very separate item of bargaining in the collective bargaining which did not represent an alternative to ERISA; that is, a firm could have a pension plan, or it could have a stock ownership plan, or it could have both.

Can you tell us, now or later, whether the Treasury would contemplate in its recommendations that an employee stock ownership plan stand on its own, although there might be another tax indulgence earned through ERISA?

Mr. WALKER. I would like to give that further thought, Senator Javits. I could respond instinctively to your question. I would want to check it out, certainly, with the Labor Department as well.

I think that if you are aiming at the objective of broadening stock ownership, that this should stand independent of other aspects that are of interest to the labor force.

Senator JAVITS. That is my instinct too. I know we are going to face some very grave concerns and doubts by the trade union movement that this is a way in which to avoid other fringe benefits, or increases in compensation and improvement in conditions. And I think the best way to exercise those fears is by having stock ownership stand on its own as a particularized move without reference to anything else which is done in the collective bargaining.

Mr. WALKER. Senator, would it help in that direction to remove the requirement that the investment be in the stock of the employer?

Senator JAVITS. I want to reserve comment on that, for this reason: That the social impact of the ESOP is something that we want to consider very carefully. That is really even an open question in my mind, because I think that there is a social advantage in workers having an interest in the economic system, generally, even a greater social advantage, because it would be tied up with efficiency, productivity, et cetera, with the worker having an interest in the enterprise itself.

I might say that I am not one of those people who are afraid of having workers on boards of directors. I know that is a hot potato in management, and I think they are wrong.

So I just put my views on the record, and I hope you will ascertain Treasury's position.

The other question I would like to ask you is this: Could you, at this time or later, give us your appraisal of whether or not, or to what extent, the Kelso plan meets your criteria, which is in your statement, that: "First, it should be a broad based program that would extend the employee benefits of ESOP's to self-employed individuals and employees of employers who do not have an ESOP. Second, that employees should have an opportunity to direct that their funds be invested in stock other than stock of the employer."

Mr. WALKER. My understanding of a Kelso-type plan is that it would not be either of those.

Senator JAVITS. Then would you have any other comment as to the tax implications of a Kelso-type plan that you may wish to consider and give us in writing? I request that. You are not volunteering it.[1]

Mr. WALKER. Senator, we would be happy to do that. There is some analysis of that in the appendix to my statement. To show the Kelso-type plan, of course, you can get into some questions as to what that is. Is this to be built on an investment credit? Is it to be fully leveraged? This does require further analysis.

Senator JAVITS. The plan is a plan of borrowing in order to acquire stock, and the payout would come as the employee deposits his part, and the employer his part.

Mr. WALKER. If I understand your question, you would like an analysis of the way the tax provisions would impact on that?

Senator JAVITS. What you people think about it.

I understand that that is one of the big reservations about it. The stock not only goes up, it often goes down.

Mr. WALKER. That is right.

Senator JAVITS. Thank you.

Thank you, Mr. Chairman. I hope that the record will be kept open.

Chairman HUMPHREY. Indeed it will. This is a very preliminary examination.

I am going to ask a few questions now, until Senator Percy has a chance to look over the testimony, and if my colleagues from the Finance Committee want to ask questions—Senator Fannin is on this committee.

Senator Fannin, would you like to ask a question now? Please go ahead.

Senator FANNIN. If the chairman would permit.

Mr. Walker, I agree that we need something to give incentive for savings.

You state in the testimony:

> Until such time that we can basically reshape the tax laws to broaden its base, reduce the tax rates, and substantially simplify it, and in the process encourage business activity, we think that tax incentives to broaden investment, including investment in stock, are desirable.

You go on to say:

> It should be a broad based program that would extend the employee benefits of ESOP's to self-employed individuals and employees of employers who do not have an ESOP.

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[1] See letter to Chairman Humphrey, dated Feb. 2, 1976, from the Department of the Treasury, beginning on p. 105.

This is getting away from the concept that is involved in ESOP, as I understand it, that it is a plan to encourage employers to do more in this regard.

Mr. WALKER. Certainly the initial concept of an ESOP was focusing on just the employer with employer stock. That much is clear.

Senator FANNIN. If you are going to have the law and the incentive, as Senator Javits expressed, for greater productivity, would it not be true that this would be brought about to a greater extent if the plan would encourage having stock ownership? It is like owning a piece of the rock, you know, the advertisement that was done by one of our insurance companies, emphasizing the interest that the employee would have in the company.

Is that not important?

Mr. WALKER. Certainly it is important, but I think it is only one of the factors that needs to be analyzed, because the motivation or objectives of plans of this sort really need to be focused upon. To stimulate productivity or loyalty or owning a piece of the rock, as you say, Senator, certainly is one objective. But there are others, I think, that should be considered in the same context and that give effect to the interest an employee of a company would have in a freedom of choice as to how his funds would be utilized.

It would give him less of a complete commitment to the welfare of a single entity.

Also to be considered, Senator, in the review of the kinds of companies in which you ought to have a piece of the rock, is the fact that there are lots of employees in smaller and closely held companies, maybe some of the larger ones, that perhaps would not be too happy to be that well identified with their employer in terms of their job future and economic future as well.

Senator FANNIN. My problem in analyzing what you have recommended is that you have practically killed the program. You would not have many ESOP plans if the employees directed that their funds be invested in stock other than the stock of the employer.

You get away from the concept of adopting an ESOP plan.

Mr. WALKER. You asked the question of what the objective is. Is it to broaden the base of stock ownership, or is it to broaden the ployee ownership of the employer's business?

They are different objectives, I grant you.

Senator FANNIN. I do not think they are different objectives. You still broaden the base of stock ownership, but it is in the company, is that not true?

Mr. WALKER. You broaden the base of the employer.

Senator FANNIN. You have more stockholders, and the stockholders have ownership of a greater amount of stock. In the plan, certainly, it could be viewed as a smaller classification, but it does accomplish the intent of the ESOP plan.

Mr. WALKER. With respect to a choice of objectives, there is a distinction between the diversity of a stock owner and the commitment to his own employer, restricting his benefit.

Another aspect of this, I suppose, Senator, is the motivation of the employer to establish such a plan. Presently there is opportunity within the employer group to establish pension plans and stock ownership plans. These are already on the books. Many companies

have used them; they are in place. It is a question of industrial relations and personnel relations to decide when they want to install them.

Senator FANNIN. The whole idea, as I understand it, of the ESOP is to give greater encouragement, to give greater benefits to the employee because most of the stock plans do not give him this broad incentive that is given in the ESOP plan.

Mr. WALKER. The broad incentive you refer to is the incentive to the employees.

Senator FANNIN. Employees, yes.

Mr. WALKER. The incentive to them, I assume, would be that they would not be getting further benefit from the employer. This begins to require one to consider why the employer would like to do this. Is it really a further compensatory arrangement that needs to be established, or a cost the employer is incurring in lieu of additional wages?

It is going to cost the employer something, unless we work just on this 100 percent financing of the investment credit.

Senator FANNIN. If you start out by being skeptical, you arrive at some of the conclusions you stated. I do not look at it on that basis.

Thank you very much.

Chairman HUMPHREY. Senator Long.

Senator LONG. Mr. Walker, I had hoped that a little friend of mine called George Lehigh would be here for this hearing. He was in my office a day or so ago showing me what he had been able to achieve in his firm with the employee stock ownership.

He took over management of this firm shortly after World War II. He had never heard of Mr. Kelso, or the Kelso plan, at that time. He thinks it is a wonderful idea, and he feels that probably it is the most perfected way to meet an objective that he has been trying to meet for years.

He has helped employees purchase over 82 percent of his stock, about half of them participating on the average of about a $50,000 equity each.

The way he has been going about it, doing the best he could to advance this concept, he showed me some figures—I would like Senator Percy to hear this—to show how productivity had increased in his operation, and the way those figures come through, it would appear that since the end of World War II the productivity had increased about 400 percent, with these employees owning a large percentage of stock in their company, and he is not at all dismayed. He is very happy about the fact that they bought it, I say 82 percent of the stock in his company, under a very generous and farsighted plan.

That man tells me—what I believe about this, he says that it is his judgment that the fate of this system of ours that we like to call capitalism is going to depend on our ability to involve these people, such as his employees. It is his judgment that that type of farsighted approach, whereby capitalism is not the private reserve of a very few, but is broadly spread among the people of this country, it may be crucial whether we are going to succeed in competition with these other forms of government, socialism in particular, or communism, if you want to speak in that fashion.

I do not see anything in the statement indicating the desirability of making employees feel that this is theirs and that they are working with management for a common endeavor, and that in the last

analysis, they are working for themselves when they are working to make that company succeed.

Do you have anything in here about increased productivity that tends to come where the workers have a substantial equity position?

Mr. WALKER. We do not have a specific reference to that, Senator. I am glad to have heard that.

The people in the ConRail analysis will be presenting material to the committee.

Senator LONG. May I say for the ConRail people, in case I am not here, that they indicate the same philosophy of the railroad executives that caused that firm to be bankrupted.

I can really see that nothing will really be achieved by that group. It looks like we are just pouring money down that rathole until we get some people to understand that you have to motivate your workers, you have to have communication between management and labor and make them all feel they are striving toward a common objective good for all, if we are going to make all those things succeed.

I can see why ConRail failed. They had the same management that made those railroads fail in the first place.

Mr. WALKER. I would like to make it clear, we certainly encourage and support any process by which there can be greater productivity. I am not trying to back off on that in the slightest, I share your views 100 percent.

My only reason for mentioning ConRail, not supporting the decisions they made, is one of the studies they asked to be made. It goes to the subject of the evidentiary support for the productivity that can be gained by establishing a stock-ownership arrangement.

I think the point in the study that was made for ConRail—whether ConRail agreed with it or not, I am not that familiar with their study—was that the advantages gained in productivity and cooperation and so forth with employees and an employer maybe a result of enlightened management policies across the board. Some companies prosper, some do not prosper. It is not entirely due to the fact that they have a stock-ownership plan.

Certainly, stock ownership is a contributing factor. I would not in any way wish to discourage that. I think that is a splendid objective.

Senator LONG. Thank you, Mr. Chairman.

Chairman HUMPHREY. Thank you, Senator Long.

Senator PERCY, Mr. Walker has to leave at 11:30 a.m. I will ask you to ask your questions.

Senator PERCY. Why do you not go ahead, Mr. Chairman?

Chairman HUMPHREY. I want you to do so.

Senator PERCY. I will be very brief.

I really do not have any questions. I would like to respond to Senator Long, because I have had some experience in whether or not stock ownership plans do motivate employees.

When I took over the Bell & Howell Co. in 1949, we had a company-paid annuity for retirement, and we were up against Japan, Germany, and that yellow box in Rochester, N.Y., where they can give away cameras in order to sell film.

Chairman HUMPHREY. We have the Lieutenant Governor of New York here.

Senator PERCY. I say, we really had tough competition, and the motivation had to be a very large factor in trying to compete, and it was my thought early in my tenure—that this annuity plan we put so many millions of dollars into had no incentive. It did not bind employees at all to the common goal that we had.

With the employees approval, we finally moved into a profit-sharing program, 20 percent of the profits went into a profit-sharing fund for retirement, of which we invested about 50 percent in the common stocks of companies. No more than 10 percent of the total funds would ever go into our own company stock. The employees became the fourth largest stockholding group in any corporation and purchased a great deal of that stock. They did not purchase too much of that in the initial years, because the value of the company was going up. It was always at that 10 percent level.

But the incentive was tremendous. The attitude and morale of those employees was that this was their company. They were represented in large numbers at a stockholders meeting. They outnumbered the other stockholders. They were really interested.

I saw firsthand over a period of a decade and a half or two decades that this concept is really a worthy one.

As I see it, what we are trying to accomplish is to open up and make available to industry more capital that would be otherwise untapped, and second, let American workers feel as though they are a part of this enterprise in the American capitalistic system.

I have always tried to figure out how a worker could ever believe in capitalism unless he became a capitalist. As they suddenly became interested, the tone of the articles I used to write for the employee publications changed entirely because I could talk about "our" company and "your" capitalistic system in which "you" form a strong part.

I am fully supportive of this concept. I have seen it really work. And of course, a group of companies that formed the profit-sharing and employee ownership associations to encourage this concept among other companies have banded together, and we are almost like evangelists in this field.

Now, the National Government, with the encouragement of Senator Javits and his authorship to a great extent, has now established and set up the Productivity Commission. The Vice President, this week, accepted the chairmanship of the Commission. Maybe all these can be fine catalysts for selling this idea.

I am sorry I was not here to hear your testimony but I am trying to quickly scan it. I will try to stay for the rest of the hearings.

I am not sure how the program is being implemented. I am concerned about this—I just came from the business council meeting. I asked a number of them, are you interested in this program, are you moving ahead? I am concerned because there are few companies that I see moving in this direction.

I am wondering why.

Perhaps my questions are—and it may duplicate ones others have asked—why, with this kind of incentive, do not more companies come into it, and in your judgment, is there a better way to move?

Some of the proposals I see as alternatives of yours concern me because they do not have the productivity incentive attached to them that stock ownership would have.

Mr. WALKER. As to the latter point, Senator, the broadened base that I had felt was important was not identified that closely with an incentive. I note in passing, your example of your own experience. I think your company's plan had only 10 percent of the company's stock in it. It never could exceed that amount.

Senator PERCY. No more than 10 percent of the funds, simply because of the diversification and vulnerability of the retirement fund.

Mr. WALKER. That has been a limitation that has been in the U.S. Code and does not exist in the plan we are talking about. It is not impossible to have 100 percent of the funds now in the stock of the employer.

I am not discouraging participation, ownership, and motivation. Motivation is certainly a key element. But along with that, one objective is to give the employee some opportunity to diversify and become a part of the larger base of the business community or the economic or capitalist system.

That is a value judgment, and I am just calling it to the committee's attention.

My position and purpose is to point out what I think are matters before the committee.

I am sorry, I lost the thread on your first question.

Senator PERCY. The level of participation we have under existing programs. What reason did companies give for not participating?

Mr. WALKER. It is a little new, Senator. This came in as a part of ERISA. The new focus came on this because of the 1-percent credit.

I think one impediment might be that there is no certainty as to how long the credit will be available and whether it would be worth establishing a plan under the ESOP approach that might not be similarly motivated. If employers establish a plan with the contributions from this 1 percent, for example, they now have a plan in force that will have some employee impact. If there is no certainty it will go on, they have to face the possibility of what they are going to do with disenchanted employees when it does not continue. There may be some concern on that score which would be removed if that program could be continued, no question about that.

I think that is one reason. Perhaps another reason is they are not too sure how the thing is going to work. It is a new device and it needs further education and further analysis.

One element of this that I heard mentioned, that I had not gotten into the details of, really requires a close view of just how the economics of this thing do work out, whether it will do as it has been hoped to do.

I cannot answer further, Senator, why not acceptance. It is a bit new.

Senator LONG. Could I add a point?

The Treasury regulations on this have not been available, unfortunately. It is a system that does require some regulation.

I am not sure—have they been fully drafted?

Mr. WALKER. What they call the Q's and A's have gone out, and the general ERISA guidelines have gone out.

Senator LONG. Plus the American Telephone & Telegraph Co. would like to use it, but they see some technical problems, and they have suggested some amendments which, if enacted—and I am confident they will—they will use them.

I think the same thing would be true of most of the public utilities, like the power companies, and the regulating utilities, for example. They would have the same problem, from a technical point of view that the American Telephone & Telegraph Co. has.

Once they see what the regulations are, they will be participating a lot more, I am sure.

Senator PERCY. What is the attitude of organized labor? Are they neutral, opposed to it, or supportive of it?

Mr. WALKER. I do not have an exact reading on that, Senator. My impression is, I do not think they oppose it. Perhaps Senator Long has a better view on it. I am not that well informed on it.

Chairman HUMPHREY. It is mixed, like most things these days.

Senator PERCY. Thank you, Mr. Chairman.

Chairman HUMPHREY. I have a few brief questions, and I will accept brief answers from you.

The Treasury Department has the power, the Secretary has the power, to prescribe the type of stock allowable in ESOP's.

Does the Treasury support the position that ESOP's must require voting common stock, having the rights, at least equal to the rights of the other outstanding employer common stock?

Mr. WALKER. If my information is correct on that, Senator, the position has not yet been stated. I think, under the direction that the decision is going, it will be to require some kind of voting provisions.

Chairman HUMPHREY. A clarification of those questions will be helpful, of course, in making an appropriate decision, or a fair decision, on the value of the ESOP concept.

Mr. WALKER. I am fully aware of that, and that is much in the analysis now, Senator.

Chairman HUMPHREY. We have such a law in existence in the State of Minnesota that relates to local and State corporations and to employer-employee relationships.

Would the Treasury support having an advisory committee elected by the employees, as in the Minnesota law?

Mr. WALKER. This gets a bit beyond Treasury. This is more in the area of the labor situation, somewhat similar to what we have under the Oversight Act, and that, I think, is working out very satisfactorily.

There are some complications, I am sure, that are still to be developed on that, to the extent that it does develop a relationship between the employer and its employees as the plans are utilized, assuming that it is confined to the employer's stock.

I do not think that is an unreasonable approach.

Chairman HUMPHREY. Is Treasury studying State laws relating to State income tax and corporate regulation on the State level on this matter?

Mr. WALKER. Not that I am aware of.

Chairman HUMPHREY. They ought to.

I think the point has arisen relating to employee stock option plans. The Treasury ought to be making a full analysis of how these plans are operating, because where States have State income tax, State

corporate tax and things like this, even in my State, they have such a plan and it is looked upon with considerable favor. What about what is being done abroad—I suppose there has been an international analysis made.

Mr. WALKER. One thing that I would like to develop with you, as you asked the question, is the identification of the source of study.

For example, an employee stock ownership plan has been available and on the books for a long time. There are many such plans out now, stock bonus plans. While these have been in the community for a long time, the kinds of plans we are talking about now are really another variety of that, with some relaxation of the prohibited transtheir action rules and diversification rules.

That is newly in place, and really has not impacted yet and really has not been implemented. As to the degree of State involvement, or regulatory involvement, with the plans in place, I am not aware of there having been such a study. Certainly we can look into this.

Chairman HUMPHREY. I think that, in light of the keen interest of the Congress in this matter, it is imperative that the two branches of Government get up to date in reference to the analysis of operating plans and rules and regulations that pertain thereto.

Are the use of tax funds in providing capital through the medium of ESOP a justifiable priority when compared with the many other claims on the Federal Treasury?

Mr. WALKER. As I point out in my conclusion, Senator, I believe that it is an appropriate device. I think that it will get to be a question again of value judgment, whether the device should be to recognize— as plans presently do—as we are trying to broaden even retirement plans through the individual retirement account system, a utilization of the tax system in that fashion, or to go still further, as the investment credit approach does, and provide 100 percent Government financing of such a plan.

Chairman HUMPHREY. That is what we have under the Tax Reduction Act of 1975.

Mr. WALKER. That is correct.

Chairman HUMPHREY. We have 100-percent Government financing of ESOP's through that 1-percent add on to the investment tax credit.

Does the Treasury see this as a justifiable provision, particularly since we do not do this for other employee compensation plans?

Mr. WALKER. I do not think that that is a desirable way to go. I think that there should be a better way to achieve the same result, if it is possible to do so.

The reason I answer that way, Mr. Chairman, is the fact that it does not really put to the employer the need to decide whether this program is the kind of thing that is really best for his employees. It is an inducement to stimulate interest in this kind of plan. At least on a long-range basis, I do not know whether it is proper to have Federal financing of all these plans. I think it should call the employer's attention to the availability, start him thinking about it.

Certainly, that is happening already. In the long run, I would not think 100 percent financing is the way to go.

Chairman HUMPHREY. As Senator Javits indicated a moment ago, this is a matter of negotiation, as in a negotiated pension plan or a negotiated retirement plan. The Senator put the question to you

whether you have to have an either/or situation—an ESOP plan, or you would have the ERISA, or whether you would have both so that you could negotiate the so-called type of ESOP in a marketing contract.

You say that there should not be an either/or, is that correct?

Mr. WALKER. As I recall the way the dialog was going, Mr. Chairman, if you were broadening the base of ownership with an ESOP so that it was not tied into broader stock, I do not think it would belong in that negotiation.

Chairman HUMPHREY. If it was tied to a particular company, it would be tied into that negotiation.

Mr. WALKER. I do not know if it would belong, but it would be there, and it would be more difficult to remove it.

Chairman HUMPHREY. Is the statement that you have given us today the administration's position as of this time rather than just Treasury's?

Mr. WALKER. This has been coordinated with other branches of the Government. The Commerce Department has had some significant dialog with this.

Chairman HUMPHREY. It has general administration support, your statement?

Mr. WALKER. That is correct.

Chairman HUMPHREY. May I say, most respectfully, I find it not too precise. It is exploratory, but not too declaratory.

Mr. WALKER. That is a fair appraisal, Mr. Chairman. We are exploring it.

We have no specific proposal or plan that we would like to come right out with. This is as new to us as it is to the Congress.

Chairman HUMPHREY. You do sense in the Congress the interest in these plans?

Mr. WALKER. Indeed, sir, and so does the administration have a deep interest.

Chairman HUMPHREY. Therefore, as we go into what we call tax reform legislation that I understand from Senator Long, chairman of the Finance Committee, will be underway sometime next spring or summer, it would seem to me that the administration ought to firm up its position on these matters.

There is a keen interest in the Congress—we are worried about capital accumulation and capital formation techniques. We are concerned about involving more people into the capital structure of our country.

The stock market is not responding as it should. Mr. Needham has been before our committee. As indicated here in your statement, and in the question from Congressman Gillis Long, ownership of stock has either leveled off or dropped down. There is a desperate need for more equity capital.

I would hope that the Treasury Department would come forth with some really constructive alternatives, with not one position, but several positions that the Congress could look at.

I am not on the Finance Committee; that is not our job here to try to legislate in this field. But this committee, the Joint Economic Committee, hopefully has some advisory capacity, and we are keenly interested in what the administration will offer.

Mr. WALKER. The administration is concerned about the capital formation problem.

Chairman HUMPHREY. I know they are concerned about it, but they do not give us any specifics.

Mr. WALKER. We are certainly being specific about the integration of corporate and individual income tax. That goes a long way in making capital formation more available. It would certainly broaden the base of stock ownership, because it would give a greater yield and attractiveness to corporate equities and reduce the imbalance that now exists in favor of debt financing; and broadening stock ownership in itself makes the stocks more productive.

We have indicated a desire to want to work with the Congress, and meet and analyze on the subject of the employee savings plans. We are presenting alternatives in my presentation here along these same lines.

We have also espoused the effort to close the gap on the individual retirement accounts. That is the opportunity for self-employed persons and those not covered under qualified plans to have their own retirement plans.

These have been specific proposals we have made in these directions. We are in motion, Senator.

Chairman HUMPHREY. I understand that. I am just trying to focus attention on some of these plans that are being talked about so much now in the Congress. We need guidance and direction.

The Treasury Department has the expertise in this matter, and I am not trying to be critical. I am trying to focus what I think is the sense of urgency that the Congress has on this particular type of tax problem.

I had just received this information that stock ownership has dropped 18 percent in the past 5 years, from 30 million to 25 million stockholders. Of course, many of these stocks are now held by pension funds.

Mr. WALKER. That was the same statistic that Congressman Gillis Long had mentioned that was recently published by the New York Stock Exchange.

Chairman HUMPHREY. I do not consider that a very healthy thing. That means that there is more of what we call debt-financing going on—more competition in the money markets.

Whatever we can do to stimulate individual stock ownership, I think, has a great deal of merit.

Mr. WALKER. One of the key things beyond that is to make stock itself a more attractive investment.

Senator JAVITS. Would the Chair yield so we can ask for more information on that?

Mr. Walker, first, could you give us a comparison between the Treasury loss due to debt service and the Treasury gain due to the taxability of dividends?

That is a big complaint in the market. Second, is the treatment of capital gains. And third, whether you would contemplate a difference of treatment for the ESOP's in both of those areas.

Mr. WALKER. Very well.

Chairman HUMPHREY. We will send you a number of written questions. Time does not permit us today to ask all of them. This is very complicated material.

[The following responses to written questions, and specific data with respect to the ESOP's which are presently in effect were subsequently supplied for the record:]

THE DEPARTMENT OF THE TREASURY,
Washington, D.C., February 2, 1976.

Hon. HUBERT H. HUMPHREY
U.S. Senate,
Washington, D.C.

DEAR SENATOR HUMPHREY: This is in response to your letter of December 18, 1975, in which you ask eight questions in further reference to the matter of Employee Stock Ownership Plans (ESOPs) about which Assistant Secretary Walker testified before the Joint Economic Committee on December 11, 1975.

Preliminarily, it is necessary to consider the objectives to be served not only by an ESOP but also by other types of plans for broadening stock ownership. Among other things it is claimed that an ESOP:

is an effective mechanism for raising capital by the employer corporation,

is a plan for the benefit of employees,

benefits the employer corporation through improved employee morale, loyalty, productivity, and incentive,

broadens the base of stock ownership throughout American society, thereby providing desirable broadened participation in the American free enterprise system.

It is apparent that not all of the foregoing objectives are consistent. What is in the best interests of one benefited group may not necessarily be in the best interests of another group. Moreover, some of the advantages of an ESOP are available under alternate plans which have other objectives that are not served by an ESOP. These other objectives include the following:

Availability of the plan to employees other than, or in addition to, employees of corporations that adopt an ESOP (such as sole proprietors; those employed by employers which do not have an ESOP; state, local, and federal government employees; and employees of nonprofit and charitable organizations).

Freedom of choice with respect to plan participation and the investment of plan assets.

Investments which are not confined to stock of an employer corporation.

In analyzing the relative advantages of an ESOP or alternative plans, each plan should be tested in light of the foregoing objectives. The objectives, themselves, can be evaluated and placed in a sequence of appropriate priority. In this fashion, a desirable balance can be achieved in whatever program is adopted.

Most importantly, the merits of any plan should initially be determined without regard to the tax inducement. Thus, if an objective cannot be achieved as readily without a tax inducement as it can be with one, it can be determined whether encouraging the objective is sufficiently desirable to warrant the granting of a tax inducement.

Voting common stock

Your first question asks whether the Treasury supports the position that ESOPs must require *voting* common stock, having rights equal to those of the other outstanding employer common stock. Response to this question first requires a determination of the objectives to be served by an ESOP.

It has been said that the primary objective of an ESOP is to provide a vehicle for the formation of equity captial. Normally, in corporate financing through the issuance of stock, a corporation will go to the market with whatever stock it believes it can sell. By hypothesis, however, the ESOP is a captive source of funds, unable to bargain in the matter, not only with respect to the price paid for the shares but also with respect to the specifications of the stock. Accordingly a, strong argument can be made that the stock sold to an ESOP under these circumstances should be common stock, of the same class as that generally held by the owners of stock who represent a majority of the voting power of the corporation.

A corollary issue deals with the nature of the stock to be acquired by an ESOP under the Employee Retirement Income Security Act of 1974 (ERISA). This defines an ESOP as a stock bonus plan or a combination of a stock bonus plan and a money purchase pension plan "designed to invest primarily in qualifying employer securities." By statute, such plans must meet the other requirements prescribed by regulations. In the development of these regulations, the problem

has been that ERISA contains specific provisions regarding the prudency of investments made by an employee benefit plan, including an ESOP. Therefore, although an ESOP is exempt from the ERISA diversification requirement, the question remains; what is the extent to which it is prudent to invest in employer stock?

This threshold question must be resolved in tandem with the determination of the specific nature of the employer stock to be acquired by an ESOP. In each case, the answer depends largely upon the objective to be served by an ESOP. If the objective is capital formation, the prudency of the investment may not be relevant, and the voting common stock provisions mentioned above would apply. However, capital formation may not be consistent with the objective of a plan designed exclusively for the benefit of employees. Thus, if an ESOP is an employee benefit plan under ERISA, it is possible that, under some circumstances, prudence would not permit a significant investment in employer stock.

These questions have not been resolved by the Internal Revenue Service and the Labor Department, which have been working together on the development of the ERISA-ESOP regulations. An effort is being made to develop regulations under which both the employee benefit and capital formation objectives will be satisfied.

Corporate finance

Your second question asks whether ESOPs should stay within the purview of the qualified retirement plan concept or should be placed under a new area of the law as a "technique of corporate finance". This question again depends upon the principal objective of an ESOP. If indeed an ESOP is designed as a corporate finance vehicle, it might reasonably be placed in a different area of the statute, not confused with employee benefit plans. Since the objective would not be that of providing employee benefits, such an ESOP would not be subject to the same safeguards for participants that ERISA provides for participants in qualified employee plans generally.

If the objective is capital formation, there is then the question of whether it is desirable to subsidize the cost of raising capital through an ESOP. If capital can be obtained from an ESOP, whereas money in the marketplace cannot as readily be found, the stock may not be worth the price paid for it by the ESOP. If so, one can question whether the tax system should be used to induce the sale of stock which is generally unattractive to the marketplace and which may result in a dilution of the other shareholders' interests.

In this respect, a basic analysis should consider the true cost of raising capital both through an ESOP and the marketplace. The cost through an ESOP would entail a review not only of the issue price but also of the process of installing and administering the ESOP. In cases where the ESOP borrows money to buy the company's stock, the analysis would consider both the cost involved in servicing the debt and the effect of utilizing the components of a leveraged ESOP transaction. Thus, when an ESOP borrows from a bank in order to purchase company stock, with the loans being repaid from future company contributions to the plan, the effect is the same as though the company had borrowed directly from the bank, and contributed employer stock to its ESOP on a tax deductible basis. As a result, a tax deduction will be available under current law not with respect to the repayment of debt, but rather with respect to contributions to a plan now described under the employee benefit plan provisions of the statute.

This brings forward a further review of one of the objectives of an ESOP, namely the fostering of employee morale, incentive and productivity. Many specific examples can doubtless be given to indicate that these benefits are derived from employee stock ownership. We are, however, not aware of any specific data on the subject. It seems almost inevitable that where there is a plan for employee stock ownership, accompanied by high productivity and incentive, and low employee turnover, there will be other factors, apart from the ESOP, that helped to induce the result. Thus, while employee stock ownership may well be a relevant factor, we have not seen evidence that it is the principal factor. That is not to say that employee stock ownership is entirely neutral or negative on the subject of productivity, particularly when accompanied by the right to vote and to have some representation or voice in management. Depending upon the company, however, voting rights and a voice in management could be considered counterproductive. Enlightened management policies doubtless could produce a high degree of morale and productivity without an ESOP.

Deduction limitations

Your third question asks what reasons exist for raising the limit on deductible contributions to an ESOP, above the present 15 percent, and what the new limit should be. This question involves some of the considerations mentioned above with respect to the objectives of an ESOP. To the extent that the ESOP is a capital raising vehicle, it is possible that no tax deduction should be available for contributions. By hypothesis, such an ESOP is not exclusively for the benefit of the employees. Hence, it could not qualify as an employee benefit plan, contributions to which are tax deductible.

The Administration favors a plan to broaden the base of stock ownership which is exclusively for the benefit of wage earners in general. Under this approach, capital formation would be provided not only by the employees of the employer corporation but also by the self-employed and the employees of other corporations.

To the extent an ESOP serves the objective of broadening the base of stock ownership, it might be appropriate to raise the current limitation upon deductible contributions to an ESOP. However, in order to avoid a substantial loss in revenue, without an accompanying increase in stock ownership, any higher limitation should apply only to employees in the low and middle income groups. This concept is embodied in the Administration's proposal to broaden the base of stock ownership.

Elimination of corporate income tax

Your fourth question refers to Mr. Kelso's view that widespread adoption of ESOPs would be of maximum advantage if the corporate income tax were eliminated and corporations were forced to distribute all of their earnings. The Treasury Department has recommended the integration of corporate and personal income taxes. The objective of the integration plan is to remove the double tax on distributed corporate earnings. To the extent that can occur, corporate stocks can show a better yield to investors and thus compete more readily in capital markets with debt financing which has no such double tax burden due to the deductibility of interest payments.

Tax incentives

Your fifth question refers to a comment made by Professor Brems, who said that widespread adoption of ESOPs, because the system is so dependent on tax incentives, would necessitate fiscal reforms through new taxes to recover the lost revenues or the sacrifice of Government services. You have asked the Treasury Department's reaction to this statement. If the only way an ESOP can be made attractive is to give it a tax incentive, there should be careful analysis of why that incentive is necessary. If, as a matter of policy, the incentive is deemed necessary, even in light of the revenue loss, it may be appropriate to provide the incentive, in which event alternative sources of revenue would have to be derived. It is questionable, however, whether the present additional investment credit available with respect to funds committed to an ESOP represents an appropriate tax incentive. This amounts to 100 percent Government financing, and provides no inducement for an ESOP to stand on its own.

Broad based stock ownership

Your sixth question asks that we spell out for your Committee the main features of an across-the-board ESOP concept, *i.e.*, one that is not confined to employees of the sponsoring corporation. As you know, in his State of the Union Message, the President proposed tax incentives to encourage broadened stock ownership by low and middle income working Americans by allowing deferral of taxes on certain funds invested in common stocks. The details of this program will be worked out with the Congress.

The proposal has the following general features:

A Broadened Stock Ownership Plan (BSOP) could be established by individuals *or* by employers for the voluntary participation of their employees.

Contributions to BSOP would be deductible from taxable income.

Participation would be restricted to individuals in the middle and low income ranges through a limit on the maximum amount of the annual contribution eligible for exclusion from income tax, with participation phased out at higher income levels.

Funds in a BSOP would have to be invested in common stocks, which could take the form of an interest in a mutual fund.

Funds in a BSOP would have to remain invested for at least 7 years and are subject to tax at the time of withdrawal.

Income earned by the BSOP would be exempt from tax until withdrawn from the plan.

The plan would go into effect July 1, 1976, and the full deduction would be allowed for calendar year 1976.

Alternative plans

Your seventh question refers to the reference in Assistant Secretary Walker's December 11 testimony to a tax credit equal to a specified percentage of the purchase price of stock held for a specified period. This is one of the alternative plans for broadening stock ownership which the Treasury has considered, along with other Departments of the Administration. Since giving the testimony, this alternative has been discarded. The same is true with respect to the Individual Stock Savings Account, although many of the concepts involved are reflected in the plan proposed by the Administration.

Revenue loss

Your last question asks "if ESOPs were widely adopted in the next year, particularly among many of the Fortune 500 firms, as a new technique of corporate financing using the leveraging available, what magnitude of revenue loss may occur in the next few years given the current tax law provisions regarding ESOPs". We estimate that for each one percent of compensation deducted by a corporate sponsor, there would be an annual revenue loss of $400 million.

I trust the foregoing will be helpful to your Committee in its continuing consideration of ESOPs. The Administration is seriously concerned about matters relating to capital formation, and we wish to cooperate in every practical way in developing an effective capital formation vehicle. We look forward to working with you on the development of a broadened stock ownership plan.

If we can be of further help in your analysis, please call upon us.

Sincerely yours,

(S) William M. Goldstein
WILLIAM M. GOLDSTEIN,
Deputy Assistant Secretary.

DEPARTMENT OF THE TREASURY,
Washington, D.C., March 19, 1976.

Hon. HUBERT H. HUMPHREY,
U.S. Senate, Washington, D.C.

DEAR SENATOR HUMPHREY: This is in response to your letter of January 5, 1976 in which you request specific data with respect to the Employee Stock Ownership Plans (ESOPs) which are presently in effect.

We have discussed your request with the Internal Revenue Service and have found that most existing ESOPs cannot be specifically identified as such based upon the records presently on file with the Internal Revenue Service. This is a result of the fact that ESOPs were not specifically defined under the Internal Revenue Code until enactment of the Employee Retirement Income Security Act of 1974 (ERISA), when the term was made operative only with respect to a limited exemption from ERISA's prohibited transaction and prudent investment rules. Under prior law, there were only five generic types of qualified deferred compensation plan—a profit sharing plan, a pension plan, a stock bonus plan, a bond purchase plan and an annuity plan. As a result, plans filing with the Internal Revenue Service were not required to indicate whether or not they employed the ESOP leveraging concept. A copy of the old submission Form 4573, which has now been discontinued, is enclosed for your information.

As a result, the estimate of 300 ESOPs which appears in my testimony of December 11, 1975 is based upon the best information currently available to the Internal Revenue Service.

It is anticipated that much of the information that you request will become available in the future, as a result of new forms which will be used by the Internal Revenue Service. Separate submission forms will be required for ESOPs adopted under the Tax Reduction Act of 1975. A copy of Form 5309, entitled Application for Determination of Employee Stock Ownership Plan, is enclosed for your information. In addition, the annual report form to be filed with both the Internal Revenue Service and the Labor Department (Form 5500) will require employers to indicate whether or not their stock bonus or money purchase pension plan incorporates an employee stock ownership feature. This is the appropriate format for such information because, as in the past, there remain only five basic forms of deferred compensation plan for qualification purposes.

There will be some data, however, which may not be developed in the future because it does not become relevant in the determination letter process. These items are as follows:

1. Sales volume or asset size of the firm.
2. Whether the firm is closely held or publicly held (although inferences may be drawn in some cases from the submission form).
3. Whether the firm is union or nonunion (although, again, conclusions may be drawn in some cases from the submission form).
4. For what purpose the ESOP was established.
5. Whether the ESOP is leveraged by a bank loan.
6. If dividends are paid out on a current basis, what has been, or is expected to be, their annual amount for a $10,000 a year employee?

In this regard, I have enclosed a copy of the submission Forms 5300 and 5301 which are currently being used by the Internal Revenue Service.

To the extent that the names of specific employers who have adopted ESOPs are available, there is also the problem of public disclosure. ERISA amended section 6104(a) of the Internal Revenue Code to provide that all applications for qualification under the Code filed after September 2, 1974 must be made available for public inspection. There is, therefore, some question about the public availability of exemption application information relating to a specific employer who filed his application prior to September 2, 1974 or who files for approval of his investment credit ESOP under the Tax Reduction Act of 1975. As a result, it would appear that the procedure established under Section 6103(d) of the Code, relating to the disclosure of tax return information, would have to be followed in order to determine specific data filed with the Service either prior to September 2, 1974 or under the Tax Reduction Act ESOP provisions. This problem will not arise in the future with respect to applications for qualification under the Internal Revenue Code, so that once plans receive determination letters under ERISA, the data base will be more helpful and accessible.

We have asked the Service to complete as much of the information requested in your letter of January 5, 1976 as possible, and we are enclosing the data that they were able to obtain from their District offices. This information relates to the 21 investment credit ESOPs which were submitted for approval on Forms 5309 between December 1, 1975 (when the form was first required) and December 31, 1975. The names of the adopting employers have been omitted because of the disclosure problem.

If we can be of any further assistance, please do not hesitate to call upon us.

Sincerely yours,

CHARLES M. WALKER, *Assistant Secretary.*

Enclosures.

Form 4573
January 1970
Department of the Treasury
Internal Revenue Service

Application For Determination

Individually Designed Plan

(Under sections 401(a), 405(a) and 501(a) of the Internal Revenue Code)

NOTE: Do not use this form for a plan established under a master or prototype program or a plan covering self-employed individuals. The term trust, as used on this form, includes a custodial account.

1. Determination requested for:
☐ Initial qualification—Date plan adopted ______ ☐ Amendment—Date adopted ______

2. Name and address (including ZIP code) of employer

3. Nature of business

4. Employer identification No.

5. (a) Date incorporated (or business commenced if not a corporation) ______
(b) Month accounting period ends ______

6(a) Predecessor name

(b) Type of business of predecessor

(c) Date of transfer

7. Type of entity: ☐ Corporation ☐ Sole proprietor ☐ Partnership ☐ Association ☐ Governmental ☐ Other (Specify)

8. Name of plan

9. Type of plan
☐ Pension ☐ Annuity plan
☐ Stock bonus ☐ Profit-sharing plan
☐ Bond purchase

10. (a) Name of trust

(b) Name and address (including ZIP code) of trustee

11. Employer identification number of trust

12. Date trust executed

13. Month accounting period of trust ends

14. Effective date of plan or present amendment

15. Date communicated to employees ______
How communicated?

16. Funding medium
☐ Trust (Bank) ☐ Trust (Other) ☐ Custodial account ☐ Group annuity contract ☐ Individual contracts ☐ Other (Specify)

17. If pension or annuity plan, indicate type of plan
☐ Unit-benefit ☐ Fixed-benefit ☐ Flat-benefit ☐ Money-purchase ☐ Other (Specify)

18. Integration features ☐ None
If applicable— (a) Integrated with ☐ OASI ☐ Railroad Retirement ☐ Other (Specify)
(b) Type ☐ Excess ☐ Offset ☐ Step-rate

Please furnish a brief description of the following provisions (on the basis of the most recent plan amendments, if any) and indicate the article or section where such provisions are contained. (Attach additional sheets if needed)

Item	Description	Article or Section
19. Eligibility Requirements (a) Length of service (years)	☐ None ☐ One ☐ Two ☐ Three ☐ Four ☐ Five ☐ Other (Specify)	
(b) Age	☐ None Minimum ______ Maximum ______	
(c) Job class	☐ None ☐ Salaried ☐ Hourly ☐ Other (Specify)	
(d) Other		
20. Employer Contribution Formula	☐ All ☐ Balance necessary ☐ Other (Specify)	
21. Allocation Formula	☐ In proportion to compensation ☐ Other (Specify)	

Under penalties of perjury, I declare that I have examined this application, including accompanying statements, and to the best of my knowledge and belief it is true, correct, and complete.

______ (Signature) ______ (Title) ______ (Date)

Item	Description	Article or Section
22. Employee Contribution Formula	☐ None ☐ Required (Specify rate) ☐ Voluntary (Specify rate)	
23. Benefit Formula (a) Normal retirement		
(b) Early retirement		
(c) Disability retirement		
(d) Death: (1) Before retirement		
(2) After retirement		
24. Requirements for Benefits (a) Normal retirement		
(b) Early retirement		
(c) Disability retirement		
25. Vesting Provisions	☐ Full and Immediate ☐ Other (Specify)	

26. Indicate the article or section of the plan or trust where the following provisions are contained.

Item	Article or Section	Item	Article or Section
(a) Definition of compensation		(f) Vesting upon termination of plan or upon complete discontinuance of contributions	
(b) Definition of net profits (profit-sharing and stock bonus plan)		(g) Prohibition against reversion	
(c) Disposition of forfeitures		(h) Annual valuation of assets	
(d) Limitation of benefits in event of early termination of pension plan		(i) If a bond purchase plan, requirement that contributions be invested solely in U.S. Retirement Plan Bonds	
(e) Nontransferability of annuity contracts			

27. Coverage at .... (date)

		5. Ineligible on account of:	
1. Total Employed		(a) Minimum age	
2. Exclusions:		(b) Maximum age	
(a) Part time (20 hours or less)....		(c) Minimum pay	
(b) Seasonal (5 months or less) ..		(d) Hourly-paid	
(c) Years of service (Specify)		....	
....		(e) Other (Specify)	
3. Total Exclusions		6. Total Ineligible	
4. Balance		7. Number eligible to participate	
		8. Number of employees participating .	

28. Does employer contribute to any other qualified plan? ☐ Yes ☐ No
If yes, please furnish the following information:

(a) Name of plan

(b) Indicate type of plan

(c) Rate of employer contribution, if fixed

(d) Monthly benefit, if pension plan

(e) Vested benefit upon termination of employment prior to retirement

29. Is any issue relating to the qualification of this plan, or exemption of the trust, currently pending before the Internal Revenue Service or any court? ☐ Yes ☐ No.

30. Total nondeferred compensation paid or accrued during the year for all employees .... $

31. Employee census (Schedule of 25 highest paid participating employees for taxable year ended ....)

(Round off to nearest dollar)

Line No.	Employee's last name and initials *(List in order of compensation)* (a)	Officer or supervisor (Check) (b)		Percent of voting stock owned (c)	Age (d)	Years of service (e)	NONDEFERRED COMPENSATION		PENSION OR ANNUITY PLAN			EMPLOYER'S CONTRIBUTION		IF PROFIT-SHARING OR STOCK BONUS PLAN		Column (l), or (l) plus (m) as a percentage of column (g) (o)	Employee contributions under the plan (p)
		Yes	No				Basic rate and overtime (f)	Total (g)	Annual benefit expected (h)	Retirement: Age (i)	Retirement: Expected Date (Month and Year) (j)	Under each other plan of deferred compensation (k)	Under this plan (l)	Forfeitures reallocated in the year (m)	Number of units if reallocation is based on units (n)		
1																	
2																	
3																	
4																	
5																	
6																	
7																	
8																	
9																	
10																	
11																	
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15																	
16																	
17																	
18																	
19																	
20																	
21																	
22																	
23																	
24																	
25																	
A. Total of above																	
B. Total of all others (Specify number ....) ..																	
C. Total for all participants (A plus B)																	

Form 4573 Page 3 (1–70)

Attach the Following Documents and Statements

32. Copies of all instruments constituting the plan (or amendment), including trust indentures (or custodial agreements), group annuity contracts, specimen copy of each type of individual contract and specimen copy of formal announcement containing comprehensive detailed description to employees, with all amendments to any such instruments.

33. If a pension or annuity plan, a detailed description of all methods, factors and assumptions used in determining costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analyses and verification thereof, and in the case of a trust a detailed description of the basis used in valuing the investments held.

34. Complete only if trusteed plan—
Financial statement of employees' trust exempt from tax for the calendar year .... or fiscal year ending ....

Statement of receipts and disbursements (Round off to nearest dollar)		Balance sheets (Round off to nearest dollar)	Amount	Total
RECEIPTS		ASSETS		
1. Contributions (a) Employer		1. Cash		
(b) Employee		2. Investments in bonds		
2. Interest		(a) U.S. and instrumentalities		
3. Dividends		(b) State, Subdivisions thereof, etc.		
4. Gain or loss from sale of assets		(c) Nongovernmental		
5. Rents		3. Investments in corporate stock or securities		
		4. Investment in employers' stock		
		5. Loans to employer		
		6. Investments in mortgage and real estate loans		
6. Other (Itemize)				
		7. Other investments (itemize)		
7. Total receipts				
DISBURSEMENTS				
1. Compensation of trustees				
2. Salaries and commissions (Other than trustees)		8. Buildings & other depreciable assets		
		(a) Less accumulated depreciation		
3. Interest		9. Total assets		
4. Distributions to participants or their beneficiaries		LIABILITIES		
		1. Accounts payable		
5. Other (Itemize)		2. Notes payable		
		3. Business lease indebtedness		
		4. Other (itemize)		
6. Total disbursements		5. Total liabilities		
7. Excess (Decrease) of receipts over disbursements		6. Participants' interest		
		7. Total liabilities & participants' interest		

INSTRUCTIONS

A. WHO MAY FILE—

1. Any employer desiring a determination letter as to initial qualification or amendment of a plan that does not (a) include self-employed individuals, (b) utilize a master or prototype plan, or (c) result from negotiation on an industry-wide or area-wide basis.

2. This application may also be utilized by an employer desiring a determination letter as to compliance with the applicable requirements of a foreign situs trust as to a taxability of beneficiaries (section 402(c) of the Code and deductions for employer contributions (section 404(a)(4)).

B. WHAT TO FILE—

1. Initial qualification: This application and a copy of documents and statements listed in items 32 and 33 unless previously submitted.

2. Amendment: This application, a copy of the amendment(s), and a detailed statement explaining the effect of the amendment(s). Furnish any information required in items 32 and 33 only if changed since previous application.

C. WHERE TO FILE—

1. A single employer will file with the District Director for the district in which the principal place of business of the employer is located.

2. A parent company and each of its subsidiaries that adopt a single plan will file with the District Director for the district in which the principal place of business of the parent is located, whether or not separate or consolidated returns are filed.

3. An employer adopting a single plan of multiple employers (for example, a plan for companies related through common ownership or stockholding, other than parent and subsidiaries) will file with the District Director for the district in which is located the principal place of business of the trustee, or if not trusteed, or if more than one trustee, the principal or usual meeting place of the trustees or plan supervisors.

4. An employer or employers adopting a foreign situs trust will file with the Director of International Operations.

D. SIGNATURE—This application must be signed by the proprietor, a partner, or principal officer or trustee authorized to sign.

Form **5309** (October 1975) Department of the Treasury Internal Revenue Service

Application for Determination of Employee Stock Ownership Plan

Under section 301(d) of the Tax Reduction Act of 1975

File in Duplicate

1 (a) Name, address and ZIP code of employer

Telephone number ▶ ( )

(b) Name, address and ZIP code of plan administrator, if other than employer

(c) Administrator's identification number ▶ Telephone number ▶ ( )

2 Employer's identification number

3 Business code no. (same as that shown on Form 1120)

4 Date incorporated or business commenced

5 Employer's taxable year ends

6 This is an application for
(a) ☐ A plan intended to meet the requirements of 301(d) of the Tax Reduction Act of 1975 (the Act).
(b) ☐ A plan intended to meet the requirements of section 301(d) of the Act and section 401(a) of the Code.
(c) ☐ An amendment to a plan previously qualified under section 401(a) intended to modify such plan to also meet the requirements under 301(d) of the Act.

If you checked (b) or (c), complete only questions 7, 8 and 12 below and file this form as an attachment to Form 4573 (if old law plan) or 5301 or 5303; if you checked (a) complete this form in its entirety and file it as directed in the instructions.

7 Plan(s): (a) Name(s) (b) Number(s) (c) Date year ends

8 Type of plan: (a) ☐ Profit-sharing (b) ☐ Stock bonus (c) ☐ Money purchase and stock bonus (see specific instructions)

9 ☐ Initial qualification Effective date of plan ▶

10 ☐ Amendment Effective date ▶

11 Date plan was communicated to employees ▶ How communicated ▶

12 Indicate the section and page number where the following plan provisions will be found: (Section and Page Number)

(a) Plan is designed to invest primarily in employer securities (see general information)
(b) The amount of employer securities or cash transferred to this plan upon its establishment is not less than 1 percent of the amount of the qualified investment (as determined under section 46(c) and (d) of the Code) of the taxpayer for the taxable year
(c) The allocation of the employer's securities is in substantially the same proportion that such employee's compensation bears to the total compensation of all participants, and as further specified in section 301(d) of the Act. (See general information 4.)
(d) Each participant must be entitled to direct the plan to vote the securities allocated in (c) above in the manner in which the participant chooses
(e) No securities may be distributed to any participant before the end of the 84th month after the month of allocation of such securities except in the case of separation from service, death or disability
(f) The rights of all participants must be nonforfeitable in the securities allocated to them in (c) above
(g) If the amount of the credit determined under section 46(a)(1)(B) of the Code, is recaptured in accordance with the provisions of such Code the contributions remain in the plan or in participants' accounts, as the case may be, and continue to be allocated in accordance with the original plan agreement
(h) Plan meets the requirements of section 415 of the Code

13 (a) Indicate the general eligibility requirements for participation under the plan and indicate the section and page number of plan or trust where each provision is contained: ((i)–(iv)) ((v)–(viii))

(i) ☐ All employees
(ii) ☐ Hourly rate employee only
(iii) ☐ Salaried employee only
(iv) ☐ Other job class (specify) ▶
(v) Length of service (number of years) ▶
(vi) Minimum age (specify) ▶
(vii) Maximum age (specify) ▶
(viii) Minimum pay (specify) ▶

(b) Are the eligibility requirements the same for future employees? ☐ Yes ☐ No
If "No," explain ▶

14 Coverage of plan at (give date) ▶ (Number)

(a) Total employed, see specific instructions
(b) Exclusions under plan (do not count an employee more than once):
(i) Minimum age or years of service required (specify) ▶
(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining
(iii) Nonresident aliens who receive no earned income from United States sources
(c) Total exclusions, sum of (b)(i) through (iii)
(d) Balance, line (a) less line (c)
(e) Ineligible under plan on account of (do not count an employee included in (b)) ▶
(i) Minimum pay
(ii) Hourly-paid
(iii) Other (specify) ▶

Under penalties of perjury, I declare that I have examined this application, including accompanying statements, and to the best of my knowledge and belief it is true, correct and complete.

Signature ▶ Title ▶ Date ▶

Form 5309 (10-75) Page 2

(f) Total ineligible, sum of (e)(i) through (iii) . . . .

(g) Number eligible to participate, (d) less (f) . . . .

(h) (i) Number of employees participating in the plan . . . .

(ii) Percent participating, (h)(i) divided by (d). (If less than 70% complete (i) and (j). If 70% or more, do not complete (i) or (j).) . . . . %

(i) Percent eligible, (g) divided by (d), if less than 70% see specific instructions . . . . . . %

(j) Percent of eligible employees participating, (h)(i) divided by (g) . . . . %

(k) If percent in (j) is less than 80, see specific instructions.

General Information

(All section references are to the Internal Revenue Code of 1954 unless otherwise specified.)

Corporate employers may apply for an advance determination letter for an Employee Stock Ownership Plan which meets the requirements of section 301(d) of the Tax Reduction Act of 1975 (the Act).

The Act amended section 46(a)(1) to allow corporations to elect an 11 percent investment credit by establishing a plan which meets the requirements of section 301(d) of the Act.

A plan under section 301(d) of the Act need not be a plan qualified under section 401(a). The requirements of section 301(d) of the Act are as follows:

1. A corporate employer (employer) must establish a written stock bonus, stock bonus and money purchase pension plan, or a profit-sharing plan.

2. The plan must be designed to invest primarily in employer securities. Such securities may only be common stock issued by the employer or a corporation in control of the employer (within the meaning of section 368(c)) with voting power and dividend rights no less favorable than voting power and dividend rights of other common stock or securities convertible into such stock issued by the employer or such controlling corporation.

3. The contribution to the plan for any taxable year for which the 11 percent investment credit is elected may not be less than 1 percent of the amount of the qualified investment (as determined under section 46(c) and (d)) of the taxpayer for the taxable year.

4. All employer securities transferred to or purchased by the plan because of section 46(a)(1)(B) must be allocated to the account of each participant (who was a participant at any time during the plan year, whether or not he is a participant at the end of the plan year) as of the close of each plan year in substantially the same ratio that the compensation paid each participant (disregarding any compensation in excess of $100,000) bears to the compensation (disregarding any compensation in excess of $100,000 with respect to any participant) paid to all participants during that year.

5. Each participant must be entitled to direct the plan to vote his allocated stock in any way he wishes.

6. No stock may be distributed before the end of the 84th month after the month in which the stock is allocated, except in the case of separation from service, death or disability.

7. The rights of all participants must be nonforfeitable.

8. No amount shall be allocated to any participant in excess of the amount which might be allocated if the plan met the requirements of section 401.

9. The plan must meet requirements of sections 410 and 415.

10. Any amounts transferred to the plan because of section 46(a)(1)(B) may not revert to the employer if the amount of the investment credit determined under 46(a)(1)(B) is recaptured in accordance with the provisions of the Code.

General Instructions

A. Who may file.—Any corporate employer, who has elected the 11 percent investment credit under section 46(a)(1)(B) and established a plan intended to meet the requirements under section 301(d) of the Act may file their application.

B. What to File.—

1. For initial determination regarding a plan intended to meet the requirements under section 301(d) of the Act but not section 401(a) of the Code, file Form 5309 in duplicate plus a copy of the plan.

2. For initial determination regarding a plan intended to meet the requirements under section 301(d) of the Act as well as section 401(a) of the Code, file Forms 5309 and 4573 (if old law plan) or 5301 or 5303 in duplicate plus a copy of all documents and statements required by such forms.

3. To amend a plan previously qualified under 401(a) so that it also qualifies as a plan under section 301(d) of the Act, submit completed Forms 5309 and 4573 (if old law plan) or 5301 or 5303 in duplicate plus all the documents and statements required by such forms.

C. Where to File.—

1. An employer other than employers described in 2 below must file with the District Director for the district in which the principal place of business of the employer is located.

2. A parent company and each of its subsidiaries that adopt a single plan must file with the District Director for the district in which the principal place of business of the parent is located, whether or not separate or consolidated income tax returns are filed.

D. Signature.—The application must be signed by the principal officer authorized to sign.

Specific Instructions

For initial qualification of a plan intended to qualify under section 401(a) as well as section 301(d) of the Act or to amend a plan previously qualified under 401(a) so that it also qualifies as a plan under section 301(d) of the Act, complete only items 1 through 8 and 12 and file this Form 5309 as an attachment to Form 4573 or 5301 or 5303. If you check item 6(b) or (c) and also check item 8(c) complete item 7 for each plan, i.e., the money purchase plan and the stock bonus plan. File a Form 4573 or 5301or 5303 for each such plan with a Form 5309 attached to each.

7(b). Plan Number.—Enter the three digit serial number you assigned this plan. Numbering starts with 001. If you have any other deferred compensation plans number these plans in sequence with existing plans.

14. Coverage.—In general, if your plan does not meet the requirements of section 410(b)(1)(A) (70–80% rule), you must submit a schedule using the format below to show that your plan meets the requirements of section 410(b)(1)(B). The question of acceptable classification is a continuing one and must be met in all subsequent years as well. You should review your classification at the time you submit your Form 5500, Annual Return/Report of Employee Benefit Plan.

1	2		3	4	5	6	7
Group	* Compensation range		Total employees	Statutory exclusions 410 (b)(2)	Other exclusions	Employees participating (3 minus sum of 4 and 5)	Participants who are officers or shareholders
	At least	But not more than					
Totals							

* The compensation brackets used must reflect the pay pattern of the employer.

Employees included in collective bargaining.—Section 410(b)(2)(A) provides that a plan may exclude certain employees who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

Nonresident aliens.—Section 410(b)(2)(C) provides that a plan may exclude nonresident alien employees who receive no earned income from the employer which constitutes income from sources within the United States.

14(a). Enter the total number of employees as of the date given on line 14. For a controlled group of corporations item 14 must be completed as though the controlled group constitutes a single entity.

¶ 5496

Form **5300** (October 1975) Department of the Treasury Internal Revenue Service

Application for Determination for Defined Benefit Plan

For Pension Plans Other Than Money Purchase Plans

(Under sections 401(a), 414(j) and 501(a) of the Internal Revenue Code of 1954)

This Form is Open to Public Inspection
File in Duplicate

1 (a) Name, address and ZIP code of employer

Telephone number ► ( )

(b) Name, address and ZIP code of plan administrator, if other than employer

2 Employer's identification number

3 Business code number (see instructions)

4 Date incorporated or business commenced

5 Employer's taxable year ends

(c) Administrator's identification number ► Telephone number ► ( )

6 Determination requested for:

(a) (i) ☐ Initial qualification—date plan adopted ► (ii) ☐ Amendment—date adopted ►

(b) Were employees who are interested parties given the required notification of the filing of this application? ☐ Yes ☐ No

(c) If this application involves a merger or consolidation with another plan, enter the employer identification number(s) and the plan number(s) of such other plan(s) ►

7 Type of entity: (a) ☐ Corporation (b) ☐ Subchapter S corporation (c) ☐ Sole proprietor (d) ☐ Partnership (e) ☐ Tax exempt organization (f) ☐ Other (specify) ►

8 (a) Name of Plan

(b) Plan number ► (c) Plan year ends ►

(d) Is this a Keogh (H.R. 10) plan? ☐ Yes ☐ No

(e) If "Yes," is an owner-employee in the plan? ☐ Yes ☐ No

9 (a) If this is an adoption of a master or prototype plan (other than Keogh), enter name of such plan

(b) Opinion letter serial number

(c) If this is not an adoption of a master or prototype plan, is the plan and trust (or custodial account) agreement patterned after and substantially the same as another plan and trust (or custodial account) agreement which conforms to the participation and vesting standards of the Employee Retirement Income Security Act of 1974 and on which a favorable determination or opinion letter was issued? ☐ Yes ☐ No
If "Yes," see specific instructions.

10 (a) Type of plan: (i) ☐ Fixed benefit (ii) ☐ Unit benefit (iii) ☐ Flat benefit (iv) ☐ Other (specify) ►

(b) Does plan provide for variable benefits? ☐ Yes ☐ No
If "Yes," check appropriate box to indicate type.
(i) ☐ Cost of living (ii) ☐ Asset fluctuation (iii) ☐ Other (specify) ►

11 Effective date of plan

12 Effective date of amendment

13 Date plan was communicated to employees ►
How communicated ►

	Section and page number	GOVERNMENT USE ONLY
14 (a) Indicate the general eligibility requirements for participation under the plan and indicate the section and page number of plan or trust where each provision is contained:		
(i) ☐ All employees (v) Length of service (number of years) ►		
(ii) ☐ Hourly rate employee only (vi) Minimum age (specify) ►		
(iii) ☐ Salaried employee only (vii) Maximum age (specify) ►		
(iv) ☐ Other job class (specify) ► (viii) Minimum pay (specify) ►		
(b) Are the eligibility requirements the same for future employees? ☐ Yes ☐ No If "No," explain ►		
(c) Does the plan recognize service only with this employer? ☐ Yes ☐ No If "No," explain ►		

	Number
15 Coverage of plan at (give date) ► Enter here the number of self-employed individuals ►	
(a) Total employed (if a Keogh plan, include all self-employed individuals). See specific instructions for item 23(c)	
(b) Exclusions under plan (do not count an employee more than once):	
(i) Minimum age or years of service required (specify) ►	
(ii) Employees included in collective bargaining (see specific instructions)	
(iii) Nonresident aliens who receive no earned income from United States sources	
(c) Total exclusions, sum of (b)(i) through (iii)	
(d) Employees not excluded by statute, (a) less (c)	

Under penalties of perjury, I declare that I have examined this application, including accompanying statements, and to the best of my knowledge and belief it is true, correct and complete.

Signature ► Title ► Date ►

Signature ► Title ► Date ►

Form 5300 (10-75) Page 2

(Section references are to the Internal Revenue Code) | Section and page number | GOVERNMENT USE ONLY

15 Coverage (continued):

(e) Ineligible under plan on account of (do not count an employee included in (b)):
- (i) Minimum pay
- (ii) Hourly-paid
- (iii) Maximum age
- (iv) Other (specify) ►

(f) Employees ineligible, sum of (e)(i) through (iv)

(g) Employees eligible to participate, line (d) less line (f)

(h) Number of employees participating in plan

(i) Percent of nonexcluded employees who are participating, (h) ÷ (d) ..... %

Complete (j) only if (i) is less than 70% and complete (k) only if (j) is 70% or more

(j) Percent of nonexcluded employees who are eligible to participate, (g) ÷ (d) ..... %

(k) Percent of eligible employees who are participating (h) ÷ (g) ..... %

If (i) and (j) are less than 70% or (k) is less than 80%, see instructions

(l) Total number of participants, include certain retired and terminated employees, see instructions

16 Employee contributions:	Yes	No
(a) Are mandatory contributions limited to 6% or less?		
(b) Are voluntary contributions limited to 10% of compensation for all qualified plans?		
(c) Are benefits unaffected by forfeitures?		

17 Employer contributions:

(a) ☐ Full amount (b) ☐ Balance necessary

(c) Are employer contributions reduced by forfeitures?

18 Integration:

Is this plan integrated with Social Security or Railroad Retirement?

If "Yes," see specific instructions.

19 Vesting:

(a) Vesting Schedule—Check the appropriate box to indicate the vesting provisions of the plan:
- (i) ☐ Full and immediate
- (ii) ☐ Full vesting after 10 years of service
- (iii) ☐ 5- to 15-year vesting, i.e., 25% after 5 years of service, 5% additional for each of the next 5 years, then 10% additional for each of the next 5 years
- (iv) ☐ Rule of 45 (see section 411(a)(2)(C))
- (v) ☐ For each year of service, commencing with the 4th such year, vesting not less than 40% after 4 years of service, 5% additional for each of the next 2 years, and 10% additional for each of the next 5 years
- (vi) ☐ Other (specify) ►

(b) If box (a)(v) or (vi) was checked, check whether you include the following years of service under the vesting provisions of the plan:	Yes	No
(i) Years of service before age 22		
(ii) Years of service for a period during which the employee declined to contribute to plan requiring employee contributions		
(iii) Years of service during which the employer did not maintain the plan or a predecessor plan		
(iv) Years of service excluded under section 411(a)(6)		
(v) Years of service described in section 411(a)(4)(E)		
(vi) Years of service described in section 411(a)(4)(F)		

20 Administration:

(a) Type of funding entity: (i) ☐ Trust (iii) ☐ Non-trusteed (ii) ☐ Custodial account (iv) ☐ Trust with insurance contracts

If you checked (i) or (ii), enter date executed ►

(b) Enter name and identifying number of fiduciary (trustee or custodian), if any ►

(c) Enter name and identifying number of fund (trust or custodial account), if any ►

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Form 5300-(10-75) Page 3

	Yes	No	Section and page number	GOVERNMENT USE ONLY
20 Administration *(continued)*				
(d) Does trust agreement prohibit reversion of funds to the employer?				
(e) If borrowing on insurance contracts is permitted, is it on a pro-rata basis and only for payment of premiums?				
(f) If Puerto Rican trust, does it qualify for tax exemption under the laws of Puerto Rico?				
21 Benefits:				
(a) Normal retirement age is ▶ .... State years of service required ▶				
(b) Benefit at normal retirement age is ▶				
(c) If benefits are measured by years of service—				
(i) Are the years of service for eligibility purposes included in credited service?				
(ii) Is only service as a common-law employee recognized?				
(d) Are benefits computed on the basis of total compensation? If "No," see specific instructions.				
(e) Early retirement age is ▶ .... State years of service required ▶				
(f) Benefit at early retirement age is ▶				
(g) If employer's consent is required for early retirement, are benefits limited to vested interest?				
(h) Does the plan provide for determining an employee's accrued benefit?				
(i) If the plan defers compensation generated increases until compensation increases sufficiently, does plan provide for increases of benefits of at least $10 per month?				
(j) If participants may withdraw their contributions or earnings, may such withdrawal be made without forfeiting vested benefits based on employer contributions?				
(k) Is duplication of benefits upon re-entry into the plan prohibited?				
(l) In the case of a merger or consolidation with another plan or transfer of assets or liabilities to another plan, will each participant be entitled to the same or greater benefit as if the plan had terminated?				
(m) Is there a disability benefit under the plan?				
(n) Normal form of retirement benefits is ▶				
(o) If plan provides for payment of annuity benefits, does the plan provide a joint and survivor benefit unless participant elects otherwise?				
(p) Does plan prohibit distribution of benefits except for retirement, disability or termination of employment or, in case of self-employed individuals, after age 59½?				
(q) Does the plan provide that the payment of benefits, unless the employee elects otherwise, will commence not later than the 60th day after the latest of (1) the close of the plan year in which the participant attains the earlier of age 65 or the normal retirement age specified under the plan, (2) the close of the plan year in which occurs the 10th anniversary of the year in which participant commenced participation or (3) the close of the plan year in which the participant terminates his service with the employer?				
(r) Does the plan prohibit the assignment or alienation of benefits?				
(s) Does the plan preclude divestment for cause?				
(t) Does the plan provide for a death benefit before retirement? If "Yes," indicate whether such benefits are limited to— (i) ☐ 100 times the monthly pension or the reserve, if larger. (ii) ☐ The actuarial equivalent of the benefits accrued to the date of death. (iii) ☐ Other explain ▶				
22 Termination of plan or trust:				
(a) Is there a provision in the plan for terminating the plan and/or trust?				
(b) Are the participants' rights to benefits under the plan nonforfeitable upon termination or partial termination of the plan?				
(c) Has the early termination rule been included in the plan (see section 1.401-4 (c)(1) and (2) of the Income Tax Regulations)?				
(d) Have the plan benefits been increased since the plan's inception?				

16—82550-1

	Yes	No	Government use only
23 Miscellaneous:			
(a) Has power of attorney been submitted with the application (or previously submitted?) . . .			
(b) Have you completed and attached Form 5302?			
(c) Is the adopting employer a member of a controlled group of corporations or under commonly controlled trades or businesses?			
If "Yes," see specific instructions.			
(d) Is any issue relating to the qualification of this plan or exemption of the trust currently pending before the Internal Revenue Service, the Department of Labor, the Pension Benefit Guaranty Corporation or any Court?			
If "Yes," attach explanation.			
(e) Other qualified plans—Enter for each other qualified plan you maintain (do not include plans that were established under union-negotiated agreements that involved other employers):			
(i) Name of plan ▶			
(ii) Type of plan ▶			
(iii) Rate of employer contribution, if fixed ▶			
(iv) Benefit formula or monthly benefit ▶			
(v) Number of participants ▶			
24 In the case of a request on an initial qualification, have the following documents been included with the application as required by instructions:	Yes	No	
(a) Copies of all instruments constituting the plan or joinder agreement?			
(b) Copies of trust indentures or group annuity contracts?			
(c) Specimen copy of each type of individual insurance contract?			
(d) Balance sheet of the trust or custodial account?			
(e) Statement of receipts and disbursements of the trust or custodial account?			
(f) Evidence that retirement benefits were the subject of good faith bargaining between employee representatives and employer(s)?			
(g) Specimen copy of formal announcement containing detailed description to employees? . . .			
(h) A detailed description of all methods, factors and assumptions used in determining costs or actual experience under the plan (including any loading, contingency reserves, or special factors, and the basis of any insured costs or liabilities involved therein) explaining their source and application in detail to permit ready analysis and verification?			
(i) Actuarial report?			
25 In the case of a request involving an amendment, after initial qualification, have the following documents been included:			
(a) A copy of the amendment(s)?			
(b) A description of the amendment covering the items changed and an explanation of the provisions before and after the amendment?			
(c) Balance sheet of the trust or custodial account?			
(d) Statement of receipts and disbursements of the trust or custodial account?			
(e) A completely restated plan? *			
(f) A working copy of the plan in which there has been incorporated all of the previous amendments representing the provisions of the plan as currently in effect? *			
(g) Copies of all amendments adopted since the date of the last determination letter for which no determination letter has been issued by the Internal Revenue Service? *			
(h) Specimen copy of formal announcement containing description to employees?			

* *If plan is being amended for the first time to conform to the participation and vesting standards of the Employee Retirement Income Security Act of 1974, or if the plan has been amended at least three times since the last restated plan was submitted, one of the documents specified under (e) or (f) must be attached.*

If any item in 24 or 25 is answered "No," please explain.

If more space is needed for any item, attach additional sheets of the same size.

☆ U.S. GOVERNMENT PRINTING OFFICE : 1975—O-548-231 16—62330-1

Form **5301** (March 1975) Department of the Treasury Internal Revenue Service

Application for Determination for Defined Contribution Plan

For Profit-sharing, Stock Bonus and Money Purchase Plans

(Under sections 401(a), 405(a), 414(i) and 501(a) of the Internal Revenue Code)

This Form is Open to Public Inspection

File in Duplicate

1 (a) Name, address and ZIP code of employer

Telephone number ► ( )

(b) Name, address and ZIP code of plan administrator, if other than employer

(c) Administrator's identification number ► Telephone number ► ( )

2 Employer's identification number

3 Business code number (see instructions)

4 Date incorporated or business commenced

5 Employer's taxable year ends

6 (a) Determination requested for:
(i) ☐ Initial qualification—date plan adopted ►........ (ii) ☐ Amendment—date adopted ►........
(b) Were employees who are interested parties given the required notification of the filing of this application? . ☐ Yes ☐ No

7 Type of entity: (a) ☐ Corporation (b) ☐ Subchapter S corporation (c) ☐ Professional service corporation (d) ☐ Sole proprietor (e) ☐ Partnership (f) ☐ Tax exempt organization (g) ☐ Other (specify) ►

8 (a) Name of Plan
(b) Plan number ►........ (c) Plan year ends ►........
(d) Is this a Keogh (H.R. 10) plan? . . . . ☐ Yes ☐ No
(e) If "Yes," is an owner-employee in the plan? ☐ Yes ☐ No

9 (a) If this is an adoption of a master or prototype plan (other than Keogh), enter name of such plan
(b) Opinion letter serial number
(c) If this is not an adoption of a master or prototype plan, is the plan and trust (or custodial account) agreement patterned after and substantially the same as another plan and trust (or custodial account) agreement which conforms to the participation and vesting standards of the Employee Retirement Income Security Act of 1974 and on which a favorable determination or opinion letter was issued? . . . . . . ☐ Yes ☐ No
If "Yes," see specific instructions.

10 Type of plan: (a) ☐ Profit-sharing (b) ☐ Stock bonus (c) ☐ Money purchase

11 Effective date of plan

12 Effective date of amendment

13 Date plan was communicated to employees ►........
How communicated ►

14	Section and page number	GOVERNMENT USE ONLY
(a) Indicate the general eligibility requirements for participation under the plan and indicate the section and page number of plan or trust where each provision is contained:		
(i) ☐ All employees; (v) Length of service (number of years) ►........		
(ii) ☐ Hourly rate employee only; (vi) Minimum age (specify) ►........		
(iii) ☐ Salaried employee only; (vii) Maximum age (specify) ►........		
(iv) ☐ Other job class (specify) ►........; (viii) Minimum pay (specify) ►........		
(b) Are the eligibility requirements the same for future employees? . . . ☐ Yes ☐ No If "No," explain ►		
(c) Does the plan recognize service with other employers? . . . . ☐ Yes ☐ No If "Yes," explain ►		

15 Coverage of plan at (give date) ►........ Enter here the number of self-employed individuals ►	Number
(a) Total employed, see specific instructions	
(b) Exclusions under plan (do not count an employee more than once):	
(i) Minimum age or years of service required (specify) ►........	
(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining	
(iii) Nonresident aliens who receive no earned income from United States sources	
(c) Total exclusions, sum of (b)(i) through (iii)	
(d) Balance, line (a) less line (c)	
(e) Ineligible under plan on account of (do not count an employee included in (b)):	
(i) Minimum pay	
(ii) Hourly-paid	
(iii) Other (specify) ►........	
(f) Total ineligible, sum of (e)(i) through (iii)	
(g) Number eligible to participate, (d) less (f)	
(h) Number of employees participating in plan	
(i) Enter percent eligible, (g) divided by (d) . . . . . . %	
(j) Enter percent of eligible employees participating, (h) divided by (g) . . . %	

Under penalties of perjury, I declare that I have examined this application, including accompanying statements, and to the best of my knowledge and belief it is true, correct and complete.

Signature ►________ Title ►________ Date ►________

Signature ►________ Title ►________ Date ►________

Form 5301 (3-75) Page 2

(Section references are to the Internal Revenue Code)	Yes	No	Section and page number	GOVERNMENT USE ONLY
15 Coverage (*continued*):				
(k) If percent in (j) is less than 80, see specific instructions.				
(l) Total number of participants, include certain retired and terminated employees, see specific instructions ▶				
16 Employee contributions:				
(a) Are they mandatory?				
If "Yes," specify rate or rates ▶				
(b) Are voluntary contributions limited to 10% of compensation for all qualified plans?				
(c) Are employee contributions nonforfeitable?				
17 Employer contributions:				
(a) Under a profit-sharing or stock bonus plan, are they determined under— (i) ☐ A definite formula (ii) ☐ An indefinite formula (iii) ☐ Both				
(b) Under profit-sharing or stock bonus plans are contributions limited to— (i) ☐ Current earnings (ii) ☐ Accumulated earnings (iii) ☐ Combination				
(c) Money purchase—Enter rate of contribution ▶				
18 Integration:				
Is this plan integrated with Social Security or Railroad Retirement? If "Yes," see specific instructions.				

19 Vesting:

(a) Vesting Schedule—Check the appropriate box to indicate the vesting provisions of the plan:

- (i) ☐ Full and immediate
- (ii) ☐ Full vesting after 10 years of service
- (iii) ☐ 5- to 15-year vesting, i.e., 25% after 5 years of service, 5% additional for each of the next 5 years, then 10% additional for each of the next 5 years
- (iv) ☐ Rule of 45 (see section 411(a)(2)(C))
- (v) ☐ For each year of service, commencing with the 4th such year, vesting not less than 40% after 4 years of service, 5% additional for each of the next 2 years, and 10% additional for each of the next 5 years
- (vi) ☐ 100% vesting within 5 years after contributions are made (class year plans only)
- (vii) ☐ Other (specify) ▶

(b) If box (a)(v) was checked, check whether you include the following years of service under the vesting provisions of the plan:	Yes	No
(i) Years of service before age 22		
(ii) Years of service for a period during which the employee declined to contribute to plan requiring employee contributions		
(iii) Years of service during which the employer did not maintain the plan or a predecessor plan		
(iv) Years of service excluded under section 411(a)(6)		
(v) Years of service described in section 411(a)(4)(E)		
(vi) Years of service described in 411(a)(4)(F)		

20 Administration:

(a) Fund type of entity: (i) ☐ Trust (ii) ☐ Custodial account (iii) ☐ Non-trusteed

If you checked (i) or (ii), enter date executed ▶

(b) Enter name and identifying number of fiduciary (trustee or custodian), if any: ▶

(c) Enter name and identifying number of fund (trust or custodial account), if any: ▶

	Yes	No
(d) Does trust agreement prohibit reversion of funds to the employer?		
(e) Specify the limits placed on the purchase of insurance contracts, if any: (i) Ordinary life ▶ (ii) Term insurance ▶ (iii) Other (specify) ▶		
(f) If the trustees may earmark specific investments, including insurance contracts, are such investments subject to the employee's consent, or purchased ratably where employee consent is not required?		
(g) If Puerto Rican trust, does it qualify for tax exemption under the laws of Puerto Rico?		

Form 5301 (3-75) Page 3

	Yes	No	Section and page number	GOVERNMENT USE ONLY
21 Allocations and distributions:				
(a) Are contributions allocated on the basis of total compensation? If "No," see specific instructions.				
(b) Enter the maximum amount of employer contribution (or rate of compensation) that may be allocated to a participant ►				
(c) Are trust assets valued at current fair market value?				
(d) Trust assets are valued: (i) ☐ Annually (ii) ☐ Semi-annually (iii) ☐ Quarterly (iv) ☐ Other (specify) ►				
(e) Trust earnings and losses are allocated on the basis of: (i) ☐ Account balances (ii) ☐ Other (specify) ►				
(f) Forfeitures are allocated, in case of profit-sharing or stock bonus plan: (i) ☐ On basis of total compensation (ii) ☐ Other (specify) ► .... and, in case of money purchase plan: (iii) ☐ Reduce employer contributions (iv) ☐ Other (specify) ►				
(g) May vested benefits be forfeited because of withdrawal of a participant's contributions or earnings thereon?				
(h) Normal retirement age is ► .... State years of service required ►				
(i) Early retirement age is ► .... State years of service required ►				
(j) Is the amount distributable at early retirement limited to vested interest?				
(k) Is employer's consent required for early retirement?				
(l) Other event permitting distribution (specify) ►				
(m) Are distributions permitted prior to termination of employment?				
(n) Distribution of account balances may be made in: (i) ☐ Lump sum (ii) ☐ Annuity contracts (iii) ☐ Substantially equal annual installments—not exceeding ► .... years (iv) ☐ Other (specify) ►				
(o) If distributions are made in installments, are they credited with: (i) ☐ Fund earnings (ii) ☐ Interest at a rate of ► ....% per year (iii) ☐ Other (specify) ►				
(p) If insurance contracts are distributed, are the modes of settlement contained in the contracts limited to those provided under the plan?				
(q) Does the plan provide that the payment of benefits, unless the employee elects otherwise, will commence not later than the 60th day after the latest of (1) the close of the plan year in which the participant attains the earlier of age 65 or the normal retirement age specified under the plan, (2) the close of the plan year in which occurs the 10th anniversary of the year in which participant commenced participation or (3) the close of the plan year in which the participant terminates his service with the employer?				
(r) If this is a stock bonus plan, are distributions made in employer stock?				
(s) In the case of a merger or consolidation with another plan or transfer to another plan, will each participant be entitled to the same or greater benefit as if plan had terminated?				
(t) Are loans to participants in excess of their vested interest permitted? If "Yes," explain ►				
(u) Does plan prohibit the assignment or alienation of benefits?				
(v) Does plan permit divestment for cause?				
22 Termination:				
(a) Is there a provision in the plan for terminating the plan and/or trust?				
(b) Are the amounts credited to employee accounts nonforfeitable upon termination or partial termination of the plan?				
(c) Upon complete discontinuance of contributions under a profit-sharing or stock bonus plan are the employees' rights under the plan nonforfeitable?				
23 Miscellaneous:				
(a) Has power of attorney been submitted with the application (or previously submitted)?				
(b) Have you completed and attached Schedule A (Form 5301)?				

Form 5301 (3-75) Page 4

23 Miscellaneous (continued):	Yes	No	Section and page number	GOVERNMENT USE ONLY
(c) Have you completed and attached Form 5302?				
(d) Is the adopting employer a member of a controlled group of corporations or under common control in the case of partnerships and proprietorships? If "Yes," see instructions.				
(e) Is any issue relating to the qualification of this plan or exemption of the trust currently pending before the Internal Revenue Service, the Department of Labor or any court? If "Yes," attach explanation.				
(f) Other qualified plans—Enter for each other qualified plan you maintain (do not include plans that were established under union-negotiated agreements that involved other employers):				
(i) Name of plan ►				
(ii) Type of plan ►				
(iii) Rate of employer contribution, if fixed ►				
(iv) Monthly benefit, if defined benefit plan ►				
(v) Number of participants ►				

24 This section pertains to Keogh (H.R. 10) plans only:	Yes	No
(a) Do owner-employees have the option to participate?		
(b) May benefits be paid to owner-employees before age 59½, except for disability?		
(c) May excess contributions be made for self-employed individuals?		
(d) Is a definition of earned income provided?		
(e) Are distributions of benefits to owner-employees required to commence not later than age 70½?		
(f) Is any self-employed individual covered under this plan also covered under any other plan as a self-employed individual?		
(g) Does plan prohibit the allocation of forfeitures to self-employed individuals?		

25 In the case of a request on an initial qualification, have the following documents been included with the application as required by instructions:	Yes	No	Section and page number
(a) Certified copies of all instruments constituting the plan or joinder agreement?			
(b) Copy of trust indenture?			
(c) Specimen copy of each type of individual insurance contract?			
(d) Balance sheet of the trust or custodial account?			
(e) Statement of receipts and disbursements of the trust or custodial account?			
(f) Evidence that retirement benefits were the subject of good faith bargaining between employee representatives and employer(s)—where that has occurred and is the basis for excluding certain employees, see section 410(b)(2)(A)?			
(g) Specimen copy of formal announcement containing detailed description to employees?			

26 In the case of a request involving an amendment, after initial qualification, have the following documents been included:	Yes	No	Section and page number
(a) A certified copy of the amendment(s)?			
(b) Balance sheet and statement of receipts and disbursements of trust or custodial account?			
(c) A description of the amendment covering the items changed and an explanation of the provisions before and after the amendment?			
(d) A completely restated plan? *			
(e) A working copy of the plan in which there has been incorporated all of the previous amendments representing the provisions of the plan as currently in effect? *			
(f) Certified copies of all amendments adopted since the date of the last determination letter for which no determination letter has been issued by the Internal Revenue Service? *			
(g) Specimen copy of formal announcement containing detailed description to employees?			

If plan is being amended for the first time to conform to the participation and vesting standards of the Employee Retirement Income Security Act of 1974, or if the plan has been amended at least three times since the last restated plan was submitted, one of the documents specified under (d) or (e) must be attached.

If more space is needed for any item, attach additional sheets of the same size.

SCHEDULE A (Form 5301)
(March 1975)
Department of the Treasury
Internal Revenue Service

Plan Characteristics Relevant to the Issuance of a Determination Letter

(Section references are to the Internal Revenue Code)

▶ Attach to Form 5301.

This Form is Open to Public Inspection

Name as shown on Form 5301 | Employer's identification number

The inclusion of any of the following plan characteristics in your plan may preclude the issuance of a determination letter in regard to your plan as provided in Rev. Proc. 75–5 or any modification thereof. Please complete ALL of the following.

Is your plan—	Yes	No
1 A money purchase pension plan (including a target benefit plan) that provides for excluding employees from participation on the basis of maximum age pursuant to section 410(a)(2)?		
2 A plan that provides for determining whether an employee has a year of service, for purposes of section 410(a)(3)(A), relating to minimum participation standards, on any basis other than a 12-month period beginning with the commencement of employment or an anniversary date thereof?		
3 A plan that includes a provision permitted under section 410(a)(5)(C) or section 411(a)(6)(C) with respect to the effect of a one-year break in service on the aggregation of years of service?		
4 A plan (including a target benefit plan) under which the test for prohibited discrimination under section 401(a)(4) is to be made by reference to benefits rather than contributions?		
5 A plan involving the question of credit for service with a predecessor employer or under a predecessor plan?		
6 A plan of an employer that is part of a controlled group within the meaning of section 414(b) or under common control with another trade or business within the meaning of section 414(c)?		
7 A multiemployer plan within the meaning of section 414(f)?		
8 A plan that permits the return of employer contributions for any reason other than because of the plan's initial failure to qualify or because of an excess remaining after its termination and the satisfaction of all plan liabilities?		
9 A plan that provides for forfeitures in the event of withdrawals of employee contributions or increments?		
10 A plan under which employees would be eligible to participate if they had one year of service within the meaning of section 410(a)(3), if any such employees are (1) engaged in the operation of vessels on bodies of water including the high seas, coastal waters and inland waterways and (2) are compensated, pursuant to articles or other similar contracts or agreements, on a basis (either expressly set forth in the governing documents or by practice) of basic pay rates computed in units no smaller than one day?		
11 A plan that permits any forfeiture of an employee's accrued benefit for cause?		
12 A plan that permits the forfeiture of a terminated employee's nonvested interest prior to the time he has a break in service?		
13 A plan involved in a merger or consolidation of plans or in the transfer of assets or liabilities from one plan to another?		
14 A plan under which seasonal employees would be considered to be eligible to participate if they had at least one year of service within the meaning of section 410(a)(3), unless the customary period of employment for all such employees is more than 1,000 hours during a calendar year. (Until regulations defining seasonal employee are issued by the Department of Labor, a seasonal employee is an employee who customarily works less than one-third of his total hours for the calendar year in the six months, whether or not consecutive, in which he works the least number of hours.)?		
15 A plan that does not contain provisions, with respect to credit for hours of service or breaks in service, consistent with those authorized in guidelines published by the Service or the Department of Labor at the time the determination letter is to be issued?		
16 A plan under which it is possible for the 12-consecutive-month period used to determine whether an employee has completed a year of service for purposes of section 410(a)(3) or section 411(a)(5) not to coincide with the 12-consecutive-month period used to determine whether the employee has had a break in service for purposes of section 410(a)(5) and section 411(a)(6)?		

Department of the Treasury
Internal Revenue Service

Instructions for Form 5301

(March 1975)

Application for Determination for Defined Contribution Plan for Profit-Sharing, Stock Bonus and Money Purchase Plans

(Section References are to the Internal Revenue Code Unless Otherwise Specified)

General Information Regarding Application for and the Issuance of Determination Letters with Respect to Defined Contribution Plans under the Employee Retirement Income Security Act of 1974

An advance determination may be sought from the Internal Revenue Service with respect to the qualification of a defined contribution plan and the exempt status of any related trust.

If you intend to request an advance determination, your request should be submitted as early as possible so that if necessary, the plan may be amended, so as to qualify for its first year of operation. Except as provided in section 401(b), an amendment cannot retroactively qualify a plan for a taxable year prior to the year in which the amendment is adopted. Section 401(b) permits certain retroactive amendments provided such amendments are made within the time prescribed by law for filing the return (including extensions) for the taxable year of the employer in which such plan or amendment was adopted or such later time as the Commissioner of Internal Revenue may designate.

Please follow the instructions carefully in completing the application form and check it over before submitting it to make sure the information provided is accurate and complete in all respects. Incomplete applications will be returned without action. In addition, the Internal Revenue Service may rely on the statements attested to in the application as interpretive of the intent expressed in the language of the plan. Incorrect or misleading information on the application may void any favorable determination letter issued in response to your application.

General Conditions Affecting All Applications and Filing Information

This application must be filed in duplicate; but attach only one copy of each document and statement listed in items 25 and 26. Please complete each item on the application. If an item does not apply, so indicate with "NA."

If more than one employer maintains a plan, file one application and attach thereto a separate page one of Form 5301 and a separate Form 5302 for each employer who adopted the plan.

A. Who May File.

1. Any employer (including a sole proprietor or a partnership which has adopted an individually designed Keogh (H.R. 10) plan) or plan administrator desiring a determination letter as to initial qualification or amendment of a plan that does not result from collective bargaining. File Form 5303 for collectively-bargained plans.

2. Any plan administrator desiring a determination letter as to initial qualification or amendment of a plan that involves more than one employer (including controlled groups of corporations and employers under common control) but does not result from collective bargaining. In such case, submit a single application.

3. Any employer or plan administrator desiring a determination letter as to compliance with the applicable requirements of a foreign situs trust as relating to the taxability of beneficiaries (section 402(c)) and deductions for employer contributions (section 404(a)(4)).

Note: *Governmental and church plans, etc., to which the participation, vesting and funding standards in Title II of the Employee Retirement Income Security Act do not apply should not use Form 5301. They should use Form 4573.*

This form may not be filed by a sole proprietor or by a partnership which has adopted a Keogh master or prototype plan previously approved by the Internal Revenue Service.

B. What to File.

1. For initial qualification: The application form in duplicate and a copy of the documents and statements listed in item 25.

2. For Amendments: The application form in duplicate and a copy of the documents and statements listed in item 26.

These forms apply to both individually designed plans and joinders to approved master or prototype (other than Keogh) plans.

A separate application must be filed for each defined contribution plan. The term "defined contribution plan" means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

Whether the application is for an initial qualification or for an amendment, attach a completed Form 5302.

3. For plans of controlled groups of corporations or common control employers, submit the documents and statements listed

in item 25 or 26 and, in addition, attach a list of the member employers and explain in detail their relationship, the types of plans each member has and the plans common to all member employers.

C. Where to File.

1. A single employer must file with the District Director for the district in which the principal place of business of the employer is located.

2. A parent company and each of its subsidiaries that adopt a single plan must file with the District Director for the district in which the principal place of business of the parent is located, whether or not separate or consolidated income tax returns are filed.

3. An employer adopting a single plan of multiple employers (for example a plan for companies related through common ownership or stockholding, other than parent and subsidiaries) must file with the District Director for the district in which is located the principal place of business of the trustee, or if not trusteed, or if more than one trustee, the principal or usual meeting place of the trustees or plan supervisors.

4. Domestic employers adopting foreign situs trusts should file with the District Director in which the principal place of business of the employer is located.

Foreign employers should file with the Director of International Operations, Benjamin Franklin Station, P.O. Box 896, Washington, D.C. 20044.

D. Signature.—The application must be signed by the plan administrator, proprietor, a partner, or principal officer or trustee authorized to sign.

Specific Instructions

1(a). Enter the name and address of the employer.

1(b) and (c). If a plan administrator, other than the employer, has been appointed, enter the name, address and identification number of such administrator. If none appointed, enter "NA."

3. See pages 3 and 4 for a list of business codes. Select the one that best describes the nature of the employer's business and enter the code number on line 3.

6(a). You must check box (i) or (ii) or both. If the plan or amendment was executed, enter the date signed.

6(b). Section 3001 of the Employee Retirement Income Security Act of 1974 states that the applicant must provide evidence that each employee who qualifies as an interested party (see section 7476(b)(1)) has been notified of the filing of the application. Rules defining "interested parties" and providing for the form of notification are contained in the regulations.

7. If the plan involves more than one employer, check box (g) and enter appropriate explanation, i.e., controlled group of corporations, employers under common control, or uncontrolled group of employers.

8(a). Enter the name you designated for your plan.

8(b). You should assign a three-digit number, beginning with "001" and continuing in numerical sequence, to each plan you adopt. Such numbering will differentiate your plans. Enter your three-digit number here. The number that is assigned to a plan must not be changed or used for any other plan.

8(c). Plan year means calendar, policy or fiscal year on which the records of the plan are kept.

9(c). If you checked "Yes" to question 9(c), attach an exhibit that gives the name of the approved plan, the identifying number of the trust or custodial account and the office that issued the letter. Also show the language differences between the two plans and agreements. Failure to show all the language differences may invalidate any letter issued for this plan.

15. Coverage.—In general, if your plan does not meet the requirements of section 410(b)(1)(A) (70–80% rule), you must submit a schedule using the format below to show that your plan meets the requirements of section 410(b)(1)(B). The question of acceptable classification is a continuing one and must be met in all subsequent years as well. You should review your classification at the time you submit your Form 4848, Annual Employer's Return for Employees' Pension or Profit-Sharing Plans.

1	2		3	4	5	6	7
Group	*Compensation range		Total employees	Statutory exclusions 410 (b)(2)	Other exclusions	Employees participating (3 minus sum of 4 and 5)	Participants who are officers or shareholders
	At least	But not more than					
Totals							

*The compensation brackets used must reflect the pay pattern of the employer.

Employees included in collective bargaining.—Section 410(b)(2)(A) provides that a plan may exclude certain employees who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

Nonresident aliens.—Section 410(b)(2)(C) provides that a plan may exclude nonresident alien employees who receive no earned income from the employer which constitutes income from sources within the United States.

15(a). Enter the total number of employees as of the date given on line 15. For Keogh plans, include all self-employed individuals. For a controlled group of corporations and for commonly controlled employers (whether or not incorporated), item 15 must be completed as though the controlled group constitutes a single entity.

15(f). The term "participant" includes retirees and other former employees (and the beneficiaries of both) who are receiving benefits under the plan or will at some future date receive benefits under the plan.

16. Employee contributions.—The term "mandatory contributions" means amounts contributed to the plan by the employee which are required as a condition of employment, as a condition of participation in such plan or as a condition of obtaining benefits under the plan attributable to employer contributions.

18. Integration.—If your plan is integrated with Social Security or Railroad Retirement, a computation appropriate to your situation should be submitted to show that your plan meets the integration requirements.

19. Vesting.—A plan to which section 411 applies must provide that each participant has a nonforfeitable right at all times to the portion of his account balance (if any) attributable to his own contributions. Such a plan must also provide a nonforfeitable right to a percentage of the participant's account balance attributable to employer contributions sufficient to satisfy one of the 3 vesting schedules provided by section 411(a)(2) (i.e. 10 year vesting, graduated vesting over 5–15 years, or rule of 45 vesting). Generally, the vesting schedule of a plan is treated as satisfying the vesting element of the nondiscrimination re-

quirements of section 401(a)(4) if it satisfies the foregoing minimum vesting requirements of section 411. However, in certain cases, additional vesting may be required in order to prevent the turnover of rank-and-file participants from causing prohibited discrimination. Benefits should vest at a rate to assure that rank-and-file employees will appropriately share in the benefits and thus keep the plan from becoming discriminatory in operation. The indicated vesting may be full and immediate, graduated, or deferred, depending upon the facts and circumstances in each case. It may be necessary for us to request additional data in order to determine whether the plan is likely to be discriminatory.

21. Allocations and distributions—*Employer contributions.*—If other than "total compensation" (generally Form W-2 pay) is used as the basis for allocating the employer's contributions, you must show that the allocation formula does not produce discrimination in favor of the prohibited group that is, officers, shareholders and highly compensated employees. As a minimum requirement in establishing the acceptability of the allocation formulas, you must submit with this application a schedule similar in format to the following if there are more than 25 participants in the plan and the plan is not integrated:

1		2	3	4	5
*Brackets based on total compensation		Number of employees in bracket	Total compensation for employees included in compensation bracket	Amount of employer contributions actually allocated to employees included in compensation brackets	Percentage of total (col. 4 divided by col. 3)
At least	But not more than				
Totals					

*The compensation brackets used must reflect the pay pattern of the employer.

Distributions—*Restriction on optional modes.*—Optional modes of distribution must be limited so that if a beneficiary is a person other than the participant's spouse, the present value of the payments to be made to the employee participant shall be more than 50 percent of the present value of the total payments to be made to the participant and his beneficiaries.

In general, if the distribution of benefits is made over the joint life and last survivor expectancy of the participant and his spouse, each periodic payment to the beneficiary shall be no greater than each payment to the participant during his lifetime.

23(*d*). *Controlled group of corporations.*—If the adopting employer is a member of a controlled group of corporations (see section 414(b)) or of commonly controlled partnerships or proprietorships (see section 414(c)) attach statement showing in detail all members of the group, their relationship to the adopting employer, the types of plans each member has and the plans common to all members.

Additionally, item 15 must be completed as though the controlled group constitutes a single entity.

Codes for Principal Business Activity and Principal Product or Service

These industry titles and definitions are based, in general, on the Enterprise Standard Industrial Classification system developed by the Office of Management and Budget, Executive Office of the President, to classify enterprises by type of activity in which they are engaged. The system follows closely the Standard Industrial Classification used to classify establishments.

AGRICULTURE, FORESTRY, AND FISHING

Code

Farms:
0120 Field crop.
0150 Fruit, tree nut, and vegetable.
0180 Horticultural specialty.
0230 Livestock.
0270 Animal specialty.

Agricultural services and forestry:
0740 Veterinary services.
0750 Animal services, except veterinary.
0780 Landscape and horticultural services.
0790 Other agricultural services.
0800 Forestry.

Fishing, hunting, and trapping:
0930 Commercial fishing, hatcheries and preserves.
0970 Hunting, trapping, and game propagation.

MINING

Metal Mining:
1010 Iron ores.
1070 Copper, lead and zinc, gold and silver ores.
1098 Other metal mining.
1150 Coal mining.

Oil and gas extraction:
1330 Crude petroleum, natural gas, and natural gas liquids.
1380 Oil and gas field services.

Nonmetallic minerals (except fuels) mining:
1430 Dimension, crushed and broken stone; sand and gravel.
1498 Other nonmetallic minerals, except fuels.

Code

CONSTRUCTION

General building contractors and operative builders:
1510 General building contractors.
1531 Operative builders.

Heavy construction contractors:
1611 Highway and street construction.
1620 Heavy construction, except highway.

Special trade contractors:
1711 Plumbing, heating, and air conditioning.
1721 Painting, paper hanging, and decorating.
1731 Electrical work.
1740 Masonry, stonework, and plastering.
1750 Carpentering and flooring.
1761 Roofing and sheet metal work.
1771 Concrete work.
1781 Water well drilling.
1790 Miscellaneous special trade contractors.

MANUFACTURING

Food and kindred products:
2010 Meat products.
2020 Dairy products.
2030 Preserved fruits and vegetables.
2040 Grain mill products.
2050 Bakery products.
2060 Sugar and confectionery products.
2081 Malt liquors and malt.
2088 Alcoholic beverages, except malt liquors and malt.
2089 Bottled soft drinks, and flavorings.
2096 Other food and kindred products.
2100 Tobacco manufacturers.

Code

Textile mill products:
2228 Weaving mills and textile finishing.
2250 Knitting mills.
2293 Other textile mill products.

Apparel and other textile products:
2315 Men's and boys' clothing.
2345 Women's and children's clothing.
2388 Hats, caps, millinery, fur goods, and other apparel and accessories.
2390 Misc. fabricated textile products.

Lumber and wood products, except furniture:
2415 Logging camps and logging contractors, sawmills and planing mills.
2430 Millwork, plywood, and related products.
2498 Other wood products, including wood buildings and mobile homes.
2500 Furniture and fixtures.

Paper and allied products:
2625 Pulp, paper, and board mills.
2699 Other paper products.

Printing, publishing, and allied industries:
2710 Newspapers.
2720 Periodicals.
2735 Books, greeting cards, and misc. publishing.
2799 Commercial and other printing, and printing trade services.

Chemicals and allied products:
2815 Industrial chemicals, plastics materials and synthetics.
2830 Drugs
2840 Soap, cleaners, and toilet goods.
2850 Paints and allied products.
2898 Agricultural and other chemical products.

Petroleum refining and related industries (including those integrated with extraction):
2910 Petroleum refining (including those integrated with extraction).
2998 Other petroleum and coal products.

Rubber and misc. plastics products:
3050 Rubber products; plastics footwear, hose and belting.
3070 Misc. plastics products.

Leather and leather products:
3140 Footwear, except rubber.
3198 Other leather and leather products.

Code

Stone, clay, glass, and concrete products:

3275 Glass products.
3240 Cement, hydraulic.
3270 Concrete, gypsum, and plaster products.
3298 Other nonmetallic mineral products.

Primary metal industries:

3370 Ferrous metal industries; misc. primary metal products.
3380 Nonferrous metal industries.

Fabricated metal products, except machinery and transportation equipment:

3410 Metal cans and shipping containers.
3428 Cutlery, hand tools and hardware; screw machine products, bolts, and similar products
3430 Plumbing and heating, except electric and warm air.
3440 Fabricated structural metal products.
3460 Metal forgings and stampings.
3470 Coating, engraving, and allied services.
3480 Ordnance and accessories, except vehicles and guided missiles.
3490 Misc. fabricated metal products.

Machinery, except electrical:

3570 Farm machinery.
3530 Construction, mining, and materials handling machinery and equipment.
3540 Metalworking machinery.
3550 Special industry machinery, except metalworking machinery.
3560 General industrial machinery.
3570 Office, computing, and accounting machines.
3598 Engines and turbines, service industry machinery, and other machinery, except electrical.

Electrical and electronic machinery, equipment, and supplies:

3630 Household appliances.
3665 Radio, television, and communication equipment.
3670 Electronic components and accessories.
3698 Other electric equipment.

Transportation equipment:

3710 Motor vehicles and equipment.
3725 Aircraft, guided missiles and parts.
3730 Ship and boat building and repairing.
3798 Other transportation equipment.

Measuring and controlling instruments; photographic and medical goods, watches and clocks:

3815 Scientific instruments and measuring devices; watches and clocks.
3845 Optical, medical, and ophthalmic goods.
3860 Photographic equipment and supplies.
3998 Other manufacturing products.

TRANSPORTATION, COMMUNICATION, ELECTRIC, GAS, AND SANITARY SERVICES.

Transportation:

4000 Railroad transportation.

Local and interurban passenger transit:

4121 Taxicabs.
4189 Other passenger transportation.

Trucking and warehousing:

4210 Trucking, local and long distance.
4289 Public warehousing and trucking terminals.

Other transportation including transportation services:

4400 Water transportation.
4500 Transportation by air.
4600 Pipe lines, except natural gas.
4722 Passenger transportation arrangement.
4723 Freight transportation arrangement.
4799 Other transportation services.

Communication:

4825 Telephone, telegraph, and other communication services.
4830 Radio and television broadcasting.

Electric, gas, and sanitary services:

4910 Electric services.
4920 Gas production and distribution.
4930 Combination utility services.
4990 Water supply and other sanitary services.

WHOLESALE TRADE

Durable

5010 Motor vehicles and automotive equipment.
5030 Lumber and construction materials.
5050 Metals and minerals, except petroleum and scrap.
5060 Electrical goods.
5070 Hardware, plumbing and heating equipment.
5083 Farm machinery and equipment.
5089 Other machinery, equipment, and supplies.
5098 Other durable goods.

Code

Nondurable

5110 Paper and paper products.
5129 Drugs, chemicals, and allied products.
5130 Apparel, piece goods, and notions.
5140 Groceries and related products, except meats and meat products.
5147 Meats and meat products.
5150 Farm product raw materials.
5170 Petroleum and petroleum products.
5180 Alcoholic beverages.
5190 Misc. nondurable goods.

RETAIL TRADE

Building materials, hardware, garden supply, and mobile home dealers:

5220 Building materials dealers.
5251 Hardware stores.
5261 Retail nurseries and garden stores.
5271 Mobile home dealers.

General merchandise:

5331 Variety stores.
5398 Other general merchandise stores.

Food stores:

5411 Grocery stores.
5420 Meat and fish markets and freezer provisioners.
5431 Fruit stores and vegetable markets.
5441 Candy, nut, and confectionery stores.
5460 Retail bakeries.
5490 Other food stores.

Automotive dealers and service stations:

5511 New and used car dealers.
5521 Used car dealers.
5531 Auto and home supply stores.
5541 Gasoline service stations.
5580 Boat, aircraft and other automotive dealers.

Apparel and accessory stores:

5611 Men's and boys' clothing and furnishings.
5621 Women's ready-to-wear stores.
5631 Women's accessory and specialty stores.
5651 Family clothing stores.
5661 Shoe stores.
5681 Furriers and fur shops.
5698 Other apparel and accessory stores.

Furniture, home furnishings, and equipment stores:

5712 Furniture stores.
5718 Home furnishings, except appliances.
5722 Household appliance stores.
5730 Radio, television, and music stores.

Eating and drinking places:

5812 Eating places.
5813 Drinking places.

Miscellaneous retail stores:

5912 Drug stores and proprietary stores.
5921 Liquor stores.
5931 Used merchandise stores.
5941 Sporting goods stores and bicycle shops.
5942 Book stores.
5943 Stationery stores.
5944 Jewelry stores.
5945 Hobby, toy, and game shops.
5946 Camera and photographic supply stores.
5947 Gift, novelty, and souvenir shops.
5948 Luggage and leather goods stores.
5949 Sewing, needlework, and piece goods stores.
5961 Mail order houses.
5952 Merchandising machine operators.
5963 Direct selling organizations.
5980 Fuel and ice dealers.
5992 Florists.
5993 Cigar stores and stands.
5996 Other miscellaneous retail stores.

FINANCE, INSURANCE, AND REAL ESTATE

Banking:

6030 Mutual savings banks.
6050 Bank holding companies.
6090 Banks, except mutual savings banks and bank holding companies.

Credit agencies other than banks:

6120 Savings and loan associations.
6140 Personal credit institutions.
6150 Business credit institutions.
6199 Other credit agencies.

Security, commodity brokers, dealers, exchanges, and services:

6212 Security underwriting syndicates.
6218 Security brokers and dealers, except underwriting syndicates.
6299 Commodity contracts brokers and dealers; security and commodity exchanges; and allied services.

Insurance:

6355 Life insurance.
6356 Mutual insurance, except life or marine and certain fire or flood insurance companies.
6359 Other insurance companies.
6411 Insurance agents, brokers, and services.

Code

Real Estate:

6511 Real estate operators (except developers) and lessors of buildings
6516 Lessors of mining, oil, and similar property
6518 Lessors of railroad property and other real property.
6531 Real estate agents, brokers and managers.
6541 Title abstract offices
6552 Subdividers and developers, except cemeteries.
6553 Cemetery subdividers and developers.
6599 Other real estate
6611 Combined real estate, insurance, loans and law offices.

Holding and other investment companies:

6742 Regulated investment companies.
6743 Real estate investment trusts
6744 Small business investment companies
6749 Holding and other investment companies, except bank holding companies.

SERVICES

Hotels and other lodging places:

7012 Hotels.
7013 Motels, motor hotels, and tourist courts.
7032 Sporting and recreational camps.
7033 Trailer parks and camp sites.
7089 Other lodging places.

Personal services:

7215 Coin-operated laundries and dry cleaning
7219 Other laundry, cleaning, and garment services.
7221 Photographic studios, portrait.
7231 Beauty shops.
7241 Barber shops.
7251 Shoe repair and hat cleaning shops.
7261 Funeral services and crematories.
7299 Miscellaneous personal services.

Business services:

7310 Advertising.
7340 Services to buildings.
7370 Computer and data processing services.
7392 Management, consulting, and public relations services.
7394 Equipment rental and leasing.
7398 Other business services.

Automotive repair and services:

7510 Automotive rentals and leasing, without drivers.
7520 Automobile parking
7531 Automobile top and body repair shops.
7538 General automobile repair shops.
7539 Other automotive repair shops.
7540 Automotive services, except repair.

Miscellaneous repair services:

7622 Radio and TV repair shops
7628 Electrical repair shops, except radio and TV.
7641 Reupholstery and furniture repair.
7680 Other miscellaneous repair shops.

Motion pictures:

7812 Motion picture production, distribution, and services.
7830 Motion picture theaters.

Amusement and recreation services:

7920 Producers, orchestras, and entertainers.
7932 Billiard and pool establishments.
7933 Bowling alleys.
7980 Other amusement and recreation services.

Medical and health services:

8011 Offices of physicians
8021 Offices of dentists.
8031 Offices of osteopathic physicians.
8041 Offices of chiropractors.
8042 Offices of optometrists.
8048 Registered and practical nurses.
8050 Nursing and personal care facilities.
8060 Hospitals.
8071 Medical laboratories.
8072 Dental laboratories.
8098 Other medical and health services.

Other services:

8111 Legal services.
8200 Educational services.
8911 Engineering and architectural services.
8932 Certified public accountants.
8933 Other accounting, auditing, and bookkeeping services.
8999 Other services, not elsewhere classified.

TAX-EXEMPT ORGANIZATIONS

9001 Church.
9319 Other tax-exempt organization.
9904 Governmental instrumentality or agency.

Case No.	Date ESOP established (a)	Number of employees of the firm (b)	How ESOP trustees are selected—by— (c)	Whether beneficiary can instruct trustee in voting ESOP-owned stock (d)	Whether ESOP permits dividend payout on current basis or reinvests until retirement (e)	Vesting provisions (f)
1	Dec. 30, 1974	117	Management	No	(1)	5 percent yr; 0 to 10 yr; 10 percent yr next 5 yr.
2	Oct. 23, 1975	8	do	No	(1)	50 percent after 3 yr; 5 percent yr to 100 percent.
3	do	139	do	No	(1)	Do.
4	do	66	do	No	(1)	Do.
5	do	34	do	No	(1)	Do.
6	do	19	do	No	(1)	Do.
7	do	20	do	No	(1)	Do.
8	do	19	do	No	(1)	Do.
9	do	22	do	No	(1)	Do.
10	do	10	do	No	(1)	Do.
11	Mar. 15, 1975	284	do	No	Reinvested	25 percent after 5 yr; 5 percent yr for 10 yr; 10 percent yr thereafter.
12	Nov. 29, 1975	33	do	No	No provision	40 percent after 4 yr; 10 percent yr to 100 percent.
13	Dec. 16, 1974	16	do	No	(1)	40 percent after 4 yr ; 5 percent yr for 2 yr; 10 percent for each of next 5.
14	do	38	do	No	(1)	Do.
15	June 27, 1975	36	do	No	No provision	100 percent after 5 yr.
16	Sept. 25, 1975	100	do	Yes	Current	Full and immediate.
17	Oct. 23, 1975	35	No provision	Yes	No provision	10 percent for each yr.
18	July 28, 1975	33,627	Management	Yes	Reinvested	Full and immediate.
19	May 28, 1975	314	do	No	Currently	10 percent yr after 3 yr, to 100 percent after 12 yr.
20	Jan. 1, 1975	16	do	Yes	Reinvested	Full and immediate.
21	Dec. 8, 1975	75	do	Yes	(1)	10 percent for 2 to 3 yr, 5 to 9 percent yr to 100 percent after 15 yr.

[1] At discretion of the administrative committee

Note: Determination letters not yet issued on above ESOP's.

Chairman HUMPHREY. The tax deductible contributions to ESOP's are currently limited to 15 percent of the payroll. That seems to make such a plan unattractive to highly capital-intensive industries.

Would the Treasury support a higher limit on such contributions?

Mr. WALKER. I believe that it is possible to go to 25 percent; if you combine a stock bonus plan and a pension plan, you can go to 25 percent.

Chairman HUMPHREY. I am talking just about a straight ESOP. If you go into a combination of retirement-pension, you get to 25 percent?

Mr. WALKER. Twenty-five percent is right, for a combination stock bonus and money purchase pension arrangement. Otherwise, for a straight stock bonus type ESOP, your 15 percent is correct.

Chairman HUMPHREY. What do you think about a higher percentage?

Mr. WALKER. I do not know why it would not be worthwhile if it would produce desirable results. This requires analysis.

I do not have a closed mind on that.

Chairman HUMPHREY. Senator Long has another question.

Senator LONG. I hope that next year we can come to terms with those of you in the Treasury and this administration to move you away from this Cole Porter line that the rich get richer and the poor have children.

If you want to accumulate capital in this country—and I favor it—I believe we are going to have to get away from this idea that it is too good for the rank and file of America. That has been tried before, and it has not gotten very far.

I do not think it is going to go very far in this Congress until we broaden this thing out to where it has some appeal to the rank and file of the people, particularly the great number of the people that get out there and earn a living by the sweat of their brow for others to enjoy all the good things in life in air-conditioned comfort.

So far, I regret to say these capital accumulation plans have been held in the most climaric areas of the world, in the most desirable circumstances, but I have not seen so much as a labor leader at some of those meetings, some of those fellows were able to enjoy some good things themselves.

It seems to me if you really want to sell a program of capital accumulation, it is going to have to result with something that uses either this employee stock ownership approach or something that has popular appeal.

Otherwise, I think that the whole thing is going to be just one big flop. It sounds like one more attempt to pass a millionaire's amendment in a somewhat different form. You are familiar with that old plan that they tried to get the State legislatures to pass until those legislators found out what it was, so you are going to fix it so no rich man pays no more than 25-percent tax on his income, and you are going to make it back up by putting a general tax on those less affluent than they are.

Do you really think that that kind of approach is going to sell in this country?

Mr. WALKER. That last one I am not familiar with, the one you just described.

Senator LONG. The old millionaire's amendment where they went to all the legislators to try to get through?

Mr. WALKER. I would like to see a copy of that.

Chairman HUMPHREY. That was going strong here in the 1950's. We were really battling around on that one.

Senator LONG. You were probably not interested in those things at that time.

It looked like they were going to get that thing through the State legislatures at a constitutional convention dedicated to an enormous tax rollback, an enormous tax cut for the rich that would not do a damn thing to help 90 percent of the people in this country—pardon my language.

Actually, it got through a lot of State legislatures before they found out what it was. Then of course, the whole thing flopped, and now it sounds like Mr. Walter Wriston, that big bank in New York, under the simplification theory it basically is the old millionaire's amendment all the way.

You are familiar with Mr. Wriston's approach? The idea you would not have to tax anybody more than 25 percent, 30 percent at tops. You would have a real simplified system of no deductions. You are familiar with that approach?

Mr. WALKER. I have certainly heard of that one.

Senator LONG. That is the rebirth of the old millionaire's amendment, as I see it, based on the same thing that the wealthy should not pay a tax at any more than the poor pay. That is the rich man's version of democratic taxation, the rich will pay the same rate as the poor. You need not have a high rate, no deduction, no point in having deductions. Everybody pays from the gross figure at a very low rate.

Mr. Wriston's speech has been mailed out around the country and has had such tremendous appeal, especially people who were not familiar with the history of the millionaire's amendment. I thought that might have inspired the Secretary in the speech he made before the Tax Foundation recently. It has tremendous appeal to it, until you see what happens.

We had a runthrough of that type of approach in the Tax Reform Act of 1969, and that idea that you would have a major cut in taxes for business while you reform the rates, it does not work out that way.

Mr. WALKER. Certainly, I agree with you, Senator. There must be a broad appeal to this, and broad aid that would be designed to aid the economy.

The tendency to oversimplify and the desire for a simplification is itself a dangerous game. It can mean so many things to so many people, and is all in theory until you can get it boiled down to where you can show where it is really going to impact, and on whom.

I, for one, would not favor oversimplification, but the tax system has gotten so complicated now that some redesigning is most appropriate. This gets beyond the scope of this meeting, I am sure, to get into that. It is a high priority item.

This broadening of stock ownership is just a small part of that whole thing, to make stocks more attractive, to make investment in America more attractive to more people so they can participate in the democratic process in the free enterprise system and preserve its integrity. That is what the whole thing is about. It is the question of how we get there.

We would like to work with the Congress, certainly, in every way we can to bring this about.

Chairman HUMPHREY. We will let you go now. You are a little late.

Would you identify the two colleagues with you?

Mr. WALKER. This is Associate Tax Legislative Counsel-Designate, Miss Patricia Metzer; and Mr. Gabriel G. Rudney of our Office of Tax Analysis.

Chairman HUMPHREY. Very good. Thank you.

We want Mr. Kelso, Mr. Brems, Mr. Brannon, and Mr. Fay.

Mr. Kelso, you have been the subject of some considerable comment this morning and I imagine you will be the subject of considerable comment in the days to come.

We are going to let you take off here right now. You have heard all of the testimony of Mr. Walker and the questions.

What we want to do here is not to have you read all of your prepared statement. We will include it in the record. I say this for all of you. We will include the prepared statements in the record.

We would like you to paraphrase briefly and let us get at you with some questions, because we have members here deeply interested in

what you have to say—not only you, Mr. Kelso, but each of the participants.

If you will do that, we will proceed along, and conduct this hearing close to 1 o'clock.

STATEMENT OF LOUIS O. KELSO, MANAGING DIRECTOR, KELSO BANGERT & CO., SAN FRANCISCO, CALIF.

Mr. KELSO. Thank you, Mr. Chairman. I want to express my extreme pleasure for the opportunity of appearing before you.

I understand my initial statement must be very short. I will try to make it so.

First, I gather that you have consented that my prepared statement may be made a part of the record?

Chairman HUMPHREY. Yes, indeed.

Mr. KELSO. Referral is made there to five exhibits that I also would like, if I may, to have printed as a part of the record. Those have been furnished to the staff of the committee.

Chairman HUMPHREY. They will be printed as a part of the record. Your statement is of substantial size.

Mr. KELSO. I and my staff have lost a lot of sleep preparing them.

Chairman HUMPHREY. I am sure it is very informative. May I say, it will not be looked at quickly; it will be studied very carefully. We are deeply interested in what you have to offer.

All of the exhibits and all of the material pertaining thereto will be made a part of the record at the end of your oral statement.

Mr. KELSO. These hearings are directed at ESOP's—employee stock ownership plans. There is on the easel——

Chairman HUMPHREY. Will you turn the easel around so members of the committee can see it?

Mr. KELSO [continuing]. A series of charts, the first one of which, by the way, is printed on page 3 of my prepared statement, so you also have it before you.

The object of this is simply to show that the ESOP is the tip of the iceberg, as it were; that it is only one manifestation or one financing technique built upon the fundamental theory of two-factor economics. This theory is simply the assertion that capital instruments in general produce goods and services, or contribute to their production, in the same way that people do and among the things that I would particularly call your attention to, and will refer to a bit later, is the fact that there are other techniques of finance built on two-factor economics that apply to public utilities, for example, that build part of the ownership of stocks representing newly formed capital into the workers and the great bulk of such ownership into the consumers.

The purpose of this chart is to show that the implications of two-factor economics go way beyond the employee field, that it has deflationary implications, that it has very strong implications for monetary reform and the acceleration of the ability of the economy to raise newly formed capital—one of the most serious problems facing our country today.

Let me pass now to the second chart that I would like to show you. It is reproduced at page 7 of my prepared statement. This chart

really lays the foundation for the need for broadening the proprietary base.

The chart in general is designed to show the change in input mix over the period of recorded history, 3000 B.C. to the year A.D. 2000, if you divide the input factors involved in economic production into people and nonpeople, people and things, people and capital, or whatever terms you want to use.

Think of these input factors in physical terms, because the production of goods and services is really a physical process, as is their consumption. From the beginning of recorded history to today, it is my belief that the relative inputs of these two factors have roughly traded places.

Whereas in 3000 B.C. labor unquestionably provided well over 90 percent of the productive input, today, I believe that it provides well under 10 percent, and that capital, or the nonhuman factor, provides well over 90 percent of productive input.

When you say this to the high priests of the conventional wisdom, the conventional economists, they will say you certainly must be dreaming; do you not know that three-fourths of the income is paid to labor for its productive input?

My reply to that is, we have spent 40 years in the United States trying to repeal the law of supply and demand as it applies to the price of labor. I do not think that you can do that and get away with it anymore than you could get away with attempts at repealing the law of gravity.

We do not make a man more productive by paying him more.

The import of this is quite simple. The method of engaging in production is changing because of the onrush and acceleration of technological change and the only way to offset that so that men's outtake is both adequate and is based on their input is to build the ownership of the other factor of production into the masses of people.

ESOP is but one of the tools for doing that.

The alternative to making the underproductive more productive by making them capital owners, of course, is to attack the effects of poverty, which we have been doing for years. We subsidize people who cannot buy houses or rent houses. We subsidize health care. We subsidize education. We subsidize all kinds of jobs.

You do not have to do that if you build productive power into the masses so that they are economically self-sufficient, so that we can stop attacking the effects of poverty and attack, as the ESOP and other financing techniques using the two-factor theory does, the cause, the one cause; namely, the low productiveness of the human being who is not aided by a viable holding of the ownership of the thing that embodies technology, the other factor of production—capital.

It is perhaps interesting to note that the studies which are cited at page 38 in my prepared statement—all the significant qualitative studies ever made—show that the top 5 percent of consumer units own all of the capital in the U.S. economy. The recent New York Stock Exchange study, showing an 18-percent drop in the number of stockholders since 1970, it should be remembered, is a quantitative study.

The ownership of significant capital holdings has shrunk from 50 percent at the turn of the century; then capital was largely represented

by land, because the Homestead Acts, and prior to them, the open frontier, made it possible for the man born without capital to come over here and get a piece of the action.

We have not had an industrial equivalent of the Homestead Acts until we come to the ESOP's. That is what it is all about.

I would like now to turn to another chart—this is printed on page 9 of the prepared statement—which shows that conventional finance, instead of offsetting the effects of technological change, actually exacerbates the degree of concentration; that is to say, as capital provides more and more of the productive input, we narrow, rather than broaden, through conventional finance, the ownership base.

This little diagram really represents quite a lot more than is found on its face. Let us say that a corporation has determined that it can sell some more of its products and wants to expand and has to buy some plant, rolling stock, or buildings to do it. There are a number of ways it can do this. It can earn profits and accumulate those profits. It is not required to pay them to the stockholders. It can accumulate the profits, and pay its corporate income taxes on them. When it has accumulated enough, it can buy its new capital instruments. Or it can borrow and then in after-tax dollars, out of its internal cash flow, we repay the loan. Or, if it can get a direct infusion of capital from the Government, which the investment credit does, or it can use techniques of accounting that permit it to form capital through accounting practices founded on legislation permitting, for tax purposes, accelerated depreciation and depletion.

Let me summarize by saying that if you average the last 15 years, these techniques of finance—I omitted one, which I will mention in a moment—these techniques of finance, involving financing from internal cash flow or through borrowings repaid from internal cash flow, provide 98 percent of the total new capital formation in the U.S. economy. In recent years, this amounts to well over $100 billion per year. These dominant—98 percent—techniques of corporate finance have one thing in common. When the financing period is completed, not a single new stockholder is created, not a one.

In other words, these techniques of finance are exquisitely designed to build incremental productive power into those who do not need it now, or potentially ever, and to deny productive power to the people who make up the markets for most of the goods and services this society could produce. Thus the combined concentrating forces of technological change and conventional corporate finance propel government into redistributing wealth, subsidizing everything, and going into ever more staggering debt, because business does not conduct itself in a way that answers the question, "How does the customer get the money to buy?"

The one conventional technique that is so far left out of this discussion—that is to say, the sale of new stock to the public for cash—accounts for a little less than 2 percent, averaged over the past 15 years. That does not change the picture either. The purchase of their television sets, their automobiles, and so forth, are the 5 percent newly issued stock is a nonfinancible transaction. With rare exceptions, the only people that have cash over and above the requirements of their daily living and paying the mortgages on their homes, their television sets, their automobiles and so forth, are the 5 percent who own all of the capital in the first place.

They are the ones who can buy the newly issued stock. Frankly, therefore, 100 percent of conventional financing techniques are designed, basically, to make the rich richer and keep the poor poor. This is the way it is. A few geniuses and unusally lucky people can acquire viable capital holdings from a cold start in spite of the obstacles of conventional finance, but an economy cannot be satisfactory operated on rules that favor only geniuses and unusually lucky people.

The poor, without being guided by Congress or by the people of recognized wisdom, simply demand jobs and welfare. And what do they get? Jobs and welfare. They stay poor.

This tells you what the real source of the problem is in the U.S. economy. Corporate business strategy is built around three very simple concepts: Maximizing production and sales, minimizing costs, and staying out of trouble.

This last precept gets to be more important, of course, with the growing impact of our defective business strategy. The missing link in this corporate strategy is that it does not explain how the customers get the money to buy. It is even worse than that, it explains why they do not get the money to buy the goods and services they need and want.

When you minimize costs, the best way to do it is to automate, to substitute machines for men, structures for men, chemical processes for men. Thus, the corporation, you might say, is engaged in customercide. It eliminates its employee constituents through automation, and eliminates possible stockholder constituents through conventional finance.

The next chart, which is reproduced on page 11 of my prepared statement, is the basic ESOP design. It is an error to think of this as a retirement thing. It is a device to build capital ownership into people, to make them economically self-sufficient, to make them productive, even though at some point they cannot engage in production through both their factors; that is, their labor power and their privately owned capital. They may be retired. They may be too old to work. They may become technologically redundant eventually.

Having a viable capital estate enables them to be productive through that capital estate.

Basically, the mechanism of the ESOP is now well known. It is simply financing the growth of the corporation through an employee stock ownership trust, and the difference between this and conventional finance is that when a particular financing process is completed, the employees have bought stock, paid for it out of what the underlying capital produced, in pretax dollars which accelerates the process because the law permits this to be done, and the corporation has gotten the advantage of low-cost capital.

Please permit me to make a couple more comparisons.

Under conventional finance, suppose the corporation desires to set up a retirement system. Of course, any employee knows he is going to be retired some day. He has got to have some way of living decently beyond that event. There normally will be great pressure on corporate management to put in a retirement system, and the conventional way is to put in a pension system, or a profit-sharing plan. These are normally, with a few rare exceptions—even some spectacular ones—are invested in what I would call "other people's

pieces of paper;" from the standpoint of the corporation itself. Such a retirement system is pure cost. It does not help the corporation to grow, yet capital is the lifeblood of the corporation. Capital is what enables the corporation to grow.

Because conventional profit sharing and pension plans are 100 percent cost, the corporation naturally tends to minimize its payments into them. Corporations operate on principles of cost minimization.

Under the ESOP, on the other hand, the very dollar that finances the corporation's growth, finances the ownership of company stock by the employees. One dollar does the work of two.

It does not end there.

Through the ESOP, the corporation can finance its growth on pretax dollars. One pretax dollar does the work of two.

So if you compare conventional finance and retirement systems on the one hand, with ESOP financing on the other, the corporation is getting $3 mileage on each dollar spent through an ESOP, as compared to 1 dollar's mileage on each dollar spent under conventional finance and retirement systems.

The advantages are overwhelming.

The next chart that I would like to refer to is reprinted on page 17 of my prepared statement.

This chart is designed to show what the adoption of a national economic policy based on two-factors theory would mean to the macroeconomy—what the big picture is.

Let me say, Mr. Chairman, this chart, simple as it is—do not ask me why, I cannot explain why—is one of the hardest things in the world for certain types of people to understand.

It is only hard because there is deeply instilled, in the human mind, probably from millions of years back, the idea that you can only finance newly formed capital through accumulated savings. This is a false idea. It is rank nonsense.

Its alternative is the idea that you can finance new capital formation out of future savings, or what I would call pure credit. I wish I could claim authorship of this idea. If this economy survives, it is going to be because that concept is so basic and so important that it is going to change history. It makes the possibility of an economically self-renewing society a realistic thing.

The idea of pure credit comes from Harold Moulton, who many years ago, you remember, was the president of the Brookings Institution. in a book published in 1935 called "The Formation of Capital".

Let us say the corporation here is the same as the one on the standard ESOP diagram on page 11 of my prepared statement. The ESOP is the same, the lender is the same. We have simply added here two new institutions.

One, we call the Capital Diffusion Insurance Corporation or "CDIC". It is simply the counterpart of the FHA housing finance insurance program vis-a-vis ESOP financing. It lowers the banks' resistance to make ESOP loans. It spreads the risk of the failure of any particular ESOP loans over the whole economic base, the broad base. Conceptually, it is well-proven financial technology.

The next step is the one that is tough to understand. This is the one that harnesses pure credit to the growth of the economy; to the

financing of basic, self-liquidating, new capital formation, in well-managed businesses.

How do you do that?

You do it by making the ESOP paper held by the bank, insurance company or other lending institution directly discountable with the Federal Reserve Bank.

Let me point out, first, that the discounted ESOP debt does not go into the Government's accounts at all. It does not become government debt in any sense of the word.

The pure credit concept is based upon the power of people in an organized society to contract with each other in contracts payable in money. The discounting with the Federal Reserve is simply the final link that closes the contract. It must be limited to self-liquidating, newly formed capital in well-managed businesses, and here is how I believe the interest rate should be computed under this use of pure credit.

Sit very tightly in your chairs.

Pure credit properly used, is a fundamental right of every citizen. Every person, simply by being a member of this society, should have access to it, if that is necessary to restore the productiveness that technology has taken away from him or her.

I believe that the way you compute the interest rate, is first, you establish a discount rate based on the actual administrative cost of handllng the discount process to the Federal Reserve Bank. Now, even though there are some very high salaries and very plush offices over there, and the price of paper and ink is going up, I believe that a discount rate so computed cannot exceed one-half of 1 percent per year. I believe that the premium of the Capital Diffusion Insurance Corp., because it insures self-liquidating capital, should be something like one-sixteenth of 1 percent, maybe one-eighth, certainly no more.

The final element in that interest cost is the administrative cost and the profit to the bank or the insurance company or the savings and loan firm (if the power to make such loans is extended to them as I believe it should be) that initially makes the ESOP loan.

That lender approves the original feasibility study, and then services the loan.

As of now, something like 8 percent of the total new capital formation process flows through the banking system. Under this technique, I would predict 50, 60, or 70 percent of it would flow through the banking system.

I believe that those institutions would not only be healthy, but they would be fat, if their share of the ESOP-loan interest rate were somewhere between 1 and 2 percent. I would hope it is closer to 1 than 2.

We are, therefore, talking about, at most, a 3 percent interest rate, to finance basic, self-liquidating new capital formation to get the American economy growing again, to build the powerplants, the rapid transit systems, the interurban systems, the housing, the hundreds of things we cannot do at 10, 12, 14, 18 percent interest rates.

Duke Power Co. the other day issued 14 percent bonds. That is murder. You can build three atomic plants with the same capital investment at 3 percent as you can at 14 percent interest rates.

This ESOP—Federal Reserve discount financing would free up accumulated savings for conventional financing of economic growth by banks, insurance companies and savings and loan firms for use for

consumer credit, for venture capital credit, and for use, to the extent that they want to match the interest rates, for pure credit in ESOP financing, for new capital formation.

I have no disagreement with the argument of the banker when he pushes the interest rate as high as he can. He says, "I am just a steward. I am loaning other people's money. It is my duty." I agree. He is stuck, and so is the borrower.

When you use pure credit for the people to build productive power into the people and to expand the economy, so that it becomes a great, strong economy, our economy will be capable of producing a high standard of living for everyone and capable of employing everyone in its expansion for at least two to three decades, with the most intense full employment, because we would then be building market power into the people through broad ownership of the second factor of production.

Now, there is one other thing I would like to talk about.

Chairman HUMPHREY. Could you now bring your case to a close? I do not want to deny other people a chance to be heard. I know it is difficult.

Mr. KELSO. I would like only to mention one point, and that is to show how easy it is to make a dreadful mistake if you do not understand two-factor economics and cannot analyze what is happening.

There is a thing called the investment credit. At the moment it is 10 percent, plus an optional 1 percent. Investment credit is simply a gift—enforced by Congress—from all taxpayers to corporations that put in certain kinds of newly formed capital during the tax year.

Since all the qualitative studies to date show that a mere 5 percent of the consumers own all of the capital stock of those corporations, Congress in the investment credit, as it stands, legislates an $8.4 billion annual gift from the poor, the middle class, and the rich—to the rich.

Now, this is incredible. This is unbelievable. This is suicide. They have too much productive power to begin with.

Senator Long's amendment, which really requires a capitalization of 1 percent, if you want to take that extra 11 percent, is only a tiny crack in the door. If you want to protect the capital ownership of the existing stockholders—and I do not think you can build a private property society on taking anybody's capital away from them—if you want to protect the status quo, you would capitalize 95 percent of the investment credit and put it in an employee stock ownership trust for the employees. It is 100 percent paid for by the taxpayers. The corporation gets the investment; the taxpayers have paid for that stock fully; and you would let 5 percent of it flow to the existing stockholders, because they constitute 5 percent of the consumer units in the economy.

I thank you very much, sir.

Chairman HUMPHREY. Mr. Kelso, I must say that you present a tremendously challenging and fascinating discussion of a complex but understandable proposal. We are going to have to spend much more time with you. We want to listen to some others.

We will place your prepared statement and exhibits, Mr. Kelso, in the record at this point.

[The prepared statement and exhibits of Mr. Kelso follow:]

PREPARED STATEMENT OF

LOUIS O. KELSO

BEFORE THE
JOINT ECONOMIC COMMITTEE
NINETY-FOURTH CONGRESS

December 11 and 12, 1975

EMPLOYEE STOCK OWNERSHIP PLAN FINANCING AND OTHER FINANCING CONCEPTS BASED ON TWO-FACTOR ECONOMICS

HEARINGS

before the

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

Ninety-Fourth Congress

First Session

December 11 and 12, 1975

Testimony By Louis O. Kelso, Managing Director
Kelso Bangert & Co. Incorporated, Investment Bankers
San Francisco, California

on

Two-Factor Economics and

Corporate Financing Techniques

Designed to Implement Its Goals.

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I

STATEMENT OF OBJECTIVES OF HEARING BY THE HONORABLE HUBERT H. HUMPHREY, CHAIRMAN.

By Invitation, dated November 20, 1975, in a letter addressed to me, as the chief executive officer of Kelso Bangert & Co. Incorporated, Investment Bankers in San Francisco, the Chairman advised that two days of hearings would be held on December 11 and 12 "focused on Employee Stock Ownership Plans (ESOPs)." The Chairman further stated, and I congratulate him on his initiative, that "The purpose of the hearings is to provide the first Congressional forum for a wide-ranging, yet in-depth examination of ESOPs."

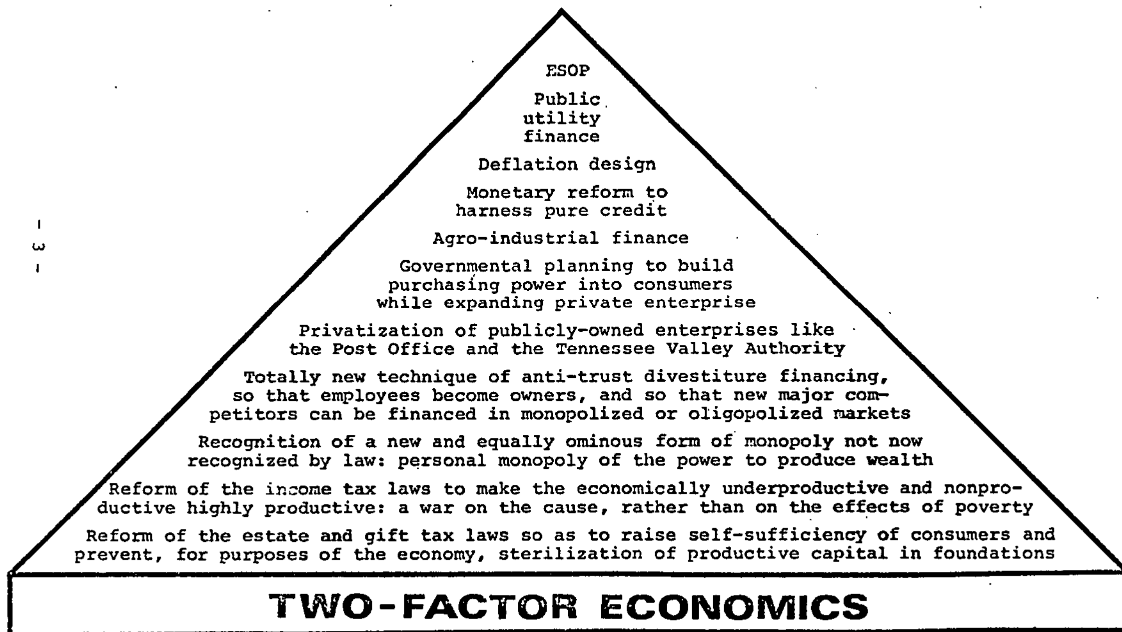
These hearings are indeed most timely, for it is evident to every citizen in this land that the fundamental economic idea upon which our national economic policy is structured, namely, that we can solve our income distribution problems entirely through employment and through attempts to repeal the law of supply and demand as it applies to the price of labor, is an obviously erroneous idea; it is an idea that has delivered us into a state of economic crisis. There can be no recovery from this crisis, in my opinion, nor indeed an avoidance of total collapse of the economy, unless we modify and enlarge our economic policy to comprehend both factors of production (capital as well as labor), the distribution of those two factors among the consumers of the economy, and, as to the non-human factor of production, or capital, the degree of concentration of its ownership and the causes of that concentration.

II

<u>ESOP FINANCING IS BUT THE TIP OF THE ICEBERG, THE VAST BULK OF WHICH IS GENERALLY UNKNOWN, AND THE BASE OF WHICH IS A CHANGED AND ENLARGED ECONOMIC POLICY OR FUNDAMENTAL OPERATING ECONOMIC CONCEPT WHICH I HAVE CALLED "TWO-FACTOR THEORY"</u>.

Indeed, ESOPs are but one--though an important one--of many actual and potential implementing techniques structured upon the concepts of two-factor economics.

ESOP Financing is but One of the Important Corporate Financing Reforms Structured upon Two-Factor Theory: The New Concept in Political Economy



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III

A BRIEF EXPLANATION OF TWO-FACTOR ECONOMICS AND OF EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) FINANCING

This new basic concept, called "Two-Factor Economics," is a simple and straightforward one. The reasoning runs as follows:

1. While it is true that people, doing their various tasks of participating in the economy in one way or another, are a basic source of productive input, they are not the <u>only</u> source of productive input.
2. Just as obviously, non-human things, like land, structures, and machines also provide productive input into the economy.
3. The division of the input sources into two types is both necessary and adequate, because the ownership of <u>labor</u> power cannot be concentrated and the ownership of non-human things can easily be concentrated. It is, after all, an individual's <u>property</u> in an input factor that entitles him to receive what it produces.
4. Both under the logic and the morality of a market economy, it is productive input by each individual that is the basis for his receipt of income. Economic input is the basis for economic outtake or personal income.
5. Technological change, which is the phenomenom underlying the "industrial revolution," which began some 200 years ago, and our own so-called automation revolution, and

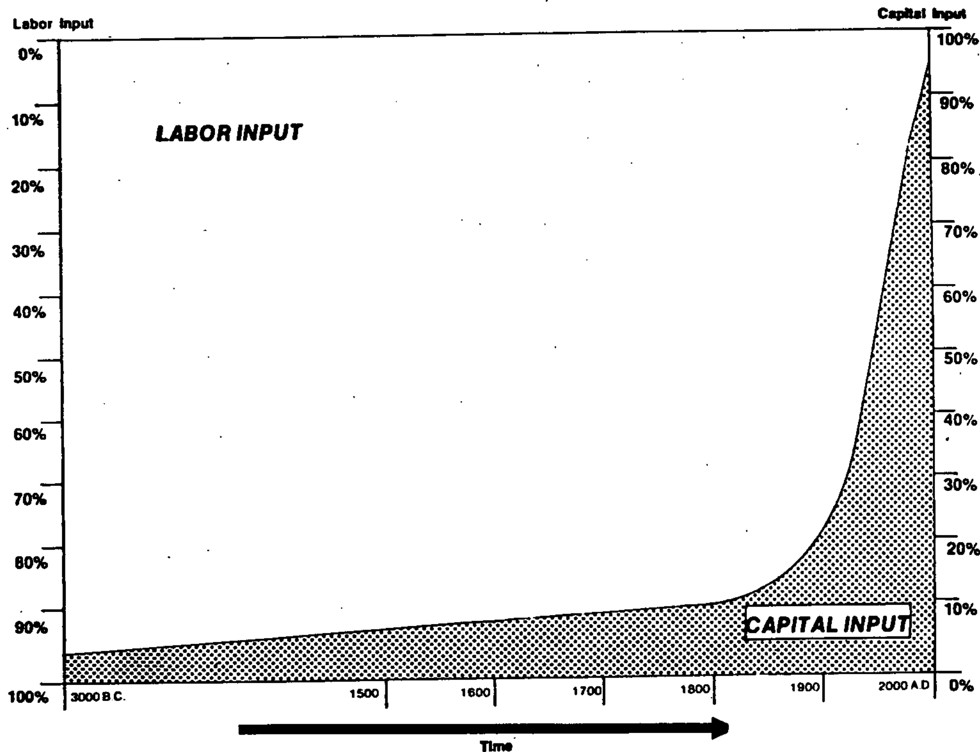
indeed of all the intermediary revolutions brought about by science and technology, changes, and is intended to change the input mix. It shifts the productive burden off labor or the human factor and onto capital or the non-human factor. Technological change does not operate directly upon humans at all; it cannot increase the economic productiveness of an individual worker, as such. The economic productiveness of human beings--what they can physically accomplish with their unaided muscles or minds--has not changed during the course of history, so long as the value of that productiveness is determined competitively by the free operation of the law of supply and demand.

6. So far has this process of technological change gone in the U.S. economy that today most of the goods and services are produced by things and only a minor portion of the productive input is made by people. With rare exceptions, it is capital that produces affluence, while labor, in a free labor market, can at best normally produce only subsistence. The relative distribution of aggregate personal income between workers (roughly 3/4th), and the owners of capital (1/4th) does not reflect this relatively higher productive input by capital because our governmental economic policy (the Employment Act of 1946) attempts to repeal the law of supply and demand as it applies to the

value of labor: minimum wage laws, coercive fixing of wages, vast governmental make-work programs, governmental subsidies to industry and to other governmental entities, etc.

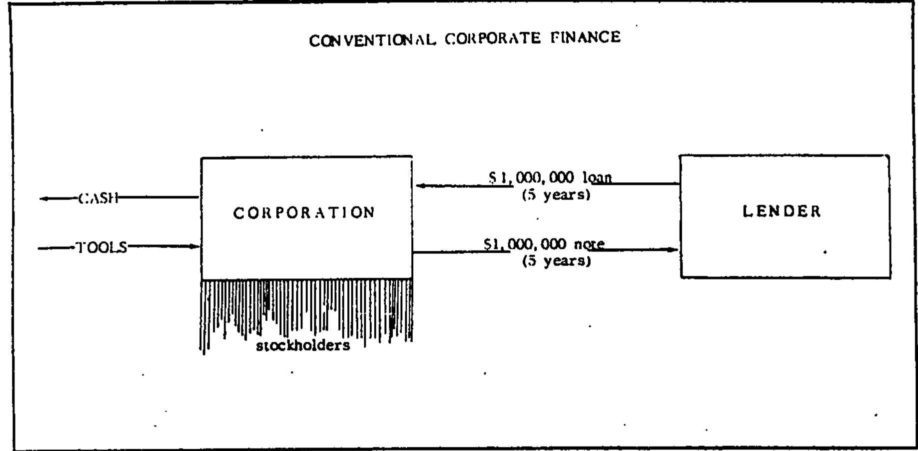
The costs of all such efforts enter into the cost of production either directly or indirectly and are thus inflationary. They become part of the costs of goods and services. These attempts to overvalue labor constitute the monetization of welfare.

THE FUNCTION OF TECHNOLOGICAL CHANGE IS TO SHIFT THE BURDEN OF PRODUCTION OFF THE HUMAN FACTOR (LABOR) AND ONTO THE NON-HUMAN FACTOR (LAND, STRUCTURES & MACHINES, I.E., CAPITAL)



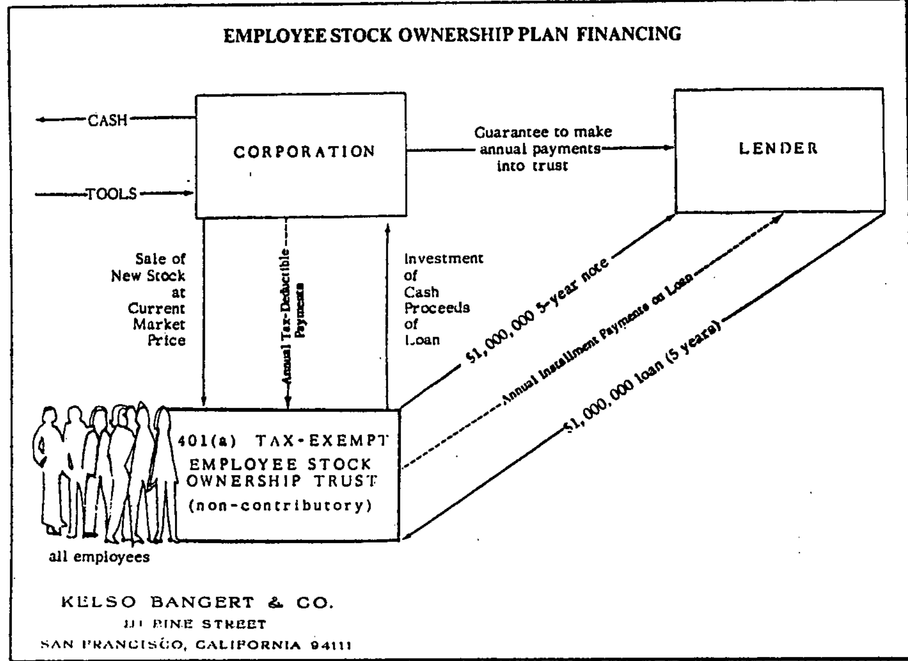
Estimated on the assumption that the value of each factor's input is determined in reasonably competitive markets.

7. The changing of the input mix in favor of capital would create no problems within the economy, even under competitive labor markets, if it happened that as technology enlarges the participation of capital in the production of goods and services and diminishes--relatively speaking--the participation of labor, workers simultaneously acquired the ownership of capital, offsetting their diminished productive power, or even better, increasing it, through their ownership of the other factor.
8. Unfortunately, the traditional techniques of finance do exactly the reverse of what is required: they assure that all newly-formed capital becomes automatically owned by those who previously owned all existing capital. Thus, the $100 billion-plus of new capital formation that comes into being in the economy of the U.S. each year becomes owned by a tiny capital-owning base: 5% of the consumer units at most. If averaged over the past 15 years, about 98% of new capital formation in the corporate sector (which produces over 85% of the goods and services of the private sector), is financed out of direct cash flow or borrowings repaid out of cash flow.


CONVENTIONAL CORPORATE FINANCE
CASH
TOOLS
CORPORATION
stockholders
$1,000,000 loan
(5 years)
$1,000,000 note
(5 years)
LENDER

These overwhelmingly dominant methods of financing new capital formation have one characteristic in common: not a single new stockholder is created in the process. The minor percentage of new capital formation (about 2%) financed by sale of equity stock to the public does not alter this propensity. It is the top 5% of consumer units (in whom, as every qualitative study to date has shown, ownership of virtually all capital is lodged) that have the excess funds to buy newly-issued stock.

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 which will then go on throwing off wealth indefinitely, its productive power being replenished 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.


EMPLOYEE STOCK OWNERSHIP PLAN FINANCING
CASH
TOOLS
CORPORATION
Guarantee to make annual payments into trust
LENDER
Sale of New Stock at Current Market Price
Annual Tax-Deductible Payments
Investment of Cash Proceeds of Loan
$1,000,000 5-year note
Annual Installment Payments on Loan
$1,000,000 loan (5 years)
401(a) TAX-EXEMPT EMPLOYEE STOCK OWNERSHIP TRUST
(non-contributory)
all employees
KELSO BANGERT & CO.
111 PINE STREET
SAN FRANCISCO, CALIFORNIA 94111

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 nonexistent savings.

11. Under two-factor techniques, means are provided 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 rises in step with the productive output of the economy.

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 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.

*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 workers' pockets.

IV

THE CONCEPT OF TWO-FACTOR ECONOMICS IS A POWERFUL GOVERNMENTAL TOOL TO GUIDE ECONOMIC PLANNING, TO ACHIEVE ECONOMIC GROWTH, ECONOMIC STABILIZATION, REDUCTION OF INTEREST RATES, AND THE BUILDING OF MARKET POWER INTO THE FINANCIALLY UNDERPOWERED MAJORITY OF CONSUMERS

Congress and the Administration need new and powerful tools to solve the twin problems of inflation and unemployment, and to attain a growth rate that will eliminate the cause of poverty within a few years.

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-suffiency 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 maintain a favorable balance of payments; build within the next decade 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 eliminated 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 by several magnitudes those of any past decade.

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, through our deliberate use of the economic tools given to us by two-factor economics, 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 in a highly-industrialized economy in which the bulk of productive input is capital input. 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 in business, industry and agriculture, strive ceaselessly to eliminate

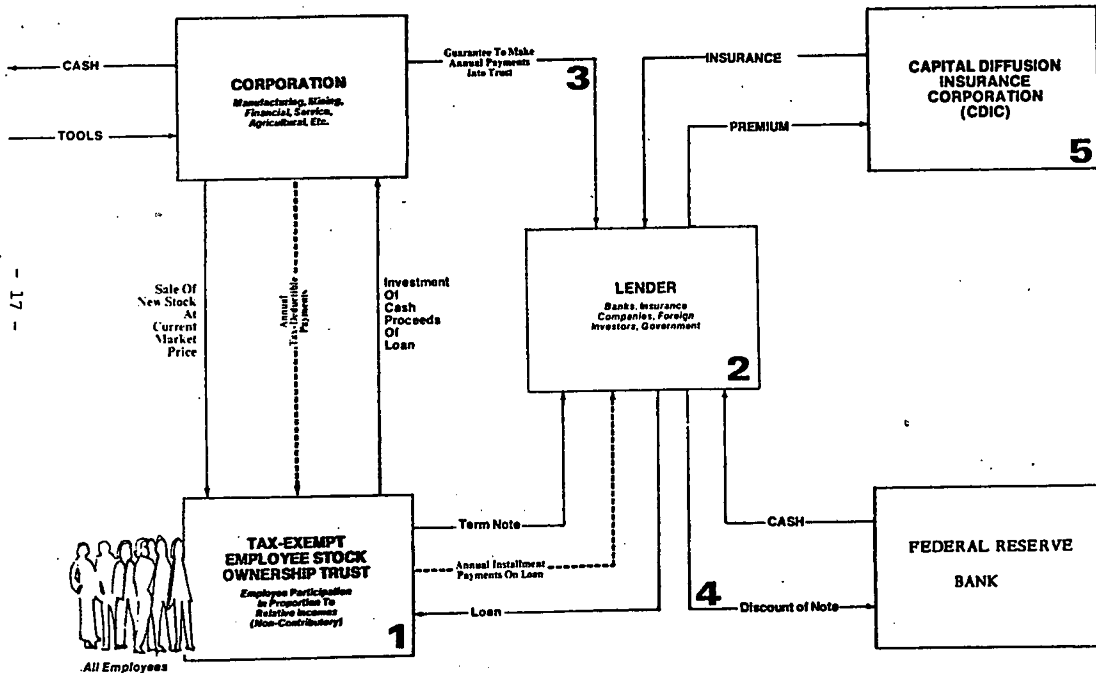
employment to minimize costs. Inflation flows relentlessly and unendingly from attempts of the Federal government to reconcile these unreconcilables, all of which take the form--recognizable or not--of the monetization of welfare. Money representing welfare is inflation in its essence.

THE BLUEPRINT FOR THE NEW ECONOMIC POLICY

The following diagram illustrates the use of pure credit to finance self-liquidating new capital formation in basic, well-managed businesses:

69-174 O - 76 - 11

FINANCING ECONOMIC GROWTH BY MONETIZING PRODUCTIVE CAPITAL WHILE BUILDING MARKET POWER INTO CONSUMERS THROUGH EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) FINANCING*



--<u>EXPLANATORY NOTES</u>.

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 <u>payable in pre-tax dollars</u>. In tax theory, this is a contribution to a qualified employee trust. In two-factor 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 to the trust representing the beneficial owners of the stock.

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. The only cost of risk involved in the fixing of the interest rate should be the CDIC insurance premium. (See Paragraph 5 below.)

5. We recommend that Congress organize a capital financing counterpart of the FHA Insurance Fund which is 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], republished by Greenwood Press, Westport, Connecticut [1975]; 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.)

6. 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 several 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], 406[d][6], 408[b][3], 408[e], 2003[a], 4975[d][3], 4875 [d][13], 4975[e][7].)

7. The diagram above, in stark and simple terms, demonstrates the enormous problem-solving power available to government through the use of financing techniques built upon the principles of two-factor economics.

The underlying basis for the exercise of this power is simply the unquestioned right of each person within the jurisdiction of the United States to life. The right to life, in terms of two-factor economics, implies the right (and the correlative personal duty) to peaceably and legitimately produce the income to support life and make life comfortable at a level compatible with our resources, our technology, our manpower, and our know-how. Contrast the difference between this position and that taken by the supporters of the "guaranteed annual income," who hold that the right to life implies the right to receive a viable income irrespective of productive input. Proponents of the guaranteed annual income are strangely silent about the guaranteed perpetual tax servitude that this unavoidably implies for the rest of the population.

8. Inasmuch as the overwhelming bulk of our goods and services is produced through the input of the non-human factor of production--land, structures, machines, and to a certain degree, intangibles, such as firms and patents--the right of each man to produce the income equivalent of a good standard of living depends upon his ownership of significant productive capital.

9. Mere full employment of the labor force cannot solve the income distribution problem in itself, even though the law of

supply and demand be totally disregarded (as today is virtually the case) in fixing the price of labor, for the productiveness of labor is not increased by paying it more than its market value, and the overpayment goes straight into costs; these costs eventually cancel out the overpayment itself and depreciate the value of the dollar by monetizing welfare. [See A. H. Raskin, "For Organized Labor, What Replaces 'More'?"; New York Times, September 1, 1975, copy of which is attached as Appendix II hereto.]

10. There is no practical means by which a person born without capital can legitimately acquire a viable holding of it except by using the logic which business itself uses, namely, by buying capital on credit on terms where it will pay for itself within a reasonable period of time, without diminishing his take-home pay or savings. His capital then will continue to produce income--a second source of income--for him.

11. The right to life thus implies the right to credit to be used to raise the economic productiveness of the non-productive and the under-productive consumers.

12. Because pure credit (as distinguished from the privilege of borrowing accumulated savings) in its very nature is social, the way in which it is used, the persons to whom it is made available, and the purposes for which it is used, are proper subjects of governmental policy and governmental execution of that policy. Since pure credit is nothing but the power of people (including juridical people, like corporations) to contract with each other under a system of law which enables everyone affected by the contract to

enforce his or its rights with respect thereto, pure credit, the use of which is illustrated by the diagram above, is by nature a social (i.e. governmental) thing, and it is unlimited. Thus, this is a technique for eliminating all institutional barriers to economic growth, leaving only the physical limitations that industry and technology are well equipped to cope with.

13. It is of the most basic importance to realize that the proposed use of pure credit for well-managed, self-liquidating basic enterprise financing does not involve the government budget. It creates no governmental debt or liability.

14. Of course physical limitations, notwithstanding the removal of institutional barriers by the use of pure credit, still remain. The availability of additional manpower, resources, know-how and unsatisfied needs and wants are all such physical limitations to the rate of economic growth achievable by this proposed policy change.

V

TWO-FACTOR FINANCING AS A GOVERNMENTAL PLANNING TOOL

The principles of two-factor economics, given the gravity of present economic conditions, suggest that government should identify those basic industries to be given access to low cost two-factor financing, both because of their inability to reach high enough growth rates without it, and because of the desirability of broadening their ownership base.

Specific allocations of this particularly favorable, low cost credit should be made only where the twin objectives of accelerating growth of a basic productive industry and of rapidly expanding the base of private, individual ownership of capital are determined to be present, and only for self-liquidating and financially feasible enterprises. For example, it would seem that, assuming sound feasibility criteria are met, financing for energy production, for rapid transit enterprises, for rehabilitation and expansion of the railroads, for new towns, for self-liquidating urban renewal and self-liquidating housing construction enterprises, for improvements to industry that protect the environment, and for other enterprises determined to be economically and socially desirable, would be given high priority.

THE REDUCTION OF INTEREST RATES THROUGH THE USE OF PURE CREDIT.

High interest rates are now being maintained to repress accelerated growth and the inflation that inevitably results from trying to operate the economy on one-factor principles. It is perfectly clear that such outrageous interest rates are inflicting enormous damage to the economy. High interest rates are causing economic pain and suffering to millions who are thrown out of jobs; they are strangling hundreds of thousands of small, medium and large businesses for whom credit is the very life blood; they are stalemating the formation of thousands of important new enterprises and expansion of existing ones. The policy of governmental selection of industries to be expanded, and governmental assurance that the expansion is limited to self-liquidating enterprises, with their long term (virtually perpetual) deflationary impact, means that interest rates on CDIC-insured loans discounted with the Federal Reserve Bank should be limited strictly to risk (covered by the CDIC premium), administrative costs of the Federal Reserve Bank, and reasonable bank, insurance company, or savings and loan profit. It would appear that such interest rates charged to the borrower should not exceed 2-1/2% or 3% at the outside. This would release the brakes on growth of the real economy, while pushing it into a cycle of stability and gentle deflation. This would free up the use of existing savings of banks, insurance companies, and other lenders for consumer credit, venture capital loans, and, to the extent they wish to compete on the basis of the pure credit interest rate, for loans to finance basic new capital formation.

THE TRADITIONAL ARGUMENTS FOR HIGH INTEREST DO NOT APPLY.

It should also be pointed out that the bankers' traditional argument for high interest, namely that the banks are only custodians of other people's money and must therefore obtain the highest return possible, although perfectly valid in respect to accumulated savings of others administered by them, has no applicability to instances where the pure credit of the people is used to raise the economic productiveness of the people.

PURE CREDIT SHOULD BE USED FOR PRODUCER FINANCING ONLY--
NEVER FOR CONSUMER FINANCING.

The crucial criteria for all loans discounted with the Federal Reserve Bank should be their capital-ownership-broadening effect, and the potential contribution of the enterprise to the quality of life, the self-sufficiency of the U.S. economy, the betterment of trade, etc. Such credit should under no circumstances be used for consumer financing purposes. The reason credit expansion consistent with two-factor economics is deflationary, while conventional efforts at closing the purchasing power gap, whether through credit, welfare, boondoggle, or otherwise, are inflationary, is that two-factor financing concentrates on the expansion of self-liquidating productive power and the raising of the productive power of financially under-powered consumers, whereas conventional financing and all types of governmental aid to the economy focus on consumption, which involves endless, nonself-liquidating expense.

CREATING LEGITIMATE FULL EMPLOYMENT THROUGH TWO-FACTOR FINANCING OF BASIC PRODUCTIVE ENTERPRISE.

The use of pure credit contemplated by two-factor economics places in the hands of government full employment-creating methods far more effective than those emanating from Keynesian economic principles, and with radically different long-term effects. Keynesian deficit spending, implied if not commanded by our National Economic Policy, the Employment Act of 1946, creates jobs for the sake of jobs, and not for the sake of the things to be produced. Such spending is almost invariably for products that do not enter the consumer markets, since the very fact of significant unemployment implies a shortage of consumer purchasing power. On the other hand, increased employment generated by this proposed use of pure credit, thus making financable needed private enterprise that will liquidate its own financing costs, builds ownership into the employees, and in so doing expands their source of income and market power without inflating costs. This in turn will expand the production of useful goods and services, i.e., those actually intended to improve the quality of human life and to strengthen the economy.

The same technique of accelerating the initiation of self-liquidating basic private enterprise can be used by government to shift employment from public payrolls to enduring private enterprise. Thus, as the implicit economic policy begins to attack the cause of poverty of the masses by raising their productive power, the myriads of Federal and State employees, many of whom

are administering only to the effects of poverty under numerous existing governmental programs, may expect to shift their employment to the private sector and to jobs that will enable them, over a reasonable working lifetime, to accumulate economic self-sufficiency in the form of a viable holding of productive capital.

THE CONVENTIONAL USE OF ACCUMULATED SAVINGS FOR FINANCING PRODUCERS AND CONSUMERS THROUGH EXISTING INSTITUTIONS.

Nothing in the use of pure credit by making ESOP-financing paper discountable with the Federal Reserve Bank should affect the use of accumulated savings in financing whatever those administering such savings may think proper and advantageous. Clearly, the long-run effect of ESOP financing techniques will either be the establishment of a two-tiered interest rate or the lowering of interest rates generally, but this is essential if the free enterprise system is to survive.

THE HIGH CAPITAL REQUIREMENTS OF THE U.S. ECONOMY BECOME ADVANTAGEOUS RATHER THAN DANGEROUS.

One estimate of the cost of new capital formation for the U.S. economy during the coming decade is $4.5 trillion. (U.S. News and World Report, May 27, 1974, pp. 22-23.) This estimate, even with the institution of the gradual hardening of money, may well be conservative. That sources of such financing do not exist under conventional concepts has been proclaimed by many economists, bankers, investment bankers, and political leaders. However, even if conventional financing could be found to satisfy such enormous

capital requirements, the distributive effects of building the ownership of an additional $4.5 trillion or more of newly-formed capital into the 5% of families who presently own all the productive capital in the U.S. economy--which would automatically occur if we continue to use conventional financing techniques--would be simply to shorten the fuse on the time bomb already ticking away within the U.S. economy.

On the other hand, the very magnitude of those capital formation financing requirements also indicates the unlimited opportunity open to the Federal government for building self-sufficiency into millions of American families, increasing their standard of living, reversing inflation, and increasing the basic economic power of the people--the ultimate assurance that the balance of power between the people and government will not in the future tip excessively in the direction of government. In other words, this is an opportunity to use a new form of government power to increase the individual power (economic power) of an ever-expanding proportion of the individual citizens. This should motivate those who are concerned with the preservation of individual freedoms to give their political support to a two-factor economic policy.

THE UTILIZATION OF ESOPS AND OTHER TWO-FACTOR FINANCING TECHNIQUES IN INTERNATIONAL ECONOMIC DEVELOPMENT.

Only when the techniques of finance built upon two-factor economic principles are used by the great U.S. multi-national corporations to build market power and the ownership of productive capital into the citizens of the host countries in which those multi-nationals operate will the United States begin to solve the problems of economic development for the under-developed economies. Conventional financing techniques have not solved these problems, nor will they.

We know how to industrialize an under-developed economy, but without the techniques of finance here discussed, we do not know how to build commensurate market power into the citizens of the host countries. If we continue to build highly productive, foreign-owned enterprises in the developing economies, these in due course will be nationalized. In many cases, the result will be a net national loss of wealth to the United States and a mutual loss of good will between the U.S. and the countries involved.

On the other hand, building a reasonable proportion of the ownership of our multinational enterprises into the individual employees of the multinational corporations in the host countries, will, of necessity, open up fields of international development vastly greater than any heretofore available to us. An international constituency of employee-citizens of the host countries in which U.S. multinationals operate would be the greatest possible guaranty of their future safety and prosperity.

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 will continue almost indefinitely to push goods and services into the markets without further capital costs. The productiveness of the new capital instruments is preserved by depreciation practices. 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; thus 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 securities of other entities, public or private. Since these do not finance growth of the sponsoring corporation, they are pure costs which can be gradually eliminated through ESOP financing.

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 little 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.

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 assessment, 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 AND OTHER FINANCING METHODS BASED UPON TWO-FACTOR PRINCIPLES.

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.

Conventional Economic Expedients	ESOP Financing Plan
Progressively more inflationary pressures.	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 motivational force in history.
Restrains economic growth.	Promotes accelerating economic growth.
Economy increasingly depends on taxation and debt.	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. The credit does not enter into the government budget or create government debt.
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 and in Congress.

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Conventional Economic Expedients	ESOP Financing Plan
	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 in the form of the private ownership of productive capital remains with the people.

RESPONSES TO THE SPECIFIC QUESTIONS OF
THE HONORABLE HUBERT H. HUMPHREY,
CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE,
IN HIS INVITATION TO LOUIS O. KELSO
TO PARTICIPATE IN THESE HEARINGS

In his letter to me of November 20, 1975, the Chairman requested that I address my testimony to a series of questions which I will here restate, together with my responses thereto.

1) "IS YOUR FORM OF ESOP TRULY UNIVERSALLY APPLICABLE?"

RESPONSE

The ESOP is but a single financing design constructed on the principles of two-factor economics (see pages 2 to 3). There are a number of different techniques designed either:

(1) to provide both low cost capital for the financing of economic growth, and to build broad capital ownership and incremental productive power into the economically underproductive (those with only their labor to sell) and the economically nonproductive (the unemployed or unemployable), or

(2) to achieve transfers in the ownership of capital instruments, for example, the transfer of ownership of a closely-held business from its retiring owners, in ways that broaden the ownership of capital and build economic productive power into the underproductive or nonproductive.

However, I believe that, except for the limitations arbitrarily imposed by law, as for example the size of the payroll base under which the amount of financing that can be channeled through an ESOP is limited either to 15% or (in the case of a combination trust) to 25% of covered payroll, the basic ESOP (see diagram page 11) has universal applicability. It is applicable equally to capital intensive industries and to labor intensive enterprises; it is equally applicable to business enterprises in any part of the world. In short, wherever the economy seeks or requires the aid of technology, which is embodied only in the nonhuman factor of production--never in the human factor--and it is recognized as desirable to raise the productive power of individuals as a means of enabling them to receive higher incomes and thus enjoy a higher standard of living, the ESOP is suitable to build the ownership of capital into employees who would otherwise own no capital or insufficient capital to enable them to produce higher incomes during their working lifetimes and to produce a higher standard of living after their normal retirement. Obviously, I am speaking here of enterprises involving the production of goods or services for market within economies designed to protect private property in the means of production. ESOPs are not applicable to socialist or communist economies, simply because those economies deny that the right to privately own the means of production is a fundamental human right. Such societies are inevitably totalitarian, though the benignity of the ruling bureaucracy may differ from country to country.

It is the universality of the logic of business in private property market economies that makes the ESOP a universally applicable tool. The logic of business is the self-liquidating character of capital investments.

In service industries where little tangible capital may be used, the firm itself acts like, and has the basic characteristics of tangible capital, for the simple reason that the combination of the talents assembled by a profitable service enterprise is capable of producing a higher level of net income than the sum of net incomes that could be produced by the individuals working separately or in different combinations. Thus, the ESOP in a service enterprise enables the individual worker to acquire a share of the ownership of the firm. Individual workers can in such enterprises through an ESOP accumulate an ownership stake that will enable them, as capital owners, to produce a viable income after retirement. In service enterprises, as in capital intensive enterprises, the ESOP can provide a second source of income over and above the wage or salary earned by the employee. Many of our most successful ESOPs have been those established in service enterprises.

2) "IS IT POSSIBLE TO IDENTIFY ANY TYPES OF CORPORATIONS WHICH WOULD FIND AN ESOP OF LITTLE BENEFIT OR PERHAPS EVEN HARMFUL?"

RESPONSE

The ESOP is of little benefit to a business corporation that, for whatever reason, is not profitable. The ESOP is no substitute for an enterprise being competitive; for good management; for a market for its products, etc.

As for financing techniques structured upon two-factor principles which are applicable to non-business enterprises, see pages 80 to 84 below.

3) "HAVE YOU MADE ANY ESTIMATES AT ALL AS TO THE EXTENT OF TAX LOSS TO THE TREASURY FROM WIDESPREAD ADOPTION OF ESOPS, PARTICULARLY IF THE CORPORATE INCOME TAX IS TERMINATED AS YOU CALL FOR?"

RESPONSE

This question involves a misunderstanding. I definitely do not urge the termination of the corporate income tax under the present pattern of concentrated ownership of productive capital. All of the qualitative studies of the ownership of productive capital in the U.S. economy made to date show that it lies almost entirely in the top 5% of wealth holders.* To remove the corporate

*While the quantitative studies indicate some 30 million shareholders in the U.S., the qualitative studies show virtually all the stock in the top 5%. As to indirect ownership, through financial intermediaries such as insurance companies and mutual funds, investments of this kind are almost never acquired on a self-liquidating basis, so they do not make a net increase in the buyer's standard of living. They are evidence of a reduced present standard of living and the "storing" of purchasing power, subject to the effects of inflation, for future use. In our advanced industrial economy, it is rare indeed for one to acquire through personal saving a capital holding that would yield a viable income. On the degree of concentration of ownership of productive capital, see Robert J. Lampman, National Bureau of Economic Research, The Share of Top Wealth-Holders in National Wealth, 1922-1956, (Princeton: Princeton University Press, 1962) pp. 23, 108, 195.

Jean Crockett and Irwin Friend, Characteristics of Stock Ownership (Wharton School Stock Ownership Study, Proceedings of the American Statistical Association, Business and Economic Statistics Section, 1963), pp. 146-168.

McClaughry Associates, Inc. Expanded Ownership, the Sabre Foundation, Fond du Lac, Wicsonsin, 1971. At pages 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.

See also 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.

income tax under conditions even faintly resembling our present distribution of wealth, particularly of corporate stocks, would simply benefit the rich.

The only repeal of the corporate income tax that I can urge as desirable from every standpoint is the limited repeal involved in making payments into ESOP trusts deductible as they are at present, or even better, as they would be if H.R. 462 were enacted.** The elimination of the corporate income tax involved in making payments by the corporation into its ESOP trust deductible from the corporate income tax is essential if the ESOP is to be sufficiently effective and efficient, if widely used, to correct the enormous maldistribution of wealth, and the resulting maldistribution of purchasing power existing in the American economy today, as well as to facilitate, at a sufficiently rapid rate, the financing of new capital formation within the economy. The widespread use of ESOP financing throughout all types of private enterprise, combined with the low interest rates attainable through the use of pure credit, as discussed above, is capable of enabling the U.S. economy to attain growth rates comparable to those of Japan in the past decade, with full employment, and with gentle but continuous deflation--that is the hardening of the purchasing power of our dollar.

I have not made estimates as to the short-term possible tax loss to the Treasury through the widespread use of ESOP financing, nor do I believe such estimates are necessary to demonstrate that widespread use of ESOP financing will in fact cure the depression

**A version of H.R. 462, with some minor suggested changes, is attached hereto as Appendices IV and V.

in the American economy and restore it to health, while eliminating its growing debt, and beginning to pay off and reverse that debt. My analysis is as follows:

(a) The chief difficulty with the U.S. economy is that its power to produce goods and services and its potential power to expand its production of goods and services is not matched by commensurate purchasing power in the pockets of those who have unsatisfied needs and wants. Rather, increased production results in increased income to those who have no unsatisfied needs and wants, present or potential, who use that excess income to acquire, through conventional finance, further excess productive power, etc., etc.

(b) All governmental efforts to close this purchasing power gap--whether by outright welfare, or by subsidization of jobs in industry and in government--involve attacking the effects of poverty, while leaving its cause untouched. Since technology is a constantly accelerating force, the labor redundancy, as well as labor inadequacy that lies behind poverty today, must inevitably grow. Government's efforts to compensate for this trend by using deficit financing must increase at a corresponding pace until ultimate bankruptcy overtakes the entire economy.

(c) ESOP financing, accelerated economic growth through low cost capital and the use of pure credit, may have a brief inflationary impact and result in a brief increase in governmental deficit financing. But it contains the seeds of deflation; within a few years, increased productive power through increased new capital formation, increased corporate and personal incomes, and in-

creased private employment would tend to restore the public revenues and ultimately the government's fiscal health. My own belief is that the cost of using financing techniques structured on two-factor principles on a widespread basis will be more than offset by savings in the financing of welfare and boondoggle.

(d) In short, the object of a two-factor economic policy, from the standpoint of the fiscal posture of the government, is to raise the productive power of the consumers as a whole, to eliminate the burden of redistribution and boondoggle that lies primarily behind government deficits, and to enable the government to gradually liquidate and pay off its debts, without impairing the rising prosperity of the economy.

(e) It is very important to understand that the discounting of ESOP financing paper with the Federal Reserve Bank does not enter into the national accounts of the government itself. Thus, the only possible cause of reduction of revenues would be the loss of the corporate income tax resulting from the deductibility of payments into the ESOP, to the extent that this loss is not offset by reductions in government welfare and boondoggle, increases in government personal income taxes and increases in gift and estate taxes of individuals. In short, the object of a change to a two-factor economic policy to encourage ESOP financing and other methods of financing built upon two-factor principles would be to build self-sufficiency into the U.S. consumers as a whole, to eliminate the government's welfare burden, and build a tax base of unprecedented dimensions for income, property, gift and estate taxes.

4) "RELATEDLY, IF THE IDEA OF EXPANDING EMPLOYEE OWNERSHIP AND A GREATER SHARING OF THE WEALTH ARE SO LAUDATORY AND NEEDED, THEN WHY IS SUCH A LARGE TAX BREAK TO THE CORPORATIONS NEEDED?"

RESPONSE

As before mentioned, the logic of business finance is, and always has been, to invest in capital on terms where it will first pay for itself within a reasonably short period of time (normally three to five years) and then go on throwing off net income indefinitely. But lacking a rational economic theory of a private property, free-market economy, our institutions were built under the guidance of some sound theoretical insight, heavily influenced by the personal greed of the wealthy individuals in power, and with heavy doses of simple business expediency, in such manner that for 150 years we were able to maintain an economic growth rate that looked good, compared with the economically primitive past, and still enabled us to turn in, as a national economy, an economic performance that was superior to all other countries on earth. Nevertheless, it was a crude performance compared to what it might have been had we understood what technology was all about, and how to harness it to the human society in such manner that we could maximize the production of goods and services, minimize toil, and maximize leisure, self sufficiency, and personal security.

It is true that the logic of business is to invest in capital on terms where the capital will pay for itself within a reasonably short period of years, normally three to five years. But under conditions where state and federal governments take 50% to 60% of

the wealth produced by capital before it can even be used by the corporation, and the principle of private property, as applied to the stockholders of the corporation is wholly negated, as it is in every state of the U.S., so that the shareholders of a corporation have no legal right to their proportionate part of the annual net earnings of the corporation, then there is no opportunity on the part of the shareholder to buy common stock in the market place on terms where he can reasonably expect to pay for its price out of its yield. In fact, exactly the reverse is true. With rare exceptions, and they have been extremely brief, the interest rate on personal loans has been higher than the yield of capital stocks. Nor is it adequate to say that in a few instances, the personal investor, had he sold his "investment," might have paid his interest costs out of his capital gains plus his yield, had he borrowed to purchase his stock. The end result is that he has a petty windfall of no investment significance, and has parted with the capital he might have retained had he been an "investor" rather than a "speculator" as the system forces him to be. Further, had the corporation, through its Board of Directors, determined to pay some part of the annual net earnings in dividends--something they are under no legal obligation at all to do--every income-taxing jurisdiction would have taken its bite out of those dividends once they reached the stockholder, thus assuring that his ultimate usable personal income from his capital stock would never pay more than a tiny fraction of the cost of purchasing that capital stock.

While it is true that the logic of corporate finance is investment in things that pay for themselves within a short period of time, it is not true that an individual can purchase capital stock representing either newly formed capital or existing capital, and pay for the price of that stock out of the nonexistent yield, or tatters of earnings which he may receive under conventional corporate practice. Perhaps in exceptionally profitable corporations, an ESOP might make it possible for employees to buy a diminished interest in the stock of their employer without such payments into the ESOP being deductible for corporate income tax purposes, provided that the further double mayhem of personal tax liability on income represented by accumulating stock interest, but not in a form usable to pay taxes, were still available.

As noted above, the more fully we give corporate stock the characteristics of private property, i.e., the right of the owner of the stock to receive periodically and dependably the full yield, or proportionate net income of his equity in the corporation, the more fully, expeditiously and efficiently can we enable those who do not own capital to buy it, pay for it out of what it produces, and then own it and employ it to enchance their lives.

Technically, it is not a "tax break" for government to protect the private property of a stockholder in his right to receive the full wages of his capital before it taxes him. Private property is a basic tenet of a democratic free society. We have not accorded the ownership of industrial capital the same rights

of private property originally accorded to agricultural private property simply because our economy was put together out of a patch work of expedients, in the absence of any comprehensive theory of capitalism.

The theory of capitalism dates from the publication of The Capitalist Manifesto written by Mortimer J. Adler and myself in 1958. Prior to that there was no theory of capitalism; there was a collection of ideas believed to be characteristic of a capitalist society, but these were not part of a comprehensive logic. The word "system" means "logic." We cannot call our economy an "economic system" unless we can define its logic. The failure to accord the stockholder the right to receive the wages of his capital, paid periodically and dependably like the wages of labor, was simply one of those missing links in our concept of a capitalist economy. Nor was that link missing without reason. Lacking a method of providing adequate--much less unlimited--financing for the growth of newly-formed capital without permitting management to arbitrarily withhold the wages of capital indefinitely, meant that economic growth would be totally stifled. The deductibility of payments into an ESOP trust from the corporate income tax only appear to be a "large tax break" because we have been conditioned to think of stock ownership as carrying no right whatsoever to the earnings produced by the underlying capital.

The corporate income tax is one of the chief lapses in the rights of the stockholder to receive his proportionate share of

the total net income produced by the underlying capital. The government intercepts the income in the corporation before it reaches the stockholder. As long as all of the capital ownership is in the top 5% of wealth holders in the economy, it would be a disaster to now totally repeal the corporate income tax. But, as noted above, it is a most desirable step in this direction to make the payments of the wages of capital to the beneficial owners of capital tax-deductible as they are paid to the ESOP for the beneficial ownership of the employee-participants.

When we have built an economy sufficiently large to produce a high standard of living for all consumers, and in that process have built capital ownership into all consumers so that they participate, on the one hand, in the production of the goods and services representing that high standard of living, and on the other hand, receive the income represented by their productive input, whether through their labor power, capital ownership, or both, it would then be appropriate, I believe, to repeal the corporate income tax altogether and to rely solely on the taxation of individual income. In this way, we correct the original mistake (the corporate income tax) while also correcting the concentration of the power to produce goods and services represented by the concentrated ownership of capital in the U.S. economy.

5) "FURTHER, ARE NOT THE IRS CODE 401 PROVISIONS SUFFICIENT INCENTIVE SO THAT FURTHER INCENTIVE THROUGH THE ADDITIONAL 1% INVESTMENT TAX CREDIT IS NOT REALLY NEEDED OR NECESSARY?"

RESPONSE

The United States economy is in a perilous condition. A major, though presently unmeasured, portion of its economy is withheld from bankruptcy by governmental ~~subsidiaries~~ subsidies of one thousand and one varieties. The national debt grows apace and inflation ravages our currency. As goods and services become technically easier to produce, income becomes harder to get, and the great majority of U.S. families and consumers struggle vainly for what is--relatively speaking--a meager living.*

Our largest cities, several of our largest states, our largest railroads, many of our major banks, many of our largest manufacturing concerns, and thousands upon thousands of businesses in general are bankrupt or are teetering on the verge of bankruptcy. To believe that this perilous situation is going to correct itself is simply to be blind to the fact that it is directly traceable to the structural flaw in our economy: most of our goods and services are produced by capital and only 5% of our consumer units own any capital whatsoever. Redistribution by government and by governmentally supported wage coercion (all of which go into inflationary costs) has reached the point of provoking a taxpayers' general strike.

Nothing short of the most strenuous effort on the part of government to facilitate the building of capital ownership into

*The affluence of an economy can only be honestly measured by comparing what it is technically capable of producing in goods and services with what its people expect and desire it to produce. By that standard, U.S. citizens are poorer than the people of India!

the noncapital-owning masses of consumers will pull us back from the brink of total disaster. We take false comfort from the fact that our example is followed by all of the other market economies of the world, and that in following our example they are getting into trouble as deep or even deeper than ours. Thus, relatively, we don't look so bad, although we are all on our way to certain economic collapse unless we begin to make sense of our economies and, indeed, convert them into economic systems, as I am urging.

But the present 1% voluntary additional investment credit available to corporations that capitalize that 1% and transfer the stock to an ESOP trust involves a still more frightening problem. First, let me say that I believe, and have repeatedly stated, that the strength of the United States is dependent upon its technology, its great accumulations of capital instruments, and its ability to bring into existence enormously greater productive power in the form of new capital formation. I therefore applaud governmental policy that encourages such new capital formation, particularly under the present circumstances of our economy that is so ill-designed to finance economic growth.

But if, as I am confident is the case, there is a time bomb ticking away in the U.S. economy because most of our goods and services are produced by capital, and only 5% of the consumer units own any capital, then it is nothing short of astonishing that Congress--particularly its members who style themselves as liberals--should order a gift to be made by all taxpayers to the already rich, to the extent of about $8-1/2 billion a year! For

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the investment credit is, in fact, a gift from the taxpayers as as whole, to the top 5% of wealth holders who own the corporations that take the investment credit. If the investment credit were used to preserve the status quo as far as the concentrated owners of capital are concerned (and I believe in the strict protection of private property, for one cannot build a private property economy upon the destruction of anyone's private property); then 5% of the investment credit would flow to the existing stockholders, and 95% of the investment credit would be capitalized and transferred, both for economic and motivational reasons, to the employees of the corporations taking the investment credit! Thus, the inteligent use of the investment credit would not only provide a means of greatly expediting the building of capital ownership into the noncapital-owning working employees of the companies that elect to use the investment credit, but it would prevent intensifying the concentration of ownership of wealth that constitutes the dagger aimed at the heart of the American economy. We would stop making the rich richer by ceasing to enforce gifts to them from the middle class and the poor.

I have heard of a thing called "practical politics", and understand that under "practical politics" Congress does not make sudden major changes, no matter how rational, nor indeed, how imperative the need may be. Consequently, perhaps the most we can hope for is that 50% or so of the investment credit will be required to be capitalized and transferred to the workers. I still

think it is important that when we do this, we understand what we are doing: we are making a gift of about $4-1/4 billion to the already excessively rich, and using $4-1/4 billion of the investment credit to build self-sufficiency into the financially underpowered American workers.

In a later section of this paper, I will outline some of the additional steps that Congress could, and I earnestly hope will, take in order to stave off the collapse of the American economy--steps that would facilitate both the acceleration of the economy's growth rate and the broadening of its capital ownership base.

Let it be remembered that profit sharing and private conventional pension systems have been encouraged by legislation in the American economy for some fifty years, but still, 5% of the consumer units own all of the capital. It is quite obvious that much more effective measures, and much more effective leadership in supporting those measures, is necessary if we are to pull back from the brink of the greatest economic collapse in history.

6) "UP TO NOW, ESOPs HAVE BEEN ESTABLISHED AND ARE CURRENTLY BEING CONSIDERED BY CORPORATIONS. YET, ONLY 22 PERCENT OF THE LABOR FORCE WORKS FOR MANUFACTURERS AND THIS IS LIKELY TO DROP BELOW 5 PERCENT IN A FEW DECADES. THUS, AREN'T YOU REALLY TALKING ABOUT A PRETTY NARROW FIELD IN TERMS OF ALL THE PROMISES YOU PUT FORTH CONCERNING GREATLY INCREASED RATES OF ECONOMIC GROWTH, UNIVERSAL CAPITALISM, AND A SUBSTANTIAL REDUCTION IN TRANSFER PAYMENTS? HOW CAN ALL THIS BE ACCOMPLISHED WITH SO MANY WORKING FOR GOVERNMENT AND IN SERVICES AND PARTICULARLY ALL THE UNEMPLOYED AND THOSE CURRENTLY RECEIVING WELFARE OR OTHER TRANSFER PAYMENTS?"

RESPONSE

Of the 150 or more ESOPs established or in the process of being installed by Kelso Bangert & Co. Incorporated in corporations to date, only a modest percentage--perhaps no more than 20%--are in manufacturing corporations. The others are in various kinds of service enterprises, like advertising, engineering, construction, banking, plant protection services, radio broadcasting, and the like, and in various trading, retail and other types of enterprise. The ESOP is as applicable to trade, service, wholesale, retail, and business corporations in general as it is to manufacturing. There is nothing peculiar to manufacturing that makes it unique in this respect.

In a book written by Dr. Mortimer J. Adler and myself and published by Random House in 1961, entitled, The New Capitalists: A Proposal to Free Economic Growth From the Slavery of Savings, Mr. Adler and I showed that the economy could build, with "the financed capitalist plan", capital ownership into all consumer units within the economy. We pointed out that because the productive power of an economy cannot be expanded many times over instantly, Congress would have to set the priorities determining

into whom the capital ownership should be built first, then secondly, etc. As has been said, the logic of well-managed private enterprise is to invest in capital on terms where it will pay for itself in a brief period of years (normally within three to five years), and then go on throwing off net income indefinitely, its productiveness being preserved by depreciation procedures that set aside funds for the restoration of wear, tear, and obsolescence before net income is computed. If this is so, and it *is* so, then it is only a question of financial and legal design, and the allocation of credit, that determines which persons become owners of newly-formed capital when it has paid for itself. Thus, Congress could select the elderly, the welfare recipients, the unemployed, or individuals released from prisons, as part of their rehabilitation, war veterans, or whomever, and in whatever order.

Obviously, our emphasis upon the ESOP represents our view as to what the present priorities should be. We are not going to be able to produce a high general standard of living unless we build the productive power to turn out a vastly greater amount of goods and services than we can produce today, while at the same time, building in the capital productive power necessary to protect the environment. This, I estimate, requires the expansion of the productive power of the existing economy, on a per capita basis, by a factor of somewhere between 7 and 12 magnitudes. This is a titanic construction and production job and it will not be accomplished unless we fully employ every employable person in the

U.S., and unless those individuals are motivated to give their best efforts to the We believe that the accomplishment of this goal will require somewhere between 25 and 30 years of the most intensive full employment, and that in the course of that period, the overwhelming majority of U.S. consumer units will acquire viable capital holdings that will provide them with economic security and independence, and the means of continuing to produce a good standard of living after they have retired from the employment world.

Thus, we would suggest that this 25 year plan should be well launched, perhaps 10 or 15 years downstream, before using the techniques of building capital ownership into people who do not take part in the construction and production of the "second economy".

In the long run, of course, we will achieve an economy that will provide us with a high general standard of living for all consumer units with only a fraction of the potential labor force being employed. Perhaps 10 years will be as long a time as any man or woman can be permitted to spend in the labor force three or four decades from now, if we believe it important that every individual spend some years in productive employment as a vital part of his or her education about how the world runs.

Obviously, in the meanwhile, we must by welfare measures support those who cannot participate in the labor force: the elderly, the sick, the mentally deficient, etc. But as the productive capability of the system expands, and as employment in the private sector soaks up the unemployed and then begins to attract people from government payrolls, the power of the society to handle its welfare

burden will not only be adquate, but the welfare burden will progressively diminish.

In short, the task of building an adequately productive American economy is so crucial that we believe it would be dangerous to enable men and women who do not lend a hand to this task to acquire capital ownership as easily as those who do. While many of our public utterances would lead one to believe that man is a toil-loving creature, this does not happen to be the fact. If people in general could become affluent--in the practical sense--as easily without working as by working, they would take the non-work route.*

*For an example as to how financing techniques employing two-factor economic principles could be used to build capital ownership into welfare recipients, see "Income Maintenance Through Two-Factor Theory and The Second Income Plan", a memorandum for the panel of the President's Commission on Income Maintenance Programs at its hearings in Los Angeles, California, on May 23, 1969, a copy of which is submitted as Exhibit 3 to these hearings.

7) WON'T THE ALLEGED INCREASE IN PRODUCTIVITY UPON CORPORATE ADOPTION OF AN ESOP BE HINDERED BY: a) THE FACT THAT THE SECOND INCOME WON'T BE RECEIVED FOR QUITE A FEW YEARS, DURING WHICH TIME MANY EMPLOYEES WILL PROBABLY LEAVE AND b) EVEN UPON RECEIPT OF THE DIVIDENDS, THEY WILL BE SUCH A SMALL PART OF THE EMPLOYEE'S TOTAL COMPENSATION THAT THEY REALLY WON'T MOTIVATE THE EMPLOYEE IN A NEW AND SIGNIFICANT WAY?"

RESPONSE

This question involves a misunderstanding as to how a typical ESOP designed by Kelso Bangert & Co. Incorporated treats the problem of dividend distribution. The great majority of the 150 or so ESOPs that we have installed or are installing in companies in the U.S. contain provisions that, on a share by share basis, as stock is paid for, any dividends declared on the paid-for stock will pass through the trust into the participant's pocket. Thus, the flow of dividends, where a dividend-paying stock is involved, would normally begin with the first payment into the trust, which would pay for a specific number of shares that are then allocated to the participants' accounts. Dividends declared thereafter on _those_ shares would then flow into the employees' pockets. The number of shares allocated, of course, increases from year to year; thus, the dividend flow increases from year to year.

It is quite true that the pay-out of dividends by U.S. corporations is relatively modest, although no one should underestimate the wonderment of the individual who has never previously received capital-produced income upon the receipt of his first few dividend checks. The size of the dividend income will grow as the use of ESOP financing grows and as Congress makes the ESOP

progressively more effective in building significant capital ownership into individuals. Thus, a major portion of the dividend credit should be capitalized and transferred to the corporation's ESOP and such treatment should be made a condition to taking the dividend credit at all. The provisions of H.R. 462 (Appendix IV attached hereto) and other legislation discussed in this paper, should be considered by Congress as means of accelerating the magnitude of the "second income" which employees can and should receive.

Finally, it is a basic tenet of two-factor economics that Congress should--even if this requires enactment of a Federal corporation law and mandatory compliance with that law by all corporations engaged in activities over which Congress has jurisdiction--protect the private property of the corporate shareholder in his right to receive his proportionate part of the net income of the corporation and to have it paid out regularly, not less frequently than annually. The essence of private property in producer goods (or capital instruments) is the right of the particular shareholder to receive the total proportionate share of the income produced by the capital represented by his shares. To the extent that such right does not exist, corporate stock does not represent private property ownership in the means of production. It is nothing short of scandalous that today the stockholder has <u>no right</u> to the earnings of the corporation in which he owns shares. The Federal government lifts up to 48%

of the wealth produced by capital before it can be used by the corporation itself. The various states then take their bite. The board of directors may appropriate indefinitely 100% of the remaining earnings. Granted that this probably was the only way to finance our inadequate rate of economic growth in the past, the techniques built upon two-factor theory (see diagram on page 17 above) eliminate this deficiency and provide an unlimited source of financing growth while paying the wages of capital fully and regularly like the wages of labor. This cannot, of course, be done overnight, but it certainly could be totally accomplished within the space of three or four years if we determine that we are going to make ours a truly capitalistic economy. I strongly urge and recommend that the Joint Economic Committee give this matter its closest consideration and, if it ultimately agrees with my recommendations, that it throw its weight behind the restoration of private property, or more accurately, the granting of private property to owners of corporate stock in U.S. corporations.

When private property is restored to the stockholders of corporate stock, and financing techniques that broaden the proprietary base become the primary methods of corporate finance in the U.S. economy, in the process eliminating inflation and unemployment, I believe that in a few years the major portion of every employee's income will be derived from capital, for the very simple reason that most of the goods and services in the U.S. economy are produced by capital.

8) "WHY SHOULD THE NEW SHARES OF STOCK BE ALLOCATED ACCORDING TO COMPENSATION LEVELS WHEN THIS WILL JUST WIDEN THE PRESENT INCOME GAP BETWEEN THE VAST MAJORITY OF LOWER AND MIDDLE INCOME WORKERS AND THOSE HIGHLY PAID EXECUTIVES?"

RESPONSE

It is entirely possible that some U.S. corporations may overpay some of their executives. But it is also true that, as a whole, executives are the most strangely propertyless class in history. They may have high incomes; they certainly have high taxes and high living costs. Their aggregate ownership of capital--I am speaking now of professional managers, as distinquished from those who inherit significant capital ownership--is negligible. It is a rare event for an executive to retire with a capital accumulation large enough to support him comfortably without his social security and his pension. Even so, it is not uncommon for his standard of living to drastically drop upon his retirement.

The great disparity in wealth is not between corporate executives and other corporate employees; it is between the 5%--mostly inheritors of wealth--who own all the U.S. capital, and all the rest of the consumer units in the U.S. economy.

Management--good management--is a rare and valuable talent. The law of supply and demand decrees that it will be highly paid where, in fact, it is particuarly well qualified and competent. On the other hand, I believe that the broadening of stock ownership among all employees, and the gradual taking of steps to establish private property in corporate stock to stockholders, will make the employee stockholders of a corporation, as well as

the non-employee stockholders, extremely cost-conscious. An excesive salary means, under those circumstances, a reduced dividend. The pressure on management to be reasonable and responsive to the interests and wishes of stockholders in general, and to employee-stockholders in particular, can almost be guaranteed.

It should not be overlooked that the relative pay granted to employees of any enterprise is the best measure of the relative importance of that employee's contribution to the corporation's income. Employees who believe their talents are worth more than they are paid customarily change jobs. It would be flying in the face of facts to assume that all employees are equally valuable; we all know otherwise.

Finally, while a few executives may be highly paid, it should be remembered that their stock ownership in the aggregate in most corporations would constitute a tiny fraction of the stock ownership of employees as a whole under the standard ESOP allocation. The ESOP allocation is as just as the wage payments; it would be difficult to see how greater economic justice could be achieved. Also, it should be remembered that under existing law, the Internal Revenue Service has the power to deny the deductibility of "unreasonable" salary payments. Perhaps the Treasury should be given Congressional encouragement to use that power more vigorously.

9) "WHY HAVE YOU ADVOCATED THAT THE SHARES ALLOCATED TO EMPLOYEES CONTAIN NO VOTING RIGHTS? SHOULDN'T ALL OWNERS OF A CORPORATION HAVE A SAY CONCERNING THE GENERAL POLICIES OF THE COMPANY THEY OWN A PART OF?"

RESPONSE

This question involves a misapprehension as to what I have advocated. I do advocate, in fact, precisely the opposite. I believe that only one of the 150-plus ESOPs that my firm has designed and established or is in the process of establishing in U.S. corporations involves non-voting stock, and that one was at the client's insistence, and contrary to our recommendation.

The function of the ESOP is to create an identity of interests on the part of public stockholders, management stockholders and submanagement employee-stockholders. This can best be done by using a single class of stock and by having voting rights attached to all such shares.

However, it is also true that the voting of shares in most of the ESOPs that my firm has designed and established is done by a committee, usually three or five persons, appointed by the board of directors, and subject to change or removal by the board of directors. In many cases, employee representatives are appointed by the board of directors to sit on the trust committee as a means of facilitating communication between mangement and employees.

A basic tenet of two-factor economics is that the function of ownership and the function of management are two entirely distinct functions It is postulated that any human being can be an owner of productive capital (usually shares of stock in business corporations) and that, ideally, every individual would actually own a

viable holding of such shares. However, it is not a postulate of two-factor economics that every individual is qualified to manage a corporation. The ideal corporation is one in which promotion from level to level in the corporate hierarchy is possible and easy. Nevertheless, management is a rare and difficult art; the health and success of the corporation as a whole depend upon its having the highest quality of management. Any sound employee communications program designed to facilitiate an understanding of the company's ESOP will emphasize to all employees the vastly greater importance to them, now that they are becoming stockholders with growing stock ownership, of the highest quality and capability of the corporation's management.

A significant number of the ESOPs which Kelso Bangert & Co. Incorporated has designed and installed provide for the passing through of the vote to the employee-stockholder. Thus, the trust operates a proxy machinery for stockholder meeting purposes similar to that operated by the corporation for non-employee stockholders.

I believe that the best ESOP trust design is one which does pass the vote through to employees as the stock is paid for and thus gives employees a voice in the voting of corporate stock. However, I believe also that a number of years of living with an ESOP and learning to understand the meaning and significance and potential value of stock ownership--in other words, a period of education about capitalism and particularly about two-factor economics--should preceed the passing through of the vote to employees where that vote represents control of the corporation.

Nothing could be more disastrous to a business than for stockholders to elect amateurs to the board of directors and for the board of directors to appoint an amateur management. Such a corporation would stand out as a disaster to be avoided by all future businesses. Too long we have thought in one-factor economic terms. It requires education to think in two-factor terms, and the most important factor in that education is for Congress itself to give guidance to the citizens of the country in two-factor terms. As pointed out later, I would recommend as a first step, that the Joint Economic Committee of Congress recommend to Congress the amendment of the Employment Act of 1946 to give the U.S. a two-factor economic policy rather than the one-factor economic policy under which it suffers today. A draft of that legislation is contained in the Appendix to the book published in 1967 by Patricia Hetter and myself: Two-Factor Theory: The Economics of Reality. A copy of that Appendix is submitted with this paper as Appendix III.

10) "AS OF NOW, GIVEN THE PAST EXPERIENCE OF CORPORATIONS WITH ESOPs AND CURRENT TAX LAWS AND CONGRESSIONAL ACTS RELATED TO THEM, IS THERE ANY POTENTIAL FOR CORPORATE ABUSE OR AT LEAST CORPORATE FINANCIAL GIMMICKRY WITH NO BROADER BENEFITS TO EITHER THE EMPLOYEES OR SOCIETY?"

RESPONSE

ESOP financing is the most complex financing ever used by a corporation, for the simple reason that it affects the entire corporate personnel and the corporate personality. The implementing of ESOP financing involves a vastly broader spectrum of professional disciplines than that required for conventional corporate finance. Very few firms, to date, realize this, or are prepared to cope with this fact. What is more dangerous, no doubt, is the entry into the field of many a self-styled "financial advisor", with scant knowledge of two-factor economics, securities regulations, tax law, deferred compensation law, labor law and practices, investment banking practices, communications insight and capability, accounting, and so forth. Thus, it is inevitable that a certain number of ill-designed, and possibly even illegal, ESOPS will be established, and that some properly established ones may be mismanaged.

Nevertheless, the ESOP is about as fool-proof a device as human ingenuity can create for the purpose. Congressional recognition of the desirability of implementing broader capital ownership is encouraging some of the most responsible investment banking firms to establish ESOP capability, and Congress can do much more in this direction.

About the only potential for serious abuse lies in the possibility that a malevolent management, or malevolent close holding

owners, will sell a worthless business to employees through an ESOP. In other words, they will vastly overprice the business acquired by the employees. Fortunately, this risk, though it does exist, is extremely remote. The stock purchased by an ESOP must be paid for. Either the ESOP must borrow, on the corporation's guarantee, sufficient funds to buy the stock, in which event the entire transaction falls under the icy scrutiny of a lender, or the sellers carry the credit themselves and are thus dependent upon the business paying for itself within a reasonable period of years. If it does this, it has demonstrated that it was not such a bad buy in the first place.

Many possible legislative steps could be taken to further minimize this risk. Perhaps the most significant one is the provision of H.R. 462 (see Appendix IV) that would permit a transaction to be reviewed by the Treasury in advance with respect to the valuation of stock to be acquired by an ESOP.

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REJECTION OF ESOP FINANCING BY
THE UNITED STATES RAILWAY ASSOCIATION
IN CONNECTION WITH THE REORGANIZATION OF THE
NORTHEAST CORRIDOR RAILROADS
AND THE ESTABLISHMENT OF CONRAIL

Perhaps as good a description as any of the background of Sections 102 and 206(e)(3) of The Regional Rail Reorganization Act of 1973, requiring U.S.R.A. to use ESOP financing for ConRail, is the account written by Mr. William Jones, a staff writer for the Washington Post and published in that newspaper's issue of January 2, 1974, as follows:

Washington Post

WEDNESDAY, JANUARY 2, 1974 Phone 223-6000

Rail Act to Spur Worker Owners

By William Jones
Washington Post Staff Writer

President Nixon plans to sign into law today a $2-billion measure that is designed to rejuvenate rail-roads in the northeastern states and which provides for potential ownership of the new system by its employees.

Inclusion of the unpublicized stock ownership section apparently marks the first time Congress has gone on record endorsing employee ownership of a key industry.

The idea came from Sen. Russell B. Long (D-La.), who argued that the entire economic system is threatened unless the "wisdom" of the Homestead Acts—spreading out wealth by making land available to many in the last century—is not applied to the nation's major economic enterprises.

"I am convinced we cannot retain our economic greatness," he said, "if we do not . . . institute steps that will make it possible within a few years, for every household and individual in America to become an owner of a viable holding of productive capital."

Long's basically Populist idea won quick support from a diverse group that included Senators Mark O. Hatfield (R-Ore.), Clifford P. Hansen (R-Wyo.), Hubert H. Humphrey (D-Minn.) and Lee Metcalf (D-Mont.), who helped in the drive to incorporate employee stock ownership in the rail legislation.

They argued that the fundamental and unprecedented reorganization of bankrupt railroads is likely to fail, and prompt more requests for government bail-outs, unless railroad workers are given a piece of ownership in the surviving system.

Under the legislation, a new for-profit railroad will begin business about two years from now, supplanting six major bankrupt systems of today—the Penn Central, largest in the nation, and Lehigh Valley, Reading, Central of New Jersey, Boston & Maine and Erie-Lackawanna.

A United States Railway Association will be created to draw up the new railroad network and to finance an overhaul of outmoded equipment and facilities with up to $1.5 billion of government-guaranteed loans.

In addition, the legislation includes some $560 million of direct federal payments—money to pay salaries for up to 30,000 workers who may lose employment in the reorganization, money to underwrite continued rail operations while the new system is designed, and subsidies to keep unprofitable branch lines in business where local governments want to share the losses.

Creditors of the Pennsy and other bankrupt railroads, if federal judges approve the plan, are supposed to receive stock in the new railroad firm in exchange for rail properties now owned but needed for the future system.

These shareholders would have no say in running the new railroad, however, until and unless the system becomes profitable and no more federal money is needed.

What supporters of employee ownership are aiming for is a decision by the bankruptcy judges to exchange only preferred stock for the rail properties, opening up the opportunity for selling common stock to employees—while at the same time raising needed capital for operating and expanding the service.

The legislation requires that U.S. Railway Association, in designing the final rail system, must set forth the manner in which employee stock ownership is to be used to raise capital.

The U.S.R.A. must take into account, according to the legislation, the "relative cost savings" compared to conventional methods of raising corporate funds, labor cost savings, a potential for minimizing strikes and producing more harmonious industry-labor relations, projected employee dividend incomes, the impact on quality of service and costs to consumers, and meeting the objective of a self-sustaining business.

Although the rail bill merely permits and does not require use of employee ownership, Long said it represents the "greatest advance Congress has made in this area."

A long-range benefit for taxpayers and the nation, he said, is that Congress might have an answer the next time some bankrupt firm asks for a bail-out. "It may be that we can say, 'If you work this out so that your employees have a substantial piece of the action, our experience is that that type thing tends to work,'" he said.

"It is indispensable that we ask ourselves a basic question," said Long recently, when the Senate was considering the rail bill:

"Why did one of the most important railroad systems in the world, located in one of the most highly populated and highly industrialized areas of the world, possessing a labor force that was more than adequate both in numbers and in skills, fall into shameful disrepair and finally bankruptcy?"

One must conclude, Long argued, that the existing financial structure was the culprit because it concentrated ownership of the entire railroad system within the hands of an elite that represents only 5 per cent of the nation's wealthy citizens.

This led, for example, to a situation where the ailing Penn Central was distributing regular cash dividends on its stock in the late 1960s, even while sowing the seeds for future disaster by ignoring long overdue modernization and repair expenses.

Sen Hatfield said: "Our railroad crisis is merely one more in a growing parade of examples where a bankruptcy in leadership and vision has led to a vacuum in our corporate structure which, not surprisingly, has been filled by increasing government powers and controls and new and more costly bureaucracies."

In addition to government-guaranteed loans to the Penn Central following its mid-1970 bankruptcy, the federal government in recent years has assisted Lockheed Aircraft Corp. and other defense contractors faced with failure.

The energy crisis has

brought renewed worries about the ability of Lockheed to survive and has led Pan American World Airways to warn that it may have to have a federal subsidy to keep free of bankruptcy courts.

There are a variety of employee ownership concepts, but the driving force behind Long's enthusiasm is the Kelso plan, named for Louis O. Kelso, a lawyer who specializes in corporate finance and author of "The Capitalist Manifesto" and "The New Capitalists," written with philosopher Mortimer J. Adler.

Kelso's concept would permit rail employees to retain all resent pay and fringe benefit levels, with the added opportunity to buy and pay for a sizeable chunk of stock in the new railroad ($10,000 on average per worker, assuming 70,000 of 100,000 current workers are given new jobs).

These holdings of stock would be protected en masse, through beneficial holdings in a trust, much the same way as wealthy Americans accumulate more wealth and isolate their risks. No taxes would be paid on any worker's property acquired through the plan, on any appreciation of the stock or dividends, so long as the assets remain "sheltered" within the overall plan.

One large railroad was sold last year to its employees, the Chicago & Northwestern. But less than 10 per cent of employees are involved and mostly they are management personnel.

The idea behind the sections calling for building ownership of the reorganized railroad into its employees through investment of government financing through an ESOP for ConRail, to put the matter simply, is that if the employees of the reorganized railroad are left in a position where they must, in order to keep up with rising costs of living and naturally rising expectations, demand progressively more pay in return for progressively less work, as they have in the past, the bankruptcy of ConRail, or its nationalization to avoid bankruptcy, will be as assured as was the bankruptcy of its predecessors. Perhaps the more likely result will be nationalization of the new railroad with the staff of U.S.R.A. as its new operating bureaucracy.

The United States is the only country on earth left with private ownership of its railroads. It is, in my opinion, as inevitable as tomorrow's sunrise, that if ConRail is financed without building a major portion of the ownership into the rail employees, the U.S. will have made certain the ultimate nationalization of this railroad.

In order to justify itself in pretending to conform to the Congressional mandate to carefully investigate and evaluate the use of ESOP financing for the government money going into ConRail, U.S.R.A. employed three consultants, who, without comprehending either the nature of ESOP financing or the cause of the original bankruptcy, recommended against ESOP financing, but, by omission, offered no solution to rail labor's historic indifference to management's problems of meeting competition and generating profits.

They suggested no alternative, if ESOP financing is not the answer, to unite the interests of management and of other stockholders--if any--with those of ConRail's unionized workers. The consultants assumed a bail-out philosophy in order to mobilize the growing hostility of taxpayers to the rising costs of bailing out of private enterprises that flounder--more often than not due to our defective economic policy and our defective corporate financial strategy bottomed on the defective economic policy.

One of the consultants, E. F. Hutton & Company, maintained that the ESOP would be an unfair windfall to the workers, but saw no windfall at all in government's providing risk-free credit to increase the net worth of existing creditors by over $3 billion. The U.S.R.A.'s consultants' evaluation of the ESOP was entirely negative, and is replete with tortured pseudo-logic, gross distortions, and biased, short-sighted comments about ESOP--precisely what one would expect from expert practioners of the conventional corporate finance that has brought the U.S. economy to its knees, and will eventually destroy it, if these defective concepts are not largely and speedily replaced with financing techniques built on two-factor principles.

Two other consultants employed by U.S.R.A. to bulwark its predisposition to keep the employees of ConRail propertyless and to prevent the use of ESOP financing were the firm of Towers, Perrin, Forster & Crosby, and a Dr. Saul Gellerman, neither of which was or is qualified to evaluate ESOP financing, or a combination of ESOP

and shippper-passenger ownership financing structured on two-factor principles.

It appears at the present time that Congress will accept U.S.R.A.'s erroneous conclusion not to use ESOP financing for ConRail and will proceed to pour successive billions of dollars into that operation without creating a single new stockholder, preliminary to the system's ultimate nationalization.

Submitted for inclusion in the printed record of these hearings is a copy of the rebuttal, dated September 8, 1975, by Louis O. Kelso, Managing Director of Kelso Bangert & Co. Incorporated, and Norman G. Kurland, its Washington Counsel, with respect to the report prepared by the consultants employed by U.S.R.A. and entitled, "An Evaluation of the Employee Stock Ownership Plan as Applied to ConRail." This rebuttal is respectfully submitted as Exhibit 1 for inclusion in the record of these hearings. Also respectfully submitted for inclusion in the report of these hearings as Exhibit 2 is a compilation of the hearings, floor statements, and other relevant legislative material relevant to the Northeast Corridor Railroad Reorganization, assembled by Kelso Bangert & Co. Incorporated under the title, "Employee Stock Ownership Plan Financing To Get U.S. Railroads Back on the Track and In The Black," dated February 4, 1974.

RECOMMENDATIONS FOR LEGISLATIVE CHANGES TO IMPLEMENT A TWO-FACTOR ECONOMIC POLICY TO ACCELERATE THE GROWTH OF THE U.S. ECONOMY, TO CREATE FULL EMPLOYMENT FOR TWO TO THREE DECADES, TO REVERSE INFLATION AND BRING ABOUT GENTLE DEFLATION, AND TO BROADEN THE CAPITAL OWNERSHIP BASE OF THE U.S. ECONOMY.

SUGGESTED EXPANSION OF U.S. ECONOMIC POLICY TO COMPREHEND BOTH FACTORS OF PRODUCTION

The idea of a defined national economic policy, the idea of the Joint Economic Committee, and the idea of the Council of Economic Advisors to the President, are all laudible and sound ideas. It is time, however, to expand the national economic policy into one that is consistent with the theory of universal capitalism, and to comprehend and recognize both factors of production for purposes of national planning and guidance of private enterprise and for guiding governmental action toward the economy.

A proposed text for the amendment of the Employment Act of 1956 was included as an Appendix in Two-Factor Theory: The Economics of Reality, written by Patricia Hetter and Louis O. Kelso and published by Random House (paperback by Vintage Books) in 1967. A reprint of that proposed legislation is included as Appendix III to this paper.

H.R. 462 (ALSO KNOWN AS H.R. 5577)

This piece of legislation, introduced by Congressman William Frenzel of Minnesota, is pending in the Ways and Means Committee. A copy of the bill in the form in which it is pending in the Ways

and Means Committee is included as Appendix IV to this paper. A slightly revised version of the bill, containing my recommendations for minor improvements in the text of the law, together with an explanation of those recommendations, is included as Appendix V attached hereto.

Perhaps a note of explanation should be here included with respect to the suggested revision of H.R. 462 providing for the valuation of corporate stock at "fair market value" (or "fair value") as defined in the various applicable laws, or book value, whichever is higher. This is definitely an anti-recession measure, and does not affect the amount of tax deduction resulting from transfer of stock to an ESOP. Rather, it affects the number of shares to be transferred to receive any particular deduction. The problem is this: where the established stock market, which the Internal Revenue Service, acting under existing legislation, has heretofore accepted as Holy Writ, values a stock at less than its book value, the absolute dilution involved will, in many cases, simply prevent the employees from acquiring any shares through an ESOP because, as the law now stands, the ESOP must not pay more than fair market value for stock which it purchases. Thus it is suggested, by this change, that during a recession, it is better that employees get fewer shares than none at all. Only the broadening of the capital ownership base can cure our recession, and thus this measure seems to be founded on common sense.

OTHER LEGISLATIVE SUGGESTIONS .

The following suggested program of legislative reforms could, if adopted into law, accelerate the broadening of the capital ownership base in the U.S. economy, and substantially transform its stock markets from speculator markets to investor markets.

The economy of the United States has endured the mythology of one-factor conventional economic concepts in a two-factor real world to the point where change can no longer be avoided.

Either we set about speedily repairing the mismatch between the possession of economic productive power and the possession of present and potential unsatisfied consumer needs and wants, so that we can achieve both a free and a genuinely affluent society, or we must accept growing totalitarianism to convert the erroneous one-factor mythology into nationalistic dogma as the totalitarian socialist economies all do.*

So close to breakdown is our myth-ridden, over-inflated, labor-strife-torn, craftsmanship-atrophied, debt-burdened, bureaucratized boondoggle economy, that steps to broaden the capital

*The most profound student of the subject, Karl Marx, was quite aware of the requirement of totalitarianism to make one-factor economic concepts feasible in the real world. He then proceeded to invent another myth, the myth that the instinct to own the means of production--the acquisitive instinct--would "wither away" under the dictatorship of the proletariat. See Kelso, "Karl Marx: The Almost Capitalist"; American Bar Journal, March 1957, Vol. 43, No. 3. The recent overthrow of the Allende Socialist government in Chile by the middle class capital owners (trucks, shops, small farms), and their sympathizers among the aspiring workers and the military, suggests that human patience with one-factor socialist mythology is growing short.

ownership base must be given priority over every other aspect of economic reform if we are to recapture the American innocence that once made the United States the epitome of a good society.

We offer some suggestions in nontechnical language of rather obvious legislative reforms that could accelerate the program of expanding the capital ownership base. We think they demonstrate how minor the required changes are.

We suggest consideration be given to making the following changes in Federal laws, with corresponding adaptations in State laws where necessary:

(1) Congress should consider legislation establishing a governmental insurance agency, which might be known as the Capital Diffusion Insurance Corporation ("CDIC"). Its purposes would be to insure banks, insurance companies, and other lenders who make loan financing to ESOP Trusts, much as the Federal Housing Insurance Agency insures banks which make consumer loans on home financing. Such an insurance company, which might ideally be imitated by private insurers, as the FHA now is, would facilitate and encourage the readiness of banks and other lenders to make such loans, and it could serve, along with the Federal Reserve Board, as a regulatory mechanism for phasing the new economic policy into the economy. The methods used in establishing the Federal Housing Insurance Agency could approximately be followed in establishing the CDIC.

(2) Legislation should be developed and adopted to enable banks and insurance companies, and other qualified lenders (which should include savings and loan associations) to discount loan paper insured by the Capital Diffusion Insurance Corporation with a Federal Reserve Bank, pursuant to regulations to be adopted by the Federal Reserve System. This would amount, in effect, to a process for monetizing productive power (represented by capital purchased under an arrangement where it will pay for itself). The ultimate effect of wide-spread ESOP financing would be deflationary. This is so because once the newly formed capital has paid for itself and the credit advanced has been reversed, the newly formed capital continues to throw off goods and services virtually indefinitely, its productive power being restored and protected by depreciation procedures that set aside, before net profts are computed, sufficient funds for this purpose.

(3) Legislation should be adopted to provide an opportunity for careful reflection upon the New Economic Policy in connection with labor relations controversies, and to relieve the economy and the society from the enormous damage done by strikes and lock-outs, the coercive tools used today in seeking or resisting the inflation-forcing demands for more pay in return for the same (or even less) work input. Such legislation should give the President power, in all instances involving interstate commerce, to suspend the use of strikes and lock-outs for a reasonable period of time while the parties involved investigate the possiblity that ESOP financing might reconcile their differences in a manner consistent with the public interest and their own mutual prosperity. ESOP financing techniques normally benefit both the corporation, by giving it access to lower-cost capital, and the union, by building the ownership of productive capital into its members with unprecedented speed. The end result is to raise employee incomes without proportionately raising business costs and without raising the price the public pays for the company's products, all of which are in the public interest.

(4) Steps should be taken to formulate a policy within the Antitrust Division of the Department of Justice, and within the Federal Trade Commission, with implementing legislation if necessary, to assure that in all divestitures, primary emphasis is placed on sale, where this is financially feasible, of divested assets to employees in the subsidiaries or divisions being divested through ESOP financing techniques. This procedure should include consideration of installment pay-out arrangements with the seller, partial payment through the issuance of subordinated debentures to the seller, and possibly governmental financing assistance through CDIC insurance or otherwise where adequate financing under prevailing market conditions is not readily available.

(5) Steps should be taken to establish a policy within the Interstate Commerce Commission, the Federal Aviation Administration, the Federal Power Commission, and within other appropriate Federal regulatory agencies to use their powers, where the best interests of the regulated industries, their employees and the public can thereby be promoted, to encourage the use of Employee Stock Ownership financing to rapidly build significant capital ownership into such employees. It is clear that if employees of transportation and other regulated enterprises progressively demand more pay in return for diminished work input--as they must to maintain or improve their standards of living if they have no access to the ownership of capital--and the regulatory bodies do not automatically permit these increases to be charged to shippers, passengers, and other users of the services of such regulated industries, the transportation enterprises or other regulated industries will sooner or later collapse--as the entire north-east railroad system of the United States is undergoing at the moment. In fact, it is safe

to predict, that the thousands of urban mass transit systems needed by all of our cities, in addition to efficient inter-urban transit systems, cannot and will not be built (except by governments) until techniques for substituting the growing ownership of capital for inflationary wage and salary demands are developed. The same is true in the airline industry as well, and in other public utilities such as the electrical, gas, and telephone industries.

(6) Consideration should be given to tax and other measures which would encourage conglomerates seeking voluntarily to divest themselves of subsidiaries or divisions or other assets, to use ESOP financing techniques to sell these assets to employees of the entities which will ultimately operate after divestiture.

(7) Studies should be made of the extent to which Federal leadership, cooperating with the appropriate regulatory bodies of the states, can encourage public utilities to finance a major portion of their expansion through a combination of Employee Stock Ownership Plan financing techniques and techniques that build ownership into customers of public utilites, in order to raise the power of the public to pay for the services. In the light of the American dream that every family and individual hopes to acquire an independent source of income through the private ownership of a significant holding of productive capital, it seems illogical to grant monopoly franchises to corporations without requiring them to finance a major part, if not all, of their expansion in ways which would build second sources of income into their employees and into their customers.

(8) In the case of sale by the U.S. Government Atomic Energy Commission of atomic fuel plants to private enterprise, and in the case of all such similar privatization transactions, studies should be made of the means of selling a major part of the equity of such enterprises to employees, and of other means of broadening the ownership base of the resulting new companies.

(9) In order to relieve the Federal Government, the states, cities, towns, and other municipal corporations, school districts, college districts, universities, and various quasi-public corporations of multitudinous debt and tax burdens, Federal and state legislation should be drafted to encourage the privatization of facilities now owned and operated by such governmental agencies and quasi-public corporations. This legislation might be modeled on the Eisenhower Post Office Law, which was designed to encourage private construction and ownership of post office buildings thereupon leased to the Federal Government. Rather than to encourage the highly concentrated private ownership of such facilities, however, they should be owned by the employees who work for the governmental agencies and quasi-public corporations involved. Such employees

can be made the employees of the respective facilities' corporations with arrangements for the "leasing" of the employees to the governmental agency at cost, and the leasing of facilities at fair market value. The end result would be the building of private capital ownership into civil servants and other governmental and quasi-public corporation employees so as to give them private security and second sources of income. The staggering costs of present public retirement systems could thereby be enormously reduced -- perhaps even eliminated.

(10) A governmental policy should be adopted for the privatization of all publicly owned assets where the ownership of such assets can be acquired by employees of entities operating such assets through the use of ESOP financing. Each step in such privatization will reduce the public payrolls and at the same time raise the tax base and the private incomes of the employees involved. The motivational implications in raising the efficiency of the economy and the power of the American workers to buy and enjoy the output of business and industry should be desireable by-products of such steps.

(11) Legislation should be developed to provide the use of ESOP financing techniques in connection with the building of new towns. Each new town represents a vast new collection of capital instruments. If those capital instruments become owned by the top 5% of wealth holders, following the patterns of the past, the new towns will quickly reach the state of economic stagnation characteristic of all old towns and cities today. To bring into existence vast amounts of productive capital without commensurately raising the power of people affected to engage in production through the ownership of the newly formed capital, as well as through their employment, is to invite the repetition of the crushing problems which we now face at every level of the economy.

(12) Legislation should be adopted to require the Federal Power Commission, which has options under the Federal Power Act to purchase some 270 used hydro-electric plants at prices which represent a fraction of their current fair market value, to assure that such plants are purchased by employees and by propertyless people who are now deprived of an opportunity to be sufficiently economically productive. It is virtually certain that these assets can be purchased on terms where they will pay for themselves quickly. Such a policy would help raise the productive power of thousands of unproductive and underproductive citizens, disalienating them, raising the Government's tax base, and carrying out the spirit of the new industrial Homestead Act policy above outlined.

(13) Our labor-management relations laws should be modified to facilitate and encourage organized labor's trading off its present

legal right to coercively abolish the law of supply and demand with respect to wages and salaries (a product of one-factor economics) for fast and effective access to the acquisition of capital ownership and second sources of income through ESOP financing. This would enable workers--and everyone else--to enjoy a reversal of inflation, higher incomes, and greater legitimate leisure and economic security. It would again enable U.S. industry and agriculture to produce the highest quality and lowest priced goods and to out-compete anyone anywhere--even after our example is imitated abroad.

(14) We should eliminate or radically reduce the capital gains tax imposed under present Federal and state income tax laws on rich individuals who sell their holdings of equity stocks to ESOP Trusts of corporations or to the ESOP Trusts established for public employees. Not only do we have the problem of guiding the new capital formation of the future away from the excessively productive rich to the underproductive and nonproductive non-capital-owning masses, but we must facilitate the broadening of the ownership of the enormously concentrated present holdings in such manner as to respect and protect private property. It should be remembered that a rich man with "liquidity" can diversify his holdings under the "Prudent Man Rule" by re-investing in other securities or assets. The "Prudent Man Rule" is a rule to live by for the rich whose capital estates have reached the caretaker stage. But the "Prudent Man Rule" which keeps the rich man rich, if mistakenly followed by capital-less workers, has the effect of keeping them poor! It is the "Prudent Capital Estate Builder's Rule" of applied Two-Factor Economics that the propertyless many must follow--and be educated and encouraged to follow.

(15) Finally, the formulation and refinement of legislation pertaining to the foreign economic policy of the United States should be undertaken. The power of business and government of the United States, through the use of ESOP financing techniques and related means, to show the developing economies how to make "haves" (that is, capital owners) out of the "have-nots," without taking from the present haves, should be the first instrument of our foreign policy. This is an awesome power, capable of relegating coercion to a secondary role in international relations. It would be a positive means of making America again a symbol of good will in the world. There would appear to be no other way for U.S. corporations to build their stockholder constituencies abroad to the degree necessary to enable the citizens of the host economies to consume their share of the goods and services which the multinational corporations wish to produce and sell in those economies.* In no other way can U.S. managerial talents, merchandising know-how and financial statesmanship be sold year-in and year-out to friendly nations for the mutual profit of all. And in no other way can U.S.

*See Kelso and Hetter, "Uprooting World Poverty--A Job for Business," Business Horizons, Fall 1964.

enterprise avoid the confiscation of its assets by the governments of developing economies (and even developed economies) in order to help solve domestic economic problems which would automatically have been solved if the proprietary base had been broadened as those economies underwent industrialization.

TECHNIQUES OF CORPORATE FINANCE
OTHER THAN ESOP FINANCING
BUILT UPON TWO-FACTOR ECONOMIC PRINCIPLES

THE FINANCED CAPITALISTS' PLAN

We propose the amendment of Federal and State banking laws and Federal and State retirement systems laws to give public employees and other Congressionally-identified groups of persons, as Congress may from time to time determine, access to non-recourse credit (as the ESOP Trust does under present law for corporate employees) to buy stocks newly issued in the course of financing the expansion of the economy by qualified corporations. Criteria, already highly developed, for identifying and selecting profitable enterprises that could qualify to finance their expansion in this manner should be adopted in order to "qualify" stocks of particular businesses for this type of financing. Corporate dividends paid into such trusts should be made deductible from corporate income taxes at both Federal and state levels. In exchange for having access to virtually unlimited financing for growth (so long as it meets the feasibility tests), corporations should be required to pay out the "wages of capital" (corporate net earnings) fully to the owners of the corporation's capital--the stockholders. Not only does mass production of humanly useful goods and services imply their mass consumption, but the double-entry bookkeeping logic of a free market economy requires that the wages of capital be paid out fully

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like the wages of labor to make such mass consumption possible with a minimum of enervating consumer debt. Consumer debt merely diminishes the market power of the consumer by the amount of interest paid over the life of the loan. In housing, for example, the buyer often pays the equivalent of two price-inflated houses in loan interest in order to buy one price-inflated house!

This technique in general is more elaborately treated in The New Capitalists, by Louis O. Kelso and Mortimer J. Adler, originally published by Random House in 1961 and republished in 1975 by The Greenwood Press, Westport, Connecticut. One aspect of this is also touched upon in the proposal submitted by Louis O. Kelso to the President's Commission on Income Maintenance Programs at its panel hearing in Los Angeles on May 23, 1969. This proposal, entitled "Income Maintenance Through Two-Factor Theory and the Second Income Plan," is included as Exhibit III among the exhibits submitted to the Committee with the request that they be printed as part of these hearings.

PUBLIC UTILITY FINANCING TECHNIQUES

This subject is referred to in paragraph (7) under the discussion of legislative recommendations above.

It is perhaps important only to note that joint financing proposals on the part of Kelso Bangert & Co. Incorporated, and Kidder, Peabody & Co., Incorporated, are pending before two of the nations's largest public utility corporations. These would

involve financing a small (but individually significant from the standpoint of employees) portion of the future growth of those utilities by using ESOP financing to build ownership into workers, and a large and unlimited portion of the future growth of those utilities by building ownership into utility energy consumers in proportion to their relative energy needs. This second phase of the proposals would, of course, require modest legislative changes both at the state and federal level and these will undoubtedly come before the respective state and federal governments within the next twelve months or so. It is important to know that the identical techniques, so far as economic theory and economic design is concerned, were used by me in designing the financial and ownership structure of Valley Nitrogen Producers, a large chemical fertilizer complex owned by some 8,000 or more California farmers, the overwhelming majority of whom paid for their stock entirely out of dividends. This corporation technically qualified as a cooperative, and thus could use the necessary tax advantages to build ownership into farmer-consumers without their being currently taxed and without the corporation being required to include as taxable income the dividends it paid. It should be noted that the tax law has subsequently been modified to make this impossible, though its benefits to California agriculture and to the economy as a whole were enormous. I estimate that it has saved California farmers as a whole well over a billion dollars in fertilizer costs in the past fifteen years. Beyond this, it built the ownership of productive capital into many farmers who had never before owned industrial capital stock.

AGRO-INDUSTRIAL TECHNIQUES DESIGNED UPON TWO-FACTOR PRINCIPLES

Kelso Bangert & Co. Incorporated has substantially developed a financing technique structured upon two-factor principles for use in creating major agricultural industries while building ownership of these diversified corporations into employees and even into former land owners who transfer their land to the agro-industrial corporation.

SPECIAL ECONOMIC DESIGNS APPLICABLE TO DEVELOPING ECONOMIES

The technique of finance, structured upon two-factor principles, applicable to particular developing economies will, or course, vary from one economy to another. While this whole subject has yet to be significantly explored at the business level, it is interesting to note that, after having his advisors study the books published to date on two-factor economics, the Shah of Iran has launched a program of building of ownership of industries into industrial workers. The techniques employed are, I would submit, capable of being much improved, but there can be no question of the soundness and farsightedness of the economic goal espoused by the Shah: broad ownership of industrial enterprise within Iran.

Kelso Bangert & Co. Incorporated, at the request of former Governor Ferré of Puerto Rico, prepared the design of a plan intended to accelerate the growth of the Puerto Rican economy and to build

the ownership of the expanded economy into the employees of all employers who elected to participate. This plan included public employees, partnership employees, domestic servants, and indeed every type of employee. The theory of Governor Ferré in selecting the final design which he chose was that, as we have expressed above, there is danger in making capital ownership available to people who do not work when in fact high levels of employment are required to expand the economy adequately to provide the general high standard of living. While the "Puerto Rican Proprietary Plan" was passed by the House of Representatives, it was never passed by the Senate becuase Governor Ferré lost the Governorship to the President of the Senate who is presently the Governor of Puerto Rico. It is interesting to note that Puerto Rican economic problems remain as unsolved as they were in 1972 and, in my opinion, they will continue to be unsolved and unsolvable until broad capital ownership is built into consumers within the Puerto Rican economy. It is interesting to note that the Puerto Rican Proprietary Plan was roundly condemned by one of the high priests of the conventional economic wisdom. An account of this rhetorical battle is set forth in the Congressional Record with an introductory note as Appendix VI to this paper.

The important message is that two-factor economic theory is of universal application, since man's economic progress lies only through technological advance, and technology in general is embodied only in capital instruments, not in human beings. There is an appropriate economic design for building capital ownership into consumers in any economy, and in any enterprise, anywhere.

THE LABOR UNION AND ESOP FINANCING

In general, it may be said that the serious study of two-factor economics by labor leadership has not yet begun. A few significant labor leaders have heartily endorsed the building of capital ownership into workers, and a few have opposed the idea. I belive that in the case of the latter, their opposition is of necessity, the result of a failure of communications and lack of understanding.

If it is fair to say that the purpose of labor unions is to improve the economic status of their members and to provide them with power to produce higher incomes. If there are in fact two factors of production rather than one, as the labor theory of value and its descendants, including Keynesian economic policy maintain, then it seems certain that a labor union which limits its jurisdiction and concerns to one factor of production alone cannot be doing its full job for its constituents. Even more true is this conclusion if the labor union depends solely upon the diminishing factor (relatively speaking) and totally disregards the factor that is increasing in productiveness and in economic importance--capital.

ESOP trusts and ESOP financing are collectively bargainable subjects under our current laws. Indeed, at the time of delivery of this paper, one local union of two thousand members, at the expiration of its contract, has formulated bargaining demands upon

its employer and has included as one of its central demands the establishment of an ESOP for its members by the employer company.

Perhaps the principal fear of union leaders who have any apprehensions about the desirability of making their consituents "rich" in the practical sense of building sufficient capital ownership into them to enable them to live well after their retirement, and to get second sources of income during their employment, may lie in what they see as an analogy to profit sharing which some aging labor union leaders have termed "anti-union."

I respectfully submit that when labor unions begin to concern themselves with building capital ownership into their consituents, taking a checkoff not merely on wages, but on the amount of capital ownership acquired by their members, their importance in the American society and their functional tasks in the economy as a whole will increase enormously, while the damage they do in employing raw physical coercion to achieve the goal of progressively more pay for progressively less work will diminish and disappear.

In this connection, the article by A. H. Raskin reprinted from the New York Times of September 1, 1975, included as Appendix II hereto, is significant in that Mr. Raskin points out that "more," with leveraged inflation, now means less, and that the goals of the labor unions must be changed if the standard of living of the working man is to continue to rise. There is no possible way out of this problem except through the use of two-factor economic principles to build capital ownership into the workers.

HOW DO WE ANSWER THE SPORADIC CRITICISM OF EXPERTS THAT ESOP FINANCING SHOULD BE ABOLISHED.

Such attitudes are based upon views that do not comprehend the dire predicament of the U.S. economy and of all market economies on earth that follow the example of the U.S. economy. They are not realistic; they are typical of the resistance of the devotees of any discipline, school of science, or school of social science to any change whatsoever. For a superb study of this phenomena, please see The Structure of Scientific Revolutions, by Thomas S. Kuhn (1970), University of Chicago Press. Some extracts from Mr. Kuhn's book are appended to this paper as Appendix VII.

As illustrative of the kind of misunderstanding that can develop out of sheer resistance to innovation, we respectfully submit, with the request that it be printed as part of the record of these hearings, my memorandum of June 13, 1974, entitled, "Should Congress Prohibit ESOP Financing? or Should It Make It More Effective?" This memorandum is identified as Exhibit 4 to my presentation.

DOES INVESTMENT BY THE ESOP WHOLLY OR PRIMARILY IN THE STOCK OF THE EMPLOYER VIOLATE THE SPIRIT OF THE PRUDENT MAN RULE?

Investment by the ESOP trust wholly or primarily in the stock of the employer does not, or course, legally violate the "Prudent Man Rule" for the simple reason that such investment is specifically authorized by law. The ESOP, and its predecessor, the stock bonus trust, are specifically intended by law to create or foster employee ownership of employer stock. But does such investment violate the spirit of the Prudent Man Rule?

In 1830 (Nine Pic.)(Mass.)446) in the case of Harvard College vs. Amory, the Supreme Judicial Court of Massachusetts, ~~in a case case~~ dealing with the nature of the fiduciary responsibility of an individual who is investing funds for another, laid down what has come to be known as the "Prudent Man Rule." The court concluded in general that the proper standard of responsibility for such a fiduciary was that of a "reasonably prudent man" investing his own funds, with a view to preservation of the principal and optimization of the income, in order that he could live comfortably thereon, and perhaps even invest further. This rule has generally been interpreted as calling for the diversification of investments in order to avoid the possibility that the entire trust might be radically affected by having the single company in which it is invested get into financial difficulty.

I submit that the failure to carefully examine the "Prudent Man Rule" has led to more economic disasters, in terms of numbers of people involved, than would a total disregard of that rule altogether.

What has been overlooked is that the "Prudent Man Rule" dealt with by the Massachusetts Supreme Judicial Court in Harvard College vs. Amory was a rich man's prudent man rule. It was sound advice as to how a rich man, or a fiduciary for a rich man, should act in order for the owner to remain rich while still living well on the yield of his capital.

But there is another prudent man rule--the poor man's prudent man rule. This rule was laid down by Andrew Carnegie in his biography in which he said, and I paraphrase him, "You want to be rich? It is easy. Just put all your eggs in one basket and watch the basket very closely." The distinquished Chairman of the Joint Economic Committee, the Honorable Hubert H. Humphrey, in a talk given in Stockholm, Sweden, on September 3rd of this year quoted the great American humorist, Mark Twain, to the same effect:

> "Only a fool saith--Do not put all thine eggs in one basket. The wise man saith, 'It's okay to put your eggs all in one basket--just remember to watch the basket.'"

Anyone who will reflect for a moment will quickly realize that no significant fortune, American, European, or otherwise, was ever built under the rich man's prudent man rule; all significant fortunes were built using the poor man's prudent man rule. By applying the rich man's prudent man rule to the poor man--the worker--we have in our pension systems and profit sharing plans (with the

exception of profit-sharing plans invested wholly or primarily in employer's stock) over the last half century managed to keep the poor man poor with exquisite effectiveness.

The ESOP applies the poor man's prudent man rule to the man who owns no capital. It puts him in a position of ownership in the only company whose profits he personally can influence--by working harder, by cutting waste, by persuading his fellow workers to do likewise, by making suggestions for improvement of efficiency, by fighting harder against competitors, and so forth.

Nor does it take much imagination to realize that if Congress should gradually extend the protection of private property to the holder of corporate stock, so that he would receive, as a matter of property right, the proportionate full wages of his capital (his proportionate share of the corporate net income) paid out periodically and dependably, the poor man's prudent man rule would be both more effective in relating the worker's performance on the job to his acquisitive instinct, and would enable him to live better when he shifts his total dependence, at retirement, to participation in production through his capital ownership.

One of the provisions of H.R. 462 (see Appendix IV hereto) would apply the logic of this analysis to ESOPs. It would permit the Trust Committee, by consultation and negotiation with the participant prior to his retirement, to diversify his holding of company stock into a portfolio that he selects or that is selected for him by the investment advisor of his choice. Thus,

the ESOP would first apply the poor man's prudent man rule to the capital-less worker until it builds a viable capital estate for him, and then it would apply the rich man's prudent man rule to him because he would then be, in the practical sense of the word, "rich."

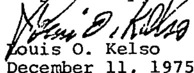
CONCLUSION

I respectfully submit that the economies of the United States and of all other countries with market economies which follow the example of the U.S. economy (as most of them do) have reached a stage of crisis of one-factor economic concepts. Because of the high degree of technological development, and because of the growing resistance of citizens to paying for full employment through boondoggle--primarily military industrial boondoggle--it is no longer possible to operate a two-factor real world on one-factor economic concepts. It can be done only in a totalitarian society. We are moving rapidly in that direction. Recent disclosures through investigations by this Congress show how close we have come to being a police state.

It is time to begin to build economic power into every consumer unit of the American economy. So long as the people, under the leadership of Congress, cry out for "jobs" and "welfare," they will get just that--jobs and welfare. And they will stay poor. Inflation will rage along, the standard of living of all consumers will continue to decline, alienation will rise to a crescendo of revolution, and the economic collapse of our society will be at hand.

The nation is in peril because of the deficiency of the economic policy under which it operates. I submit that this Committee, more than any other Committee of Congress, is uniquely positioned to start the wheels of change that can restore us to economic health.

Respectfully submitted,



Louis O. Kelso
December 11, 1975

APPENDIX I

Partial Bibliography on Two-Factor Economics and Financing Tools Designed to Implement the Concept.

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For Organized Labor, What Replaces 'More'?

THE NEW YORK TIMES, MONDAY, SEPTEMBER 1, 1975

By A. H. Raskin

Nearly a century ago Samuel Gompers summed up the goals of the American labor movement in the single word "more." Asked what labor would want after it got "more," his answer was "more and more."

Few forecasts, especially in the murky realm of economics, have stood history's test as well as that laconic response by the founder of the American Federation of Labor. Unions have grown vastly in size, scope and power, especially in the four decades since Franklin D. Roosevelt's New Deal.

Their collective bargaining agreements now cover so many items that some exceed telephone directories in thickness. Union leaders walk with assurance through the White House and the halls of Congress; they push around governors and mayors; they move on terms of easy familiarity among corporate executives and bankers (and even, in many cases, among their own rank and file).

The faces at the top change, though usually with glacial slowness, but the Gompers credo has come essentially unchanged through such dissimilar latter-day types as John L. Lewis and Walter P. Reuther and James R. Hoffa to remain unionism's central objective in the never-ending reign of George Meany. In Hoffa's words, "What's it all about if not to bring back the highest buck for our people?"

But this Labor Day, for the first time, some leaders steeped in the practices of bread-and-butter unionism are finding the answer to that rhetorical query not at all self-evident. On the contrary, the dismal experience a few unions have had recently of negotiating down, not up, under the pressure of pinched municipal budgets or the deadening effect of low-wage imports on their industries makes them feel that the answer may be almost as much a mystery as whether Jimmy Hoffa himself is alive or dead.

For unionists in this class, the pivotal question is one almost no one in labor's top echelon likes even to think about: What can a labor movement built on "more" find as a substitute reason for being if the recession-tightened squeeze now afflicting particular fields proves the forerunner a few year hence of a lasting slowdown—perhaps even a dead stop—in the exuberantly expanding economy that made the Gompers doctrine work?

The problem is already here for New York City's civil service unions, fastest runners in the race for wages and benefits through all of the last decade, now in the unhappy position of having to give back some of what they got and facing a three-year freeze on getting any more.

The first impact is on the job security of the "pork-choppers"—the unions' paid leadership—especially in the police and fire unions, where militancy in delivering "more and better" has been the test of fitness to such an extent in the last three or four years that one transient officer suggested equipping the union president's office with an aircraft ejector seat.

In the case of the Uniformed Firefighters Association, a revolving door might be even more appropriate. Michael J. Maye, an ex-Golden Gloves boxing champion, was voted out as president two years ago on the ground that he had not fought hard enough for his men. In July he was voted back again, largely because his interim successor, Richard Vizzini, was rolled flat by the budget juggernaut.

"The days of great longevity among public sector union leaders are over," says Ken McFeeley, president of the Patrolmen's Benevolent Association, who got his own job a year ago by accusing his predecessors of doing too little to bolster police prestige and pay.

He predicts that there will be no more careers like that of John J. DeLury, who has been representing the city's sanitationmen since the mayoralty of Fiorello H. La Guardia. The 36-year-old Mr. McFeeley was not even born when the president of the Uniformed Sanitationmen's Association started building political fences in City Hall and Albany.

"The DeLurys could think in terms of stable relations like the Southern Democrats in Congress," the P.B.A. head notes. "The new crop all grew up in the 1960's when you threw a rock and got a bargaining concession. The turnover in union leadership is fast. You have two or three years to produce. Otherwise, somebody else has got your job."

In this twilight of "more," it is not only leaders but also unions that have to pass the "what have you done for me lately?" test. An object lesson in what can happen to those that flunk is being provided by the Civil Service Employes Association in New York State. A strong favorite of Nelson A. Rockefeller when he was Governor, it won bargaining rights in 1968 for 124,000 state employes and 90,000 others in county and local governments.

This year Governor Carey rejected a fact-finding board's recommendation that the state workers receive a 6 per cent wage boost. Instead, he decreed that they be given a one-shot bonus of $250 for the year. The union decided not to strike. Now it is under two-pronged attack by rival unions seeking to capitalize on rank-and-file disaffection by swallowing up its membership.

Outside the civil service sector, the first major casualties of what may become permanent stagflation are two of the country's most respected unions—the International Ladies Garment Workers Union and the Amalgamated Clothing Workers of America, each with close to a half-million members.

Both have suffered mass layoffs and drastically shortened work-weeks, primarily as a result of imports. That has made the two unions, built by immigrants in the old Lower East Side and the slums of Chicago, fiercely protectionist. It has also cut the average earnings of their members—those who still have jobs—to levels less than half those in steel and auto.

Sol C. Chaikin, the dynamic incoming president of the I.L.G.W.U., is close to despair at the plight of his people. He believes the country must start developing an incomes policy that will aim at a genuine redistribution of income, not just in the "soak the rich" terms of atavistic union oratory.

"We may have to stop giving any more money to construction, steel and auto and give it to the people at the bottom in garment, hotel and restaurant, retail trade and all the other places where people are pushing, pulling, carrying for less money than it takes to live," Mr. Chaikin says.

That is not a view likely to evoke cheers from the entrenched labor hierarchy nor will it find many echoes at the bargaining table, where unions representing almost 5 million workers will be arguing for "more" next year.

Unfortunately for workers, however, there is a squirrel-cage quality to the contract process even where the recession has brought no break in the wage climb. In the first half of 1975, for instance, first-year pay increases in all major settlements averaged 11 per cent. This was double the anti-inflation standard enforced by the old Pay Board and nearly quadruple the long-term rate of past growth in national productivity.

Yet, even with the reinforcement of cost-of-living escalators, which now cover half the unionized work force, workers have been running a losing race against inflation. The purchasing power of the average weekly pay envelope went down by 5.6 per cent in the last two years, and the loss would have been over 10 per cent without the buoying effect of the one-year cut in withholding taxes in May.

Since 1970 the average worker has had a gain of 35.8 per cent in gross wages, virtually all of it rubber. After adjustment for higher prices and taxes, only about $1 of the $43.01 in nominal increases could be traded in for more meat and groceries at the supermarket.

The institutionalization of that treadmill bespeaks a broadening of labor's horizons, whether or not the pessimists are right in predicting that this country may have to adjust to a revolution of declining expectations after two bullish centuries.

In Europe, where unions never got anywhere close to American standards on the way up, the almost universal trend is toward much greater worker involvement in management; everything from co-equal representation in company boardrooms to employe participation in the design of jobs.

Co-determination on the West German model, now about to become law throughout the Common Market, is still poison to American unions. But the United Auto Workers and a few others are moving forward on joint experiments with their employers in projects designed to improve the quality of working life and to increase employe satisfaction in their jobs.

Most unions scoff at such projects as boondoggles or attempts to defang labor. Indeed, the A.F.L.-C.I.O. has just succeeded in all but eliminating references to work quality from a bill the Senate is expected to pass this week establishing a new National Center for Productivity and the Quality of Working Life, with a $5-million annual budget.

But the sterility of the pursuit of "more" and the pressures for change from a changing work force are likely to make a larger voice in everything having to do with the job a big element in labor's future.

A. H. Raskin is assistant editor of the Editorial Page of The Times.

APPENDIX III

THE FULL PRODUCTION ACT OF 19—

EXPLANATORY NOTE

The Full Production Act of 19——, although useful as a model for economic policy legislation based on two-factor theory, either at the national, state, or provincial level, has been designed for illustrative purposes to replace the Employment Act of 1946. Since the latter act is generally recognized to be the most important economic policy legislation in the United States, the immediate question arises as to why it should be superseded.

The reason is this: the Employment Act of 1946 is bottomed on one-factor economic theory. It assumes that economic goods and services are produced only by labor, and that capital (the nonhuman factor of production) functions mysteriously to make labor more productive. This is what the "conventional economic wisdom" of our day holds to be true, but in fact, it is not true.

If the function of technology is to shift the burden of production from labor onto capital—that is, to substitute production by the nonhuman factor for human toil; and if the great bulk of our wealth is already produced by capital (rather than by labor), as our eyes tell us is the case, then full employment, even if attainable, *is never enough*. No household can reach its maximum economic productiveness, no matter how many members of it are

employed, nor can it enjoy equality of opportunity for personal leisure and economic security, unless it also owns a viable capital estate.

The Full Production Act retains the ethical principle of the Puritan Ethic and of the Employment Act of 1946; namely, that every household should produce the wealth it reasonably desires to consume. Morally, this is beyond dispute. The question is one of means. If only labor produced goods and services, then people could only legitimately produce income through their labor. But if there are two factors of production (and, *a fortiori*, if the tendency of technology is to improve the productivity of only one of them: capital), then equality of economic opportunity clearly means something more than opportunity to obtain a job, and being fully productive in the economic sense means something more than employing only one's labor. This is the ethical import of the Full Production Act, which defines economic opportunity as the right to be productive, either through employment (where the prevailing state of technology requires it) or vicariously through private ownership of the non-human factor of production: capital—or through a combination of both.

The Full Production Act would declare a public policy of extending affluence to all households by raising their economic productiveness. Because the productiveness of labor in general has at best remained stationary through the ages, while the productiveness and relative quantity of capital instruments has been and is constantly rising through technological progress, the one-factor theory Employment Act of 1946 of necessity has been implemented largely by artificially contriving employment for its own sake, and distributing welfare under the guise of higher wages and fringe benefits. The Full Production Act would be implemented to a substantial degree by changes in corporate financing practices and facilitating legislation making it possible for more and more households to increase their economic productiveness through purchasing, paying for,

and thereafter employing the private ownership of productive capital in their daily lives.

THE FULL PRODUCTION ACT OF 19—

An Act to declare a national policy (1) on facilitating the full employment (as herein defined) of all able-bodied and competent persons, (2) on the full participation in the production of economic goods by all consumer units in the economy, (3) on the protection of private property in individual labor power and in the ownership of capital as the factors of economic production, and for other purposes . . .

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

Short Title:

SECTION 1. This Act may be cited as *The Full Production Act of 19——.*

Declaration of Policy:

SECTION 2. Congress declares it is the continuing policy and responsibility of the Federal Government to recognize, and to encourage the citizens of the United States to recognize that:

A. Man is born a creative entity combining the physical attributes of an animal with the spirit and soul of a human being.

B. Man's creativeness imposes upon him the duty and obligation to engage in creative work from his maturity and the completion of his formal education until the cessation of his creative capacity through death or disability, subject only to reasonable respite for rest and recreation, and that one who so engages in such creative work is "fully employed" within the contemplation of this Act.

C. The creative work of man is of two kinds, corresponding in general to the two aspects of man, animal and spiritual: one of these is the work of producing economic goods and services to satisfy man's need for creature comforts and economic security, and the other is the work of producing the goods of civilization which administer primarily to the mind and spirit of man, including the arts, the sciences, religion, education, philosophy, statesmanship, and the like.

D. There are two factors or instrumentalities which engage, or may be engaged, in the production of economic goods. These are the human factor (which is commonly called "labor") and the nonhuman factor (which is commonly called "capital"); that capital consists of all those things which are external to man, are privately ownable under the prevailing system of laws, and which are capable of being engaged in production.

E. The nonhuman factor, as the result of technological advance (including automation), plays (and increasingly since the beginnings of the industrial revolution has played) an expanding role in the production of economic goods and services, while the human factor plays (and presumably will always play) the dominant and unlimited role in the production of the goods of civilization. The purpose and end of all productive activity, both economic and of the goods of civilization, is the consumption and enjoyment of such goods by man.

F. It is the policy of the laws of the United States to assure and protect the integrity of private ownership of the factors of production by the individual citizens of this nation and by others; that in the case of the production of economic goods and services, the functional essence of such private ownership lies in the right and privilege of the individual owner of each productive factor so engaged in production to receive, *as a matter of right,* the entire net product of the thing owned; that this principle of private property is equally applicable to the income or wealth produced by the labor power pri-

vately owned by the worker (the human factor) and to the income or wealth produced by the non-human factor owned by the capital owner; that the right and privilege of private property in the means of production is meaningless in a free economy and free society unless the *value* of the income or wealth produced by a factor of production is (except in the case of legally authorized and regulated monopolies) freely and impartially determined by the forces of supply and demand in workably free, competitive markets; that this principle of private property in the means of production is embodied in the principle of distribution of economic goods and services (or their purchasing power equivalent), of the private-property, free-market economy of the United States, which is "from each according to what he produces, to each according to what he produces."

G. The nature and function of technology is to provide the means by which man subdues nature and makes her perform for him the work of producing economic goods and services; that through progress in technology, man transfers the burden of economic production from the human factor (labor) to the nonhuman factor (capital); that the promise implicit in technology is the release of man from the obligation to toil for the production of economic goods and services, and thus to free him to devote ever more fully his energies to the advancement of his civilization through the more disciplined and difficult work of producing the goods of civilization, so that the full employment of man's creative energies must consist increasingly, as technological progress moves forward, in his devoting his energies, efforts, and powers to the production of the goods of civilization.

H. The freedom and dignity of each consumer unit (household) within the American economy, whether it be comprised of an individual or of two or more individuals, requires that each such consumer unit produce, and that it constantly have the power and opportunity to *produce*, within the limits of the overall capacity of the economy

the purchasing power equivalent of the economic goods and services which it reasonably desires to consume; that the recognition of this right on the part of each household imposes upon the government of the United States and upon the governments of the several states of the Union, to the extent they shall by appropriate legislation concur herein, a social responsiblity to foster the institutions under which citizens may produce the economic goods and services, and may acquire the private ownership of the means of producing the economic goods and services necessary to provide themselves with individual economic wellbeing and security and to render unnecessary any citizen's being or becoming an object of economic distribution based upon need in any form.

I. The production of wealth (i.e., economic goods and services) is a means to an end, and is not an end in itself; that the human factor of production (labor) should never be considered a "resource" to be "fully employed" in the production of economic goods and services if those economic goods and services can be produced by the nonhuman factor of production; that the end to which the production of wealth is a means is the living of a good, comfortable, secure, creative and law-abiding life for individual citizens.

J. The market value of the economic goods and services produced by a free-market economy within a given period of time is approximately equal to the aggregate purchasing power distributed as a direct result of the productive process to those who participate, either through employment of their privately-owned labor power or their privately-owned capital, or both, in the process of economic production.

K. Any consumer unit of this economy that consistently produces, either through its privately-owned labor power, its privately-owned capital, or both, wealth and income in excess of what it reasonably desires to consume and reasonably needs to provide it with economic security, under conditions wherein any other consumer

units in the economy are consistently deprived of the opportunity to produce sufficient economic goods and services or the purchasing power equivalent thereto equal to what they reasonably desire to consume and to provide themselves with economic security, is thereby seeking to excessively concentrate its ownership of personal economic power to produce wealth and thus to indulge its greed; that it is the policy of the United States to discourage and prevent greed where it interferes with the individual economic productive rights of citizens of the United States.

L. Unlike the production and employment of economic goods and services, the production and enjoyment of the goods of civilization is an end in itself, and the need of society for the goods of civilization is unlimited; that the ultimate goal of a free society is to maximize the production and enjoyment of the goods of civilization, not for economic reward, for they are things that are inherently desirable and that ideally would not be produced for economic reward but for their intrinsic value, for the contributions to society and humanity which they comprise, and for the achievement involved in their creation and contribution.

M. Assuming the availability of land and natural resources, each mature individual other than those who suffer physical or mental infirmity is born with the private ownership of the means (his labor power) to contribute, in a pre-industrial, pre-automated economy, to the production of economic goods and services for the satisfaction of his creature needs and desires; that as technological change moves through the advanced stages of automation, the burden of production of economic goods and services falls increasingly upon the nonhuman factor of production, thus reducing and in some cases destroying the economic productiveness of the human factor of production; that under these conditions, the freedom, dignity and general affluence of individuals requires that the Government of the United States and the governments of the several states of the Union, to the extent that each of them, by appropriate legislation, shall concur herein, promote and foster the institutions under which citizens may maintain and increase their economic productiveness through their lawful and orderly acquisition of increasing quantities of the private and individual ownership of the nonhuman factor of production.

SECTION 3. The Congress declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, banking, finance, agriculture, labor and State and local governments, to coordinate and utilize all its plans, functions and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and broad, effective, individually-owned, private property in capital, and the institutions and agencies necessary thereunto, and the general welfare, conditions under which there will be afforded full opportunity for every household, comprised of one or more individuals, able, willing and seeking to produce the wealth (income) which its member or members reasonably desire to consume, to produce such wealth and income either through useful employment, including self-employment, or through the private ownership of interests in productive capital, or through a combination of the two, and to promote the maximum production of wealth and income for all households in the economy with a minimum of personal toil and drudgery.

SECTION 4. Economic Report of the President.

A. The President shall transmit to the Congress not later than January 20th of each year an economic report (hereinafter called the "Economic Report") setting forth:

1. The rate of production of economic goods and services, the levels of participation in economic production by the households of the economy, the extent to

which such production is being achieved respectively through the human factor, and through the privately-owned nonhuman factor, the levels of purchasing power of the households of the economy and the extent to which they result from employment, the private ownership of the nonhuman factor, and from other sources, and the levels and composition of production needed to carry out the policies declared in Sections 2 and 3 hereof;

2. Current and foreseeable trends in the rate of production of economic goods and services, the levels of participation in economic production by the households of the economy, the levels of employment, the levels of capital ownership, and the levels of purchasing power of the households of the economy resulting respectively from participation in production through employment, through the private ownership of the nonhuman factor, and from other sources;

3. The degree to which the value of labor and the value of the nonhuman factor of production are determined by the forces of supply and demand in workably free competitive markets or are administered, manipulated or controlled by private persons, by private corporation, or by public agencies, or otherwise;

4. The extent to which goods and services are being produced by government or government-owned agencies or entities or by nonprofit corporations;

5. The levels of concentration of the ownership of the nonhuman factor of production, and the extent to which greed in connection therewith may be impairing the right of all households within the economy to produce the wealth or income which they reasonably desire to consume;

6. The availability and adequacy of private and/or governmental institutions or agencies for facilitating by financing and by other lawful means the purchase or acquisition of capital equities by households with sub-viable capital holdings;

7. The levels of idleness or failure to engage in creative work within the society, and current and foreseeable trends therein;

8. The extent to which the economically available creative talents and energies of the citizens are fully engaged in contributing to the work of civilization, including the arts, the sciences, religion, education, philosophy, statesmanship, etc., the current and foreseeable trends therein and recommendations for changes or improvements therein;

9. The degree of effectiveness of the laws, both Federal and of the several states, providing for the protection and integrity of private property in the ownership of each of the factors of production;

10. The levels of technological improvement, and the adequacy thereof, under the prevailing state of development in the physical sciences and in engineering to maximize the production of goods and services within the economy with a minimum input of human toil and drudgery;

11. The extent to which wealth and income may be distributed within the economy on the basis of need rather than on the basis of contribution to production, and of current and reasonably foreseeable trends therein and recommendations for the minimization thereof;

12. The levels of technological advance within the various industries, and the current and foreseeable trends therein, and recommendations for the acceleration and improvement thereof;

13. A review of the economic programs of the Federal Government and of the several state governments relating to each of the foregoing during the preceding year and of their effect upon the production of goods and services, the production of the goods of civilization, the minimization of toil, the private ownership of the means of production, the existence of workable and free competition within the markets of

the economy, and upon the existence and extent of idleness or the failure to fully employ the creative talents and energies of the people of the United States, and of the means available for the minimization and elimination of such idleness;

14. A program for carrying out the policy declared in Sections 2 and 3, together with such recommendations for legislation as he may deem necessary or desirable.

B. The President may transmit from time to time to the Congress reports supplementary to the Economic Report, each of which shall include such supplementary or revised recommendations as he may deem necessary or desirable to achieve the policy declared in Sections 2 and 3.

C. The Economic Report, and all supplementary reports transmitted under subsection B of this Section shall, when transmitted to Congress, be referred to the Joint Committee created by Section 6.

SECTION 5. *Council of Economic Advisers.*

A. The Council of Economic Advisers (hereinafter called the "Council") created in the Executive Office of the President by the Employment Act of 1946 is hereby designated as the Council of Economic Advisers under and for the purposes of this Act. The Council shall continue to be composed of three members who shall be appointed by the President by and with the advice and consent of the Senate, and each of whom shall be a person who, as a result of his training, experience and attainments, is exceptionally qualified to analyze programs and activities of the Government in the light of the policy declared in Sections 2 and 3 of this Act and to formulate and recommend national economic policy to promote full participation in the production of economic goods by all households in the economy, broader and more effective private capital ownership, production, the expansion of privately-owned competitive enterprise, the

full utilization of the creative energies and talents of all citizens and residents of the United States and its territories, and the minimization of human idleness. The President shall designate one of the members of the Council as Chairman and one as Vice Chairman, who shall act as Chairman in the absence of the Chairman. The incumbents of the Council of Economic Advisers established by the Employment Act of 1946 holding office on the effective date of this Act shall hold such offices in the Council of Economic Advisers hereunder, subject to the provisions of this Act.

B. Employment of Specialists, Experts and Other Personnel.

The Council is authorized to employ, and fix the compensation of, such specialists and other experts as may be necessary for the carrying out of its functions under this chapter, without regard to the civil-service laws, and is authorized, subject to the civil-service laws, to employ such other officers and employees as may be necessary for carrying out its functions under this chapter.

C. Duties.

It shall be the duty and function of the Council:

1. To assist and advise the President in the preparation of the Economic Report;

2. To gather timely and authoritative information concerning economic development and economic trends, both current and prospective, to analyze and interpret such information in the light of the policy declared in Sections 2 and 3 of this Act for the purpose of determining whether such developments and trends are interfering, or are likely to interfere, with the achievement of such policy, and to compile and submit to the President studies relating to such developments and trends;

3. To appraise the various programs and activities of the Federal Government in the light of the policy declared in Sections 2 and 3 of this Act for the purpose of determining the extent to which such programs and

activities are contributing, and the extent to which they are not contributing, to the achievement of such policy, and to make recommendations to the President with respect thereto;

4. To develop and recommend to the President national economic policies to foster and promote free competitive enterprise, full and effective private ownership of capital, rapid growth in the number and proportion of households owning viable capital estates as a means of increasing their economic productiveness, avoidance of economic fluctuations or diminution of the effects thereof, and to maintain the maximum economic productiveness of all households within the economy of the United States either through employment, the private ownership of the nonhuman factor of production, or a combination of the two, as the current state of technology may determine, and thus to promote the growth and expansion of the purchasing power of the households of the economy;

5. Continuously to study and from time to time to formulate and to recommend to the President means for determining:

(a) the actual needs of the civilian economy for employment of the human factor of production after the elimination of all pretended or false employment, featherbedding, or employment which has been governmentally or privately synthesized for the sake of effecting a laboristic distribution of wealth rather than to fulfill an actual need for such employment under the prevailing state of technology;

(b) the size (by dollar value) of capital estate (herein called a "viable capital estate), generally capable, if owned by households of various sizes, of enabling such households to participate in the production of economic goods and services sufficiently to provide a reasonable degree of affluence and private economic security within the capability of the economy as a whole, which determinations shall be for the purpose of fixing from time to time the minimum goal of capital ownership for all households of the economy which it is the policy of this Congress to encourage;

(c) the size (by dollar value) of capital estate (herein called a "monopolistic capital estate"), which, if owned by households of various sizes, would tend to enable them continuously to participate in the production of economic goods and services in excess of a level necessary to provide a reasonable degree of affluence and private economic security and thus necessarily to deprive other households of the opportunity to participate in the production of economic goods and services sufficiently to provide a reasonable degree of affluence and security within the capacity of the economy as a whole.

6. Continuously to study and from time to time to formulate and recommend to the President means for implementing the policy of the United States to foster the institutions and conditions under which households of the economy can build their privately-owned economic power to enjoy a reasonable degree of affluence as a result of their participation in production through their private ownership of one or both of the factors engaged in production, and thereby to minimize the extent to which such households need rely upon any form of social security or socially distributed welfare within the economy.

7. To make and furnish such studies, reports thereon, and recommendations with respect to matters of Federal economic policy and legislation as the President may request.

D. Annual Report.

The Council shall make an annual report to the President in December of each year.

E. Consultation with Other Groups and Agencies;

Utilization of Governmental Services and Private Research Agencies.

1. In exercising its powers, functions and duties under this chapter:

(a) the Council may constitute such advisory committees and may consult with such representatives of industry, banking, finance, science, agriculture, labor, consumers, state and local governments, and other groups as it deems advisable;

(b) the Council shall, to the fullest extent possible, utilize the services, facilities and information (including statistical information) of other Government agencies as well as of private research agencies, in order that duplication of effort and expense may be avoided.

F. Appropriations.

To enable the Council to exercise its powers, functions and duties under this chapter, there are authorized to be appropriated such sums as may be necessary.

SECTION 6. Joint Economic Committee.

A. The Joint Economic Committee, created by the Employment Act of 1946, is hereby designated as the Joint Economic Committee under and for the purposes of this Act. It shall be composed of seven Members of the Senate, to be appointed by the President of the Senate, and seven Members of the House of Representatives, to be appointed by the Speaker of the House of Representatives. The party representation on the Joint Committee shall, as nearly as may be feasible, reflect the relative membership of the majority and minority parties in the Senate and House of Representatives.

B. Duties.

It shall be the duty and function of the Joint Economic Committee:

1. To make a continuing study of matters relating to the Economic Report;

2. To study means of coordinating programs in order to further the policy of this Act;

3. As a guide to the several committees of the Congress dealing with legislation relating to the Economic Report, not later than March 1 of each year (beginning with the year —) to file a report with the Senate and the House of Representatives containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report, and from time to time to make other reports and recommendations to the Senate and House of Representatives as it deems advisable.

4. Continuously to study, formulate and recommend to the Congress means for raising the economic productive power of those households of the economy that are not already affluent, in order thereby to raise their economic power to consume, including, but without being limited to, the following:

(a) promotion of the acceleration of technological progress in the means of producing increased quantities and improved quality of goods and services and the minimization of the use of human toil required for such production;

(b) simultaneously increasing the rate of new capital formation within the civilian economy of the United States and the rate of production and consumption therein of consumer goods and services;

(c) developing means of extending private ownership of capital to a rapidly expanding number and proportion of the households of the economy:

i) through improved and/or new methods of financing the acquisition of equity capital ownership through the use of pure credit in such manner as to create future savings by households devoid of present or past savings, as well as out of current and past savings;

ii) through modifications of the estate and gift tax laws and through discouraging or prohibiting the use of gifts, testamentary or otherwise, or of other practices or devices, to unreasonably concentrate the ownership of capital within particular households;

iii) through methods of financing new capital forma-

tion in commerce and industry in ways which enable workers having sub-viable capital estates to purchase and pay for additional capital interests and through promoting reasonable and adequate diversification in such holdings;

iv) through coordination of antitrust policy and the policies hereby declared, including means of financing the purchase by households having sub-viable capital estates of assets of corporations subjected to divestiture decrees pursuant to the antitrust laws of the United States;

v) through facilitating the establishment and financing of new enterprises and the ownership of such enterprises by a maximum number of households theretofore owning sub-viable capital estates;

vi) through the development of a system of investment preferences on newly issued securities of high investment quality for those households which have sub-viable capital estates;

vii) through such other tax, credit, and other devices or institutions as will be effective for that purpose within the policies hereby declared, together with appropriate restrictions on the use of such devices for speculative purposes or to create concentrated or monopolistic capital holdings;

viii) through the primary use of the credit system to promote new capital formation under the ownership of households having sub-viable capital estates, and through a diminishing use of credit to support the purchase of consumer goods and services as the increased participation in production by all households of the economy through increased capital ownership is achieved.

(d) ascertaining and recommending to the Congress the elimination of governmental practices which encourage the concentration of the ownership of the nonhuman factor of production.

5. Continuously to study and formulate means for making effective in both the legal and economic sense the laws of private property as they apply to the human factor and the nonhuman factor of production, including, but not limited to the following:

(a) the elimination, over a reasonable transition period, of the corporate income tax and other taxes which are levied in such manner as to intercept the income arising from production by the nonhuman factor before it reaches the hands of the individual owners thereof, together with adjustments in the personal income tax laws so as to prevent them from raising more than the necessary revenues required by government;

(b) the formulation of legislation designed to encourage or require mature corporations (corporations having reasonable access to market sources of financing new capital formation) to pay out to their stockholders 100% of their net earnings, after setting aside only reasonable operating reserves;

(c) the development and encouragement of freely competitive markets within which the value of the factors of production, both human and nonhuman, is determined, provided, however, that the necessity of maintaining a general high level of purchasing power should take precedence over a competitive decline in the value of the human factor of production where it is not substantially offset by an increased participation of the households involved in the production of goods and services through ownership of the nonhuman factor of production.

6. Continuously to study, and from time to time to formulate and to recommend to the Congress means for facilitating the full employment of all able-bodied and competent persons:

(a) to the extent necessary, under the prevailing state of technology, in the production of economic goods and services sufficient to provide a generally affluent economy; and

(b) to the extent that the production of a high and adequate level of production of economic goods and services can be maintained through the full and effective employment of the nonhuman factor of production and the freeing of a maximum number of individuals from the necessity of performing toil in

economic production, in the production of the goods of civilization, including the arts, the sciences, religion, education, philosophy, statesmanship, and the like.

7. Continuously to study and from time to time to formulate and to recommend to the Congress means for extending and deepening the understanding on the part of all citizens of the meaning and implications of the policies hereby declared and adopted.

C. Vacancies.

Vacancies in the membership of the Joint Committee shall not affect the power of the remaining members to execute the functions of the Joint Committee, and shall be filled in the same manner as in the case of the original selection. The Joint Committee shall select a Chairman and a Vice Chairman from among its members. The members of the Joint Economic Committee created by the Employment Act of 1946 who are holding office thereon at the effective date of this Act, shall hold such offices on the Joint Economic Committee hereunder, subject to the provisions of this Act.

D. Hearings.

The Joint Committee, or any duly authorized subcommittee thereof, is authorized to hold such hearings as it deems advisable, and, within the limitations of its appropriations, the Joint Committee is empowered to appoint and fix the compensation of such experts, consultants, technicians, and clerical and stenographic assistants to procure such printing and binding, and to make such expenditures, as it deems necessary and advisable. The Joint Committee is authorized to utilize the services, information, and facilities of the departments and establishments of the Government, and also of private research agencies.

E. Appropriations.

There is authorized to be appropriated for each fiscal year, the sum of $5,000,000, or so much thereof as may be necessary, to carry out the provisions of this Act, to be disbursed by the Secretary of the Senate on vouchers signed by the Chairman or Vice Chairman.

SECTION 7. The Employment Act of 1946 is hereby repealed.

APPENDIX IV

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 tradeoff 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 V

SUGGESTIONS FOR REVISION AND IMPROVEMENT OF

H.R. 462 (H.R. 5577)

1. Revise H.R. 462 so that ESOP allocations will be made substantially in proportion to relative compensation and that debt-financed employer stock is to be allocated as debt principal and interest are repaid, in a manner similar to that required under the Trade Act of 1974.

2. Provide that Treasury regulations may be prescribed to further define ESOP.

3. Permit ESOP diversification as necessary or desirable, with respect to providing benefits to employees and creating a market for employer stock.

4. Provide that the special individual retirement account (IRA) may be used to receive ESOP distribution of diversified assets, with modified IRA requirements to allow for holding of income producing assets with full payout of current income.

5. Extend the corporate dividend deductions to employer securities held by a former participant (or beneficiary) or by special IRA currently distributing dividends.

6. Provide that a "charitable" contribution to an ESOP is treated as an employer contribution for purposes of taxability and vesting.

7. Provide that newly-issued common stock transferred or sold to an ESOP by an employer may be valued at book value if higher than current market value.

8. Provide for immediate appeal to the Tax Court with respect to advance opinion procedure relating to ESOP transactions.

9. Amend ERISA to clarify the fiduciary standards applicable to ESOP transactions.

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APPENDIX VI

June 16, 1972

The political battle now being waged in Puerto Rico over Governor Luis Ferre's proposed Proprietary Fund for the Progress of Puerto Rico raises issues of fundamental significance to every individual and every nation. The question is whether the keystone assumptions of Keynesian economics are valid or relevant to modern industrial economies, either advanced or aspiring. Governor Ferre, in sponsoring legislation that would enable Puerto Rican wage-earners to attain ownership of income-producing capital, has challenged the authority of the Keynesian school of economics, which has influenced or dominated government policy and public opinion in western industrial democracies for 40 years or more.

Therefore, it is hardly surprising that the dean of Keynesian economists, Professor Paul A. Samuelson of the Massachusetts Institute of Technology, author of a best-selling economics textbook and a Nobel laureate, has been motivated to enter the Puerto Rican political controversy. His statement was written at the request of Senate president Rafael Hernandez Colon, leader of the Popular Democratic Party, the party opposing Gov. Ferre's New Progressive Party. The Governor's party dominates the House, which speedily approved the Proprietary Fund bill. The Senate, which is dominated by the opposition, withheld its approval on the grounds that it did not have sufficient time to consider the bill properly. Governor Ferre then called a special session to provide the Senate with this opportunity.

Senator Fred R. Harris concluded that the controversy is significant enough that his colleagues in the Senate would benefit from study of the exchange of views between Samuelson and Kelso/Hetter. The CONGRESSIONAL RECORD item is herewith reproduced.

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Senate

DISTRIBUTION OF WEALTH

Mr. HARRIS. Mr. President, one of the great undiscussed issues of our time is the distribution of wealth in this country. More and more of our public figures finally are beginning to understand that the distribution of income in the United States is unfair. From time to time in newspaper articles we now read the troubling revelation that the top 20 percent of the income bracket receives around 41 percent of the Nation's income after taxes, whereas the bottom 20 percent receives only around 5 percent.

But how much more unequal is the distribution of wealth. According to a survey by the Federal Reserve Board published in 1964, the wealthiest 20 percent of the population in 1962 owned 75 percent—I repeat 75 percent—of all private assets. Meanwhile, the poorest 25 percent of all families had no net worth—their debts equaled their assets. And the wealthiest 8 percent of the population owned 60 percent of all private assets.

Unfortunately, most American economists are not interested in this problem. They are lost in the clouds of macroeconomics and view wealth distribution as an equity question which is political most economic in nature. They, therefore, help to insure that no one will talk about it, that it will remain the great secret of our economy.

There is, however, an outsider to the profession who has attempted to force

the establisment economists to face up to the problem of the unequal distribution of wealth in the United States. The man's name is Louis Kelso, a highly successful San Francisco lawyer. The author of several books and articles on various mechanisms which would attempt to broaden the ownership of stock and real property in the United States, recently he encountered a breakthrough. Although economists would not listen to him, the new Governor of Puerto Rico would.

Governor Ferre thus proposed the creation of a Proprietary Fund which would assist the citizens of Puerto Rico to become stockholders. The idea behind his fund was not crude leveling but the creation of a mechanism which would insure that as the Puerto Rican economy grew, the benefits of growth would be more widely distributed among the population. In other words, his purpose was to attempt to bring to a halt the current system which permits those already owning great wealth to accumulate even more. His intention was to enable the little guy to have a chance to become a property holder.

The Ferre proposal soon gave rise to an exchange of views between noted economist Paul Samuelson and Kelso. Although the exchange is perhaps more polemical than a real examination of the problem would require, it is instructive.

In the case of Samuelson, despite hard points which Kelso must answer, we see again the unwillingness to face up to the problem of the distribution of wealth. Nowhere in Professor Samuelson's contribution is there any concern expressed over the extremes in wealth ownership on the island of Puerto Rico.

In the case of Kelso, whatever we may think of his recommendations, we have a man who at least is talking about an important problem. I am not judging his scheme one way or another. Neither man goes into sufficient detail for an outsider to judge the logical rather than the polemical face of the argument. Nevertheless, I rather feel Kelso won the exchange and for this reason. If his scheme is economically faulty as Samuelson suggests, then I agree with a point Kelso has made repeatedly, namely that the more established economists should come forward with a scheme which is not faulty. For the problem of such gross disparities in ownership is a real one. It will not go away because our more established economists ignore it.

Mr. President, I believe that others in the Senate will benefit from study of the Samuelson-Kelso exchange of views. I therefore ask unanimous consent that it be printed in the RECORD. I also ask unanimous consent that an article from the Wall Street Journal on the Puerto Rican plan be printed in the RECORD, as well.

There being no objection, the items were ordered to be printed in the RECORD, as follows:

[From the San Juan Star, Apr. 27, 1972]

THE PROPRIETARY FUND CRITICIZED

(By Paul A. Samuelson)

(EDITOR'S NOTE.—The following was released Wednesday by Senate President Rafael Hernandez Colon. Samuelson is the Nobel Prize-winning professor of economics at MIT who lectured at the University of Puerto Rico earlier this year.)

Statement by Paul A. Samuelson on House Bill 1708, concerning the Patrimony for the Progress of Puerto Rico (the Proprietary Fund).

1—This statement is prepared at the request of the president of the Senate of Puerto Rico, soliciting my views on the wisdom of this measure. The views I express are my own and have no relation to the views of any political parties or factions in Puerto Rico. Moreover, I make no pretense toward expert knowledge of Puerto Rico: I confine myself to problems of broad general economic principle, relating to the distribution of income and to economic development.

2—The general purposes of the bill must strike an economist as being vaguely philanthropic if not grandiose. One would wish for the typical citizen of any land both higher real wages and higher non-wage income. However, the guiding philosophy that underlies the bill is that associated with the two-factor theory of Louis Kelso (and various collaborators such as Mortimer J. Adler). Kelsoism is not accepted by modern scientific economics as a valid and fruitful analysis of the distribution of income, but rather it is regarded as an amateurish and cranky fad. Although it has been put forth in more than one book and has been around for a long time, the principal learned journals of economic science—e.g., the American Economic Review, the Royal Economic Journal, the Harvard Quarterly Journal of Economics, the Chicago Journal of Political Economy—have steadfastly withheld recognition and approval from the doctrines of Kelsoism. Its central tenet is contradicted by the findings of economic empirical science: according to statistical study of macroeconomic trends, by such distinguished scholars as Professor Simon Kuznets of Harvard (Nobel laureate in economics for 1971), Senator and Professor Paul H. Douglas (award winner for his Cobb-Douglas statistical measurement of the aggregate production function), MIT Professor Robert M. Solow, and numerous researchers at the National Bureau of Economic Research under the directorship of Arthur F. Burns, chairman of the Board of Governors of the Federal Reserve System, economic adviser to Presidents Eisenhower and Nixon, the contribution of labor to the totality of GNP is in the neighborhood of 75 per cent, with only 25 per cent attributable to land, machinery and other property.

Moreover, an increasing proportion of labor productivity is attributable in modern economics, such as Puerto Rico is aspiring to become, to investment of "human capital" in the form of education and skill enrichment. This 75-25 per cent breakdown is diametrically opposite to the Kelso presuppositions, which are purely speculative and not based upon econometric analysis of the observed statistics of nations at different stages of development.

3—Because the basic economic principles underlying the proposal are faulty, it is likely in practice to prove a cruel disappointment to the Puerto Rican people. Beyond its fundamental weaknesses, the proposal has many pitfalls and loopholes that the American Congress would condemn it to oblivion. Let me enumerate only a few of the defects that struck me at first study of the matter. If so many defects appear on the surface, think how many more a careful and informed analysis would reveal.

(a)—It is a first principle of sound finance that families at low income level must not invest so heavily as more affluent families in venture equities. Although Puerto Rican incomes are higher than they used to be and higher than in many Latin countries, island incomes are lower still than in any of the 50 states. It would be rash for California, our most affluent state, to tempt people into venture equity investment by guaranteed bank loans and various gimmicks of government guarantees and tax abatements. How much more rash for Puerto Rico.

(b)—You cannot get something for nothing in economic life. The scandal of John Law in ancient France pretended otherwise, and led to fiasco. I fear the same in this case. If the Commonwealth guarantees bank loans to purchase Patrimony stocks, it has thereby less credit to expend in other directions of development. What advantage is there in a dollar of dividends if it slows down the growth of productivity of real wages by tens of dollars?

(c)—The Commonwealth has a limited tax base. It must not squander that base. It must expend it prudently in developing industry. Every dollar of tax exemption squandered on the Patrimony is that much less of a dollar available for other Bootstrap operations. Here in the states, we have much experience, much of it sad, with venture capital efforts—the disastrous Small Business Investment Companies with their water tax exemptions, etc. All the least, very wealthy men who can afford to lose their money, should be relied on for such risky ventures. To tempt, or coerce, the masses and the poor into such avenues is to invite, if not disaster, at the least disappointment, economic inefficiency, and waste.

(d)—Further, the program is open to dangerous pitfalls of corruption, political patronage, and tax avoidance. Thus, if one has tens of thousands of dollars of capital gains in a business, and even if it makes no economic sense for this to be acquired by the Patrimony, there is a tax reason for selling to that body and temptation to lobby with some future government official to have this done. Who will be able to prevent this or even recognize that such a miscarriage of sound finance is taking place? To avoid inheritance tax, some men will send for the priest and at the same time acquire tax-exempt Patrimony shares, only to have their heirs sell off those shares after they have performed their loophole functions.

These are not vague possibilities. As consultant to the U.S. Treasury over the years and as an expert witness before congressional committees, I have had occasion to see every chink in the law exploited in this way, and yet I have never seen a mainland bill so carelessly drafted in terms of providing such tax-avoidance opportunities. The Puerto Rican legislature is warned!

4—In summary, despite the laudable intentions of the Patrimony bill, a careful cost-benefit analysis of its features in terms of scientific economics must raise grave fears concerning its unsoundness for a commonwealth anxious to elevate the standard of living of its citizens.

KELSO ANSWERS SAMUELSON'S ATTACK ON THE PROPRIETARY FUND BILL

(By Louis O. Kelso and Patricia Hetter)

We are grateful to Senate President Rafael Hernandez Colon. He has succeeded in doing what we have failed to do in more than a decade of effort. He has enticed a Keynesian economist—indeed, the dean of Keynesian economists—to break the conspiracy of silence which the profession has drawn around two-factor economics. More, he has wrung from Professor Samuelson an admission that the conspiracy has existed.

Professor Samuelson is correct in stating that "the principal learned journals of economic science," which he proceeds to name, "have steadfastly withheld recognition of approval from" two-factor economic concepts. The conspiracy extends beyond the refusal of the learned economic journals to publish articles, review books, or to acknowledge the existence of two-factor theory in any form. In the 14 years that have passed since the publication of The Capitalist Manifesto, no academic economist who has dis-

agreed with it has seen fit to accept numerous invitations to subject two-factor concepts to public debate and discussion. Nor have two additional books, numerous articles and lectures succeeded in tempting the dissenting academic economists to engage in open, forthright dialogue.

The official silence which the academic economics fraternity has carefully preserved over the years does not mean that academic economists have not heard of two-factor theory or are indifferent to the challenge it offers to their 30-year reign over men's minds and the economic policies of the governments of the West. During these same years we have acquired an impressive collection of private "economic analyses" and "critiques" written by academic economists. Not one of these "refutations" has ever reached us through the courtesy of its author, or through the medium of print. The academic economist knows that controversy spreads ideas. Therefore, he prefers to attack underhandedly by stealth, using his self-conferred status as "expert" to disparage two-factor economics and to intellectually intimidate anyone of prominence who appears likely to succumb to this dangerous new heresy.

Even surreptitious attacks would be welcome and valuable if they were addressed to the actual concepts and assumptions of two-factor economics, and to the concrete business applications and the proposals and policies which this line of thought suggests. But this has yet to occur. Invariably the academic economist constructs out of a melange of fact and fiction a conceptual scarecrow which, he assures his reader, is an accurate representation of Kelso's ideas. With self-righteous ostentation, he then proceeds to demolish this effigy straw by straw, to demonstrate of what flimsy stuff it is constructed.

We had supposed that an academic economist of Prof. Samuelson's distinction would be above such shabby tactics. But his statement on the Ferre Fund is indistinguishable from the works of his minor league precursors. Like them, Prof. Samuelson has not bothered to read the books or articles which set forth the ideas he presumes to criticize. He does not understand two-factor economics. He does not understand the mechanics of the Proprietary Fund. He does not, by his own admission, understand the economy of Puerto Rico or the aspirations and needs of its people. Before we present the evidence for this harsh judgment, however, we would like to make a few general remarks about the academic Keynesian economist and the relationship between Keynesian economics and the state of the world today.

During the thirty-five years Kelso has spent as a corporate and financial lawyer among the men who actually organize and manage the wealth-producing enterprises that academic economists theorize about, the only professional economists he has encountered were in staff capacities, mostly in very large banks. Economists, particularly academic economists, have no function in the productive sector of the economy. They theorize about it (from a distance), they are supported by it, but they are not part of it.

The layman is inclined to believe that the "economist" is the final authority on all things economic; the economist, being human, does not discourage the illusion that without him the macro-economy would come crashing down about our ears in ruin. Happily for mankind, however, the facts are quite the opposite. We think it would help the people of Puerto Rico to evaluate Prof. Samuelson's contribution if we briefly considered the subject matter and limitations of Keynesian economics. For Prof. Samuelson is, of course, a Keynesian.

In his own words, "I first resisted the Keynesian revolution, and was finally won over." [1] Not only is Prof. Samuelson a Keynesian economist, he is the archetypical Keynesian economist. From the same New York Times interview, published shortly after he was awarded the Nobel Prize in economics in 1970: "Mr. Samuelson gladly accepted the award as evidence of the respect still due, in his opinion, the Keynesian school of thought. 'I have never been,' he said, 'a lone wolf outside the frame of reference of modern economists generally. My faults are the faults of my contemporaries. I have been through all the metamorphoses.'" [1]

But the world is waking up to the fact that Keynesian economics is not quite as "scientific" as its practitioners pretend. Sweden, one of the first countries to run its economy on Keynesian principles and widely proclaimed as a model of success, is in deep economic trouble. Here is the distinguished economics journalist Leonard Silk reporting to the New York Times from Stockholm:

"Public indignation over the failure of governments to solve the problem of inflation by conventional monetary and fiscal measures—without causing more unemployment than is politically tolerable—is starting to force a breakup of economic dogmas and political alignments throughout the Western world. The trend is comparable to the impact on politics and economics of persistent mass unemployment in the 1930's. But now as then, *public demands for improvement in economic policy are in advance of what either the economics profession or the politicians are yet prepared to offer.*" [2] [Italics ours.]

After 40 years of the harshest redistributive taxation in the Western world (average income tax 40%, sales tax, 17%), a Swedish government commission in 1968 found that taxation and social policies had little effect on income distribution, and that concentration of ownership of capital is even greater in Sweden today than in the United States or England. Inflation rampages on—it was 6% in 1971.

Recently the influential magazine, Saturday Review, devoted an issue to questioning the relevance of Keynesian economics. Here is Robert A. Solo of Michigan State University; not as illustrious an academic economist as Prof. Samuelson, but more honest:

"It comes down to this: the Establishment economics that is taught in the universities, proliferated in the journals, regurgitated in the councils of government, with all its mountains of published outputs, has not advanced our capacity to control our economy beyond what it was in the late 1930s.

"That after the clear failure of neo-classical and Keynesian concepts and techniques of monetary and fiscal control, the nation is left with no answer to the persistent and profound economic problems of inflation and unemployment save a wage-price freeze in the manner of World War I or World War II attests to the sterility of economic thought and policy." [3]

In 1971 the distinguished journalist Edwin L. Dale, Jr., of the New York Times, himself an economist, brought back what he described as a "cautionary tale" from England. There a great debate had raged over the question of whether Britain should or should not join the European Common Market. About a week before the decisive vote in Parliament, two letters appears in the Times of London. The first letter, signed by 154 full-time teaching officers of economics in British universities, predicted that the economic effects of joining the European Common Market "are more likely to be unfavorable than favorable to Britain." The second letter, signed by 142 full-time teaching officers of economics in British universities, predicted that these economic effects "are more likely to be favorable than unfavorable to Britain."

"Thus did the informed British public receive the verdict of the 'experts,' following about 10 years of erudite discussion and a mass of written material (including statistics) that probably equaled the entire literary output of the productive, eighteenth century," commented Edwin Dale. He went on to explain that the issue was not the merits of Britain's entry into the Common Market. The issue was economists.

"In the United States we have gone through the strange drama of the monetarists versus the fiscalists while the economy itself was going to pot. We have had ever more complex econometric models of the economy with ever more dubious results.

"As the mountain of literature grows, and the mathematical equations become more impenetrable, and the predictions become more suspect, it is fair to ask a cruel question: are we seeing the decline and fall of the economists' empire?" [4]

The failure of Keynesianism in Great Britain was conceded as long ago as 1958. The august journal, The Economist, wrote the obituary. It recalled that Keynes had observed at the end of his magnum opus, "The General Theory of Employment, Interest and Money":

"Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

The Economist then delivered the coup de grace:

"The piquant situation today is that Keynes himself is now a defunct economist." [5]

It is true that The Economist only dethroned Keynes in order to crown Milton Friedman and his monetary doctrines. But now the monetarists, after a brief day in the sun, are themselves defunct. At the American Economic Association annual meeting in New Orleans in January of this year, Milton Friedman made this memorable confession:

"I believe that we economists in recent years have done vast harm—to society at large and to our profession in particular—by claiming more than we can deliver. We have encouraged politicians to make extravagant promises [which] promote discontent with reasonably satisfactory results because they fall short of the economists' promised land." [6]

At the same meeting, Arthur Okun admitted, in the words of The Wall Street Journal, "How distressing it was for himself and other Johnson administration fiscalists that the 10% income tax surcharge of mid-1968 failed to dampen the inflationary boom. 'When we were able to call the policy tune . . . the economy did not dance to it,' he ruefully recalls." [7]

Nor does Arthur F. Burns, chairman of the Board of Governors of the Federal Reserve System, seem to consider Keynesian economics the last word in scientific exactitude. In July of 1971 he issued this understatement of the fiscal year: "The rules of economics are not working in quite the way they used to." [8]

And this brings us to the heart of the matter.

Society imposes on "experts" in other professions—most particularly the sciences—the most rigorous standards of accountability. Society does not bestow honors on engineers whose bridges collapse, nor do people queue up to consult physicians whose patients mainly end up in the cemetary. The reward of a lawyer who counsels his client to ruin is not the Nobel Prize but a malpractice suit. But economists so far have been excused from having to submit their theories to the test of empirical reality which society imposes on more mundane disciplines. In the forty years that have turned all economists into Keynesians, the diagnoses, proposals and remedies emanating from this profession have been consistently in error. The institutional walls between our actual and potential productive power on the one hand and our proliferating poverty and misery on the other, have remained. These theories display without exception the fatal character to which Pasteur, who was a true scientist, declared the infallible sign of a false theory, namely, "the impossibility of ever foreseeing new facts; whenever such a fact is discovered, those theories have to be grafted with further hypotheses in order to account for them." [9]

"True theories, on the contrary," continued Pasteur, "are the expression of actual facts and are characterized by being able to predict new facts, a natural consequence of those already known. In a word, the characteristic of a true theory is its fruitfulness." [10]

With a sound theory, in other words, you can make accurate predictions. But the "scientific economics" of Prof. Samuelson and his colleagues is virtually useless for providing reliable information about the future.

The ancient Roman Senate consulted public soothsayers or augurs before every important act of policy, government or war; these haruspices—liver inspectors—would report on the will of the gods by examining the entrails of sacrificed animals. Academic economists are the augurs of our day, although their clients could probably learn more about the future by reading an academic economist's entrails than by consulting his prognostications and econometric models.

Here we venture to make a modest prediction. The world is about to discover that economics is only potentially a science. True "scientific economics" is two-factor theory, not yet recognized in the circles of the academic economists. Fashionable economics today is in exactly the same state that medicine was before the germ theory of Pasteur. Prof. Samuelson considers two-factor economics a "crankish fad." We consider his one-factor economics preposterous quackery which enlightened people will soon discard. Puerto Rico, indeed, is already in the process of doing just that—which is the real motivation for Prof. Samuelson's attack.

The fundamental absurdities of Keynesian "scientific economics" are generously illustrated by Prof. Samuelson in his statement.

To begin with, the Professor asserts that the central tenet of two-factor economics is "contradicted by the findings of empirical science," as personified by various Keynesian colleagues and institutions whose names he proceeds to drop for the next 10½ lines—in the belief, evidently, that the people of Puerto Rico will be intimidated by this fusillade of authority into relinquishing the right to think for themselves. Prof. Samuelson would do well to recall the wise warning of one of his colleagues, the British economist Colin Clark: "Economists, speaking collectively, have a remarkable capacity for being wrong." [11]

Unfortunately, Prof. Samuelson has either dashed off his statement in careless haste, or entrusted its preparation to one of his students. For he neglects to identify two-factor economics' central tenet. He implies that it is the opposite of what empirical "economic science" has found, namely that labor contributes about 75% to the total GNP, and land, machines and other property only 25%. If Prof. Samuelson means that labor receives about 75% of the total income in the economy, while capital owners receive about 25%, this is such a universally-known fact that no one would bother to dispute it. This statistic is not the central tenet of two-factor economics, however. Since Prof. Samuelson does not seem to be able to locate its central tenet, perhaps he will not be offended if we venture to enlighten him.

The central proposition of two-factor theory is simply that there are two factors of production, people and things, and that the function of technology is to shift the burden of production from the human factor to the non-human. Each factor produces wealth in exactly the same sense—physical, economic, political and moral. An individual can legitimately and effectively engage in the production of wealth through the ownership of either factor, or, as common sense suggests, through a combination of both.

This is a momentous and basic truth which Prof. Samuelson could not refute even if he understood the significance of what is asserted, which he does not.

It is also a truth which neither the economic policy of the United States nor that of any other nation recognizes. Under the tutelage of one-factor Keynesian "scientific economics," the economic policy of all the Western nations is exactly the same. Full employment of the labor force alone is relied upon to enable all people to produce an adequate income. It is full employment that is the number one goal—not the highest level of affluence attainable with current technology and consistent with environmental protection and wise resource use. The Keynesian economic goal is indistinguishable from that of the Soviet Union, and its imitators in Cuba, China, etc. Its spirit may be summarized in a phrase: Full toil for all forever.

Puerto Rico, through the Ferre Plan, would be the first government in the world to recognize that things produce wealth as well as do people and that in an age of accelerating technology, a family can rarely produce an affluent standard of living for itself through labor alone, even if all of its members are employed. Each consumer unit must have the opportunity to produce some of its income through ownership of productive things, as well as through employment. No Keynesian has ever suggested such a policy, nor could he, for his pre-industrial tunnel mind is focused on just one factor of production, labor, and his ideal for humanity is to make a toiler out of every human being not confined to his crib or his bed, and to leave the ownership of proliferating and ever-more productive capital to the already rich.

The people of Puerto Rico must be alerted to one other Keynesian blind-spot before we dispose of Prof. Samuelson's other erroneous and irrelevant criticisms of the Ferre Fund. Keynesian doctrine is totally oblivious to the concept of private property. It is indifferent to ownership—to its legal attributes, to its personal, social and economic benefits, to the relationship between private property and freedom, to the economic and social consequences of the concentration of ownership of industrial wealth (with only a handful of exceptions), and to the hole of private property in power diffusion. To the Keynesian, the income produced by capital exists only to be redistributed. Property, like freedom, independence, leisure, affluence, love of peace, and other human desires, are "values," and "ethical judgments," and the Keynesian economist is not concerned—to quote Prof. Samuelson's best selling economics textbook—with "basic questions concerning right and wrong goals." These are beyond the realm of their "science."

Property, of course, is a supreme value—it is only private property in one's labor power that distinguishes the free man from the slave. Being oblivious to property, the professional economist also ignores the evidence that most human being are fiercely attached to their property, resent parasites, and strenuously resist all the plans of the professional Keynesian economist to redistribute their property, income, from labor or from capital, to the less productive or the non-productive. In the 8th edition of Prof. Samuelsons textbook, Economics, the concept "property" appears in the index only twice, one of these entries being "Property taxes." A total of 71 pages is devoted to employment, full employment and unemployment. This emphasis eloquently reveals the Keynesian blind spot.

But the American economic dream—indeed, the universal economic dream—has never been toil, but a defendable property relationship between the individual and the productive land, structures, and machines on which economic wellbeing depends. The Keynesian "scientific economist," who considers the realm of value judgments none of his affair, does not understand that his sacrosanct goal of full employment is itself a value judgment, for if capital instruments are the source of affluence and leisure, why should men and women be condemned to make their productive input solely through toil and labor? Why should economic policy fly in the face of technological facts? Why should the rich get more capital and the poor stay capital-less?

The goal of the Proprietary Fund is to eventually create a generally affluent Puerto Rico. Employment opportunities will be greatly increased by the new consumer demand that the Proprietary Fund will help unleash. Full employment should be an important *effect* of the Ferre Plan. It is not the *goal*. Its goal is greater affluence for Puerto Ricans.

Mr. Samuelson states that "one would wish higher real wages and higher non-wage income for everyone." This pious sentiment confuses the issue at the outset. The Proprietary Fund envisioned by Gov. Ferre is not designed to create just any kind of "non-wage income." It is specifically designed not to create any of the kinds of non-wage income that the Keynesians rely so heavily on to accomplish redistribution. Indeed, it is precisely such kinds of non-wage income that bloat the statistics Prof. Samuelson cites as evidence that labor *produces* 75% of the economy's goods and services. That labor *receives* 75% of the economy's income does not mean that labor produced it. The statistics include income obtained through organized coercion, doles, unemployment compensation, redistributed income removed from the productive sector through taxation, governmentally subsidized boondoggle paid for by taxpayers (income channeled through boondoggle is disguised to look like "wages," but actually represents non-productive make-work grants, subsidies, or other types of hand-out).

Not a trace of criticism is due labor unions or individual wage-earners for this development. The responsibility rests squarely on Keynesian "scientific economics" which lie, misrepresent or equivocate about technology's logic and function. Keynesian "scientific economists" assure workers that technology causes the productivity of their labor to rise, although the facts are just the opposite. The Keynesians, in short, with their one-factor myopia, have put the workers and their unions in a position where, as inevitable technological change robs them of the adequacy of their labor power, their Keynesian-misguided institutions do not restore and enhance that productive power by building capital ownership into them. Keynesian doctrine forces labor to demand more pay for less work—a short-term gain that is quickly offset by the resulting rise in the cost of living.

Prof. Samuelson frequently invokes the "findings of economic empirical science" based on "statistical study of macrocosmic trends." But a real scientist looks behind observed phenomena for the explanation or cause. To ignore the role that coercive redistribution plays in the national income statistics, and to assert that all the income diverted to labor represents real productive input, is about as "scientific" as reading a thermometer while holding a blow torch under the mercury bulb.

As for the scientific basis of Keynesian economics, Prof. Samuelson's advice to beginning economists who study his textbook, Economics, reveals his contempt for scientific method:

"'Satchel' Page, a great baseball player, once said: 'Never look back: someone may be gaining on you.' This is good advice in economics, too. Do not look back to see what caused past layoffs; look forward to see what you have to do to restore high employment. This is more efficient—and more helpful.

"Better still, this approach means you do not have to decide whether the pessimists are right who argue that inventions will kill off more jobs than they create. Why care? *In every case we know that high employment without inflation will require monetary and fiscal policies of the correct magnitudes and mixed economies know what needs doing.*" [12] [Italics his.]

The Ferre Fund is designed to enable men born without capital, or without adequate capital, to buy it, to pay for it out of the income *it* produces, to own it and thereafter to receive capital income in addition to their wages.

"Wishing" is one thing. Translating the wish into action is another. Perhaps Mr. Samuelson would come forward and identify those of his works (written works, that is) where this "wish" has been translated into an actual proposal for enabling the non-propertied many to obtain capital ownership. We have searched his writings carefully and are confident that no such proposal has ever been made or implied. Since Prof. Samuelson is a millionaire and is proud of his speculations in the stock market, it may be presumed that he is aware that capital ownership exists and is a good thing—for Prof. Samuelson and the 5% or so of families who monopolize ownership of capital assets in the United States and elsewhere.

As for the Proprietary Fund proving "a cruel disappointment to the Puerto Rican

people," that is a strange prophecy, considering its source. Keynesian "scientific economics" has been disappointing people in one economy after another for almost 40 years. Since 1932 the Keynesians have pretended to be fighting poverty. In actuality, they have invariably confined their attacks to the *effects* of poverty, while meticulously ignoring its cause: the low economic productiveness of exclusively labor-dependent people unassisted by capital ownership in an economy where progressively more goods and services are produced by the non-human factor of production owned only by a few families at the economy's pinnacle. As a consequence, and with rare exceptions, the only poverty consistently cured under Keynesian policies and prescriptions is the poverty of Keynesian economists. Little wonder that Gov. Ferre's proposal to attack the causes of Puerto Rican poverty by building capital ownership itno the people has triggered Prof. Samuelson's desperate effort to save the Keynesians' faces. He libelously insinuates that Gov. Ferre is the modern day counterpart of the 1720 infamous stock swindler, John Law, who nearly bankrupted France with his fraudulent scheme.

As for the "defects" that Prof. Samuelson thinks he sees in the Proprietary Fund proposal, not one is well founded.

"It is a first principle of sound finance that families at low income levels must not invest so heavily as more affluent families in venture equities." The professor has managed to overlook the fact that the Proprietary Fund involves making available to the average worker the logic of business investment that is traditionally used by the business corporation itself on behalf of its stockholders: to provide them with access to *nonrecourse credit* on terms where it will be used to buy newly issued stock, the proceeds of which to the corporation will be used to acquire business capital on terms where it will pay for itself. The Proprietary Fund, like the growing applications of two-factor financing techniques used in business in the United States, does not call for any deductions from the worker's paycheck, nor for investment of his savings. Thus, it is a kind of investment which enables the man born without capital to invest in the largest and best managed corporations on terms where, when the productive capital has paid off its financing cost, he can own it, protect it, and enjoy its income. Nothing in the Proprietary Fund proposal, nor in any use of two-factor theory to build equity ownership into those who are born without capital, involves any "venture equity investment" by the individual either of his income or his savings. Thus Prof. Samuelson, by misrepresenting the nature of the proposal, seeks to mislead his readers and his clients.

"You cannot get something for nothing in economic life," says the professor. What the professor implies here is that (1) one who does not own capital can legitimately acquire it only to the extent that he foregoes the use of current income for consumption and (2) that one cannot acquire income without personal toil. The first point, as noted above, happens to be contrary to the basic self-liquidation logic of financing capital formation that is standard operating procedure in well-managed businesses everywhere. The second implication happens to be a variation on a favorite phrase that Prof. Samuelson repeats over and over again in his writing and in his lectures: "There is no such thing in economics as a free lunch."

In the pre-industrial past, the "no free lunch" assertion was true for most men. Today, it is not true except to the extent men continue to be victims of one-factor Keynesian thinking. The essence of two-factor theory is that there are two factors of production, the human factor or labor, and the non-human factor or capital. In the sense that men may legitimately and properly enjoy income produced by their privately owned capital, there is such a thing as a toll-free lunch. Indeed, the industrial world lives primarily on toll-free lunches, and as technological advance progresses, it will increasingly do so. In the sense of saving toil, you can indeed get something for nothing in economic life, and it is the purpose of the Proprietary Fund to make this advantage of technology available to those who traditionally do not own capital. That Prof. Samuelson will have many of his most cherished misconceptions trampled upon by such a program is perhaps of less importance than solving the problems of poverty for the masses and the inadequacy of their purchasing power for the merchants.

Prof. Samuelson darkly hints that "if the Commonwealth guarantees bank loans to purchase Patrimony stocks, it has thereby less credit to expend in other directions of development." What he conveniently overlooks is that the proceeds of the Patrimony Fund received from the credit-financed purchase of its stock is indeed invested in economic development. That is one of the main purposes of the Proprietary Fund.

"The Commonwealth has a limited tax base. It must not squander that base. It must expend it prudently in developing industry. Every dollar of tax exemption *squandered* on the Patrimony is that much less of a dollar available for other Bootstrap Operations." Prof. Samuelson again resorts to incredible misrepresentation. One of the prime purposes of the Proprietary Fund is the developing of industry, the building of the Commonwealth tax base, the the expansion of Commonwealth private industry. All of the expertise that has been used in "Bootstrap Operations" will be used in the operations of the Proprietary Fund, with this difference: the ownership of the industry thus developed and expanded will be built into private individual citizens of the Commonwealth.

The scientific professor, in referring to the said experience of the United States with "venture capital efforts" is disregarding in total the objectives of the Proprietary Fund. Its function, exactly like the function of "Operation Bootstrap" is to bring to Puerto Rico or expand in Puerto Rico the largest, best financed, best managed and most prosperous business corporations that can be found. The difference is that a portion of their ownership, to the extent financed through the Proprietary Fund, will be in the individual Puerto Rican employee, without any deduction from his paycheck or investment of his savings. Capital, in well-managed businesses, pays for itself, not just once, but repeatedly. The object of the Proprietary Fund is to assure that the first time following investment by the Proprietary Fund that the capital pays for itself, it will be owned outright by the employee-investors (through non-recourse credit) in the Proprietary Fund. The scandalous distortion about "tempting" and "coercing" the masses and the poor into giving up their limited wealth is simply "scientific" misrepresentation.

"Further, the program is open to dangerous pitfalls of corruptions, political patronage, and tax avoidance." If Prof. Samuelson can conceive of any greater corruption than that fostered by the "scientific economists" through their subsidized boondoggle in agriculture, industry, education, research, foreign aid, and elsewhere, we would like to know about it. The cheap political trick of trying to prevent sound change by conjuring up visions of misuse and human fraud is an old one. The fact of the matter is that those economies which do not make the ownership of capital available to the great majority of their citizens inevitably invite fraud and corruption.

The American Dream, so far as economics is concerned, is the ownership of a private holding of capital that will produce a private supplement to income. The "scientific economists" have succeeded in defeating realization of this dream for most Americans for 40 years. Without legitimate avenues to buy capital, pay for it out of what it produces, and to own it and enjoy its economic security and its support to political freedom, fraud inevitably becomes a part of the distribution structure itself. Thus the activities in recent decades of the "scientific economists," in limiting the masses of citizens of every economy to the solution of their personal income problems through employment (real and pretended) alone, are the chief perpetrators of fraud and corruption. If men cannot acquire capital ownership legitimately, in a world where it is perfectly clear that the ownership of capital is critical to their wellbeing, then they will acquire it illegitimately.

The important truth is that all schools of one-factor economic thinking—the "scientific economists"—are obsolete. The "scientific economists" of the Keynesian or Keynesian-Samuelson schools, like "scientific Marxism," are as non-scientific and as contrary to reality as it is possible to be. Their theory of the "rising productivity of labor" (a more grotesque version is called "increasing human capital") is a hoax. It consists of measuring the output of two factors of production (the human and non-human) in terms of the input of one (the human) and attributing all gains, where comparisons are made, to the human factor. In reality, the gains in productiveness are not in the human factor but in the non-human factor. It is capital that is the source of our increasing affluence, and when "scientific economists" deprive most men of the legitimate, effective and speedy means of acquiring the ownership of capital, they deny them the right to freedom, to leisure, to peace, and to affluence.

Gov. Luis A. Ferre is a modern hero in his earnest effort to make the ownership of capital accessible to those Puerto Ricans who are not born with it. It may well serve the purpose of Gov. Ferre's political opponents to call upon the pseudo-scientific economists like Prof. Samuelson to mislead the public as to the nature and purpose of the Proprietary Fund bill, but it does not serve the interests of the people of Puerto Rico, nor their future prosperity, nor their liberty.

Puerto Rico has before it in the Ferre proposal the opportunity to show all of Latin America, and indeed all of the world, that there is an alternative to socialism, either of the Marxian variety such as that found in Cuba, or of the Samuelson variety that is gradually converting the United States economy into state capitalism.

FOOTNOTES

[1] New York Times, Nov. 7, 1970, p. 2-E.

[2] New York Times, Oct. 7, 1970, p. 67.

[3] Saturday Review, Jan. 22, 1972, p. 47.

[4] New York Times, Nov. 7, 1971, p. 7 Financial Section.

[5] New York Times, Nov. 6, 1968, p. 53.

[6] The Wall Street Journal, Jan. 10, 1972, p. 1.

[7] The Wall Street Journal, Jan. 10, 1972, p. 1.

[8] Statement before the Joint Economic Committee, July 23, 1971, p. 2.

[9] The Life of Pasteur, by Rene Vallery-Radot (Garden City Publishing Co., Inc., N.Y.), p. 243.

[10] Op. cit.

[11] The Cost of Living, a pamphlet (Hollis & Carter, London) 1957.

[12] P. 319, Economics, 8th Edition.

[From the Wall Street Journal, Mar. 29, 1972]

IN PUERTO RICO, STOCKS FOR EVERYONE

(By Richard F. Janssen)

SAN JUAN.—To examine garden-variety government giveaways, one needn't come to Puerto Rico. To the chagrin of conservatives and the applause of liberals, governments around the world long have been handling out everything from false teeth to flour and beans, from welfare checks to subsidized mortgages.

But one does have to come to Puerto Rico to find a government planning a giveaway that is uniquely seasoned to both liberal and conservative tastes: shares of stock, and for nearly everyone.

In essence, Puerto Rico is considering opening up to the average mechanic or garbageman the same avenue a wheeler-dealer might take toward investment in a corporation with no cash outlay of his own—borrow money from a bank, use it to buy stock and use the dividends to pay off the loan. To make this painless approach to investorhood feasible on a mass basis, the Puerto Rican author-

ities propose to prearrange and guarantee the loans, and provide the stock through a sort of government-run national fund.

If the bill being pushed by Gov. Antonio Luis Ferre is enacted (and prospects appear good), it could gradually transform Puerto Rico into a "commonwealth" in actuality as well as name, making it an island populated almost entirely by capitalists. All this, advocates admit a bit nervously, may flow from a theory that no country has hitherto tried to apply, and one that most prominent American economists dismiss as a crackpot dream.

MR. KELSO'S THEORY

For years now, Louis O. Kelso, a San Francisco lawyer-author, has been telling people about his "theory of universal capitalism." It holds that the economy would grow much faster if the earnings of capital went to the great mass of people poor enough to speed them swiftly on the wordly goods they need, rather than to a tiny slice of wealthy investors already sated with possessions.

If the theory takes roots in Puerto Rico's lush tropical climate, it just might be transplanted to northerly industrial nations. Canadian officials are already expressing interest, sources here say, and the more enthusiastic backers can envision long-poor Puerto Rico someday leading the U.S. itself into a bright new era in which every worker enjoys a sizeable "second income" from his dividends.

So what happens here is "important for the world," says Joseph A. Novak, a 41-year-old private tax lawyer from Massachusetts. Mr. Novak finds himself the key man in the effort to tailor the theory to Puerto Rican conditions. His assignment owes much to some chance personal encounters.

Mr. Kelso met once with Gov. Ferre some time ago, while on a mission involving a much narrower aspect of his dream, a corporate employe stock ownership plan. On the airplane back to the mainland, Passenger Kelso happened to sit next to Passenger Novak, and sparked his interest. Last summer, chance struck again. Gov. Ferre tapped Mr. Novak's law partner to be his treasury secretary, and Mr. Novak sent the idea up through the newly personalized channels. He almost instantly drew the assignment to draft a detailed plan, which stayed quite secret until the governor sprang it early this year.

If it succeeds, the impact could be nothing less than "to save capitalism," Mr. Novak asserts. By giving almost everyone "a piece of the action," he figures, there's at least a fighting chance to counter the alienation of the young and poor, and to inspire employes to greater loyalty and diligence. Maybe, others add, it would even make workers less likely to resort to strikes and sabotage such as the much-criticized-local telephone company has suffered lately.

Failure, on the other hand, could cause at least as much grassroots disillusionment with the free enterprise system here as the collapse of speculative off-shore mutual funds has among Europe's small stockholders.

Even if so much weren't potentially at stake, the details of the plan would be inherently intriguing. And they could, of course, make it foolproof, or mask a fatal flaw.

The basic instrument is to be the "Proprietary Fund for the Progress of Puerto Rico," known popularly in Spanish as the "Patrimonio" and in English as the "Ferre Fund," a nicety not lost on the governor's political opponents in this election year. Every employed Puerto Rican with gross wages between $800 and $7,800 a year would be eligible to buy convertible preferred shares in the fund. In turn, the fund's professional managers would invest in a diversified portfolio of commercial, industrial and agricultural operations in Puerto Rico.

The individual shareholders could buy in "without putting up a dime," Mr. Novak stresses, because the government expects banks to make fully guaranteed loans to every eligible person. And there's a free bonus to lure eligible investors into the plan; if a worker borrows his proposed first-year limit of $50 to buy the preferred shares, the government will draw from a $10 million appropriation to buy him a matching $50 of common shares.

With priority accorded to those at the lowest end of the income scale, planners expect they'll be able to accommodate about 200,000 of the 800,000 eligible investors the first year. The dividends on both classes of stock will be earmarked for paying off the bank loans, at which point the preferred shares will be converted into common and the worker-investor can start pocketing the dividends.

That should take only about five years, they figure, counting on shrewd investment decisions and a generous array of tax advantages to produce a return to the fund of 20%, maybe even 40% annually. (If it does take longer than five years, the government pays off the bank loans and gets all the dividends until it in turn has been paid off.) Under the law, the individual's credit record would be protected against any blemish.

For earnings to be at least 20% annually is "not all that unrealistic," Mr. Novak argues. Some of the investment will be in small, presumably fast-growing local ventures, and in most cases the fund will insist on a "relatively high" dividend payout before investing. The fund will be free of all taxes, and it can issue tax-exempt bonds to supplement its resources.

That's not all. If the fund owns, say, 25% (the proposed maximum control) of a corporation, then 25% of that company's income tax will be turned over to the fund in addition to the dividends. To encourage people to sell shares they now own in profitable existing businesses to the fund, the bill would make their capitol gain tax-free. These receiving dividends on fund shares won't pay any income tax on them, and higher-income residents earning up to $18,000 a year will get an income-tax deduction for buying up to $100 in fund common shares under a "supplemental investment plan." This might provide many more millions to add to the fund's basic first-year resources of $20 million.

HAZARDS CONCEDED

There are hazards, even ardent backers concede. At one extreme, the fund could become too successful. Within a few decades, some figure, it could prosper so massively that it would clearly be the most pervasive force in Puerto Rico's economy, in effect socializing or nationalizing much of industry, agriculture and retailing. Conceivably, the fund's chunk of big U.S. and foreign companies doing business in Puerto Rico could give it the pivotal voice in proxy fights, pollution-policy battles and other corporate issues, with global reverberations.

At the other extreme, it could be starting so small that it will stay that way. The prospective five-year wait for the first dividend check could deter many from even bothering to make the trip to the bank and to fill out the loan application. And then the dividends might not be more than a few dollars a year, or an almost imperceptible few cents a week, far from enough to bring a meaningful reordering of social attitudes and economic standing.

Despite a lot of local press attention, proponents are well aware that overcoming apathy, misunderstanding and outright mistrust rank as major problems. "The Patrimonio? I know noting of it," shrugs Umberto, a short-order cook in a working-class restaurant here; nor does he want to, and not because he's uninitiated in the world of finance. "A few years ago I bought stock in a very famous food company, and now I hear nothing from them—except I read that they are bankrupt."

Unsettling for one Ferre plan fan is that he tried to explain it to the family cleaning woman, finally settling for the simplest possible description that it is "just like *acciones*," Spanish for common stocks. Only she hadn't heard of acciones. Other potential investors are unshakable in their misimpressions. "It is only for government employees," insists Juan, a part-time waiter who cites his credentials as a student of political science as authority. Besides, he argues, "I am a socialist, and this is a reactionary sham."

Some more careful analysts come to much the same conclusion. The suspicion can't be avoided that the Ferre Fund is "little more than a dressing up of the facade of the body politic, or worse still, politicking for the working class vote in an election year," contends an article by Richard Gillett, director of the Puerto Rico Industrial Mission, and Jose J. Villamil, a professor in the University of Puerto Rico Planning School.

A BASIC OBJECTION

The basic objection, these and other academic critics contend, is that with an unemployment rate running around 12% there are other things that Puerto Rico needs more—among them a more progressive tax system and greater budget outlays for housing, welfare and other services rendered more directly to the poor.

Legally required profit-sharing by individual companies probably would have more impact on worker morale than this "indirect and most likely ineffectual" economy-wide form, suggests the university's Prof. Arthur J. Mann. He doubts it can do much to redistribute income; now, he calculates, the poorest fifth of Puerto Rican families have 3.2% of the income, while the richest fifth have 47.2%.

The advocates appear no less sincere, however, in wanting to reach the same ends of a more equitable distribution of wealth, and in a way that strengthens rather than weakens the free enterprise system. Anyway, the appeal of "something for nothing" is so elemental that labor and political leaders to the left of Gov. Ferre's GOP-oriented New Progressive Party generally aren't inclined to risk outright opposition.

So it appears that Mr. Kelso's long-scorned plan for a short-cut to universal capitalism is due for its first practical test. It is hard to shake the thought that it is probably just as well that the test take place on a very small island. But it is also hard to avoid the conclusion that it is well for the test to be made.

APPENDIX VII

Signs of Crises in Economic Theory

1. "Normal science can proceed without rules only so long as the relevant science community accepts without question the particular problem-solutions already achieved. Rules should become important, and the characteristic unconcern about them should vanish whenever paradigms or models are felt to be insecure. That is, moreover, exactly what does occur." p. 47.

2. "Because it demands large-scale paradigm destruction and major shifts in the problems and techniques of normal science, the emergence of new theories is generally preceeded by a period of pronounced professional insecurity. As one might expect, that insecurity is generated by the persistent failure of the puzzles of normal science to come out as they should. Failure of existing rules is the prelude to a search for new ones." pp. 67-68.

3. "If the complexity of a 'science' increases faster than its accuracy in problem solving beware: a crises is at hand." pp. 68-71. "Proliferation of versions of a theory also foreshadow a paradigm crises -- the discrediting of a theory." p. 7.

4. Mr. Kuhn makes absolutely clear the vital role of crises in making possible the recognition of innovation.

5. He also points out that so long as accepted theory solves most of the problems, innovation is unlikely. (p. 76)

From: The Structure of Scientific Revolutions, by Thomas S. Kuhn, University of Chicago Press, 1970.

EXHIBIT 1
to Testimony of Louis O. Kelso

Joint Economic Committee
Hearings on Employee Stock
Ownership Plan (ESOP) Financing

December 11 and 12, 1975

September 8, 1975

REBUTTAL BY

LOUIS O. KELSO
Chairman of the Board and Managing Director

and

NORMAN G. KURLAND
Washington Counsel

KELSO BANGERT & CO., INCORPORATED
INVESTMENT BANKERS

WITH RESPECT TO

"AN EVALUATION OF THE EMPLOYEE STOCK OWNERSHIP PLAN

AS APPLIED TO CONRAIL," MAY 12, 1975

prepared under contract with

UNITED STATES RAILWAY ASSOCIATION

by

Towers, Perrin, Forster & Crosby
E. F. Hutton & Company, Inc.
Saul Gellerman/Consulting, Inc.

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I

SUMMARY

1. The three consultants hired by USRA to critique the use of an ESOP to finance the capital formation needs of ConRail share one blind spot in common: in making their "negative case" against the ESOP, they are totally oblivious of the stark reality that the top 1% of Americans own over 50% of all individually owned U.S. corporate stock and that conventional methods of financing new capital formation in U.S. industries, like our railroads, will create trillions of dollars of new industrial capital without creating any new owners in the process.

2. The USRA report is silent regarding the increasing vulnerability of companies in basic industries, like energy and rail transportation, to nationalization pressures, a situation rooted in their extremely narrow ownership base, leaving them with hardly any popular constituency, even among their own employees.

3. Close analysis of today's crisis of capitalism around the world, evidenced by the decline of our Northeast and Midwest rail systems, is directly traceable to serious structural flaws in our business corporations, labor unions and most particularly, in our extremely primitive modes of financing corporate capital requirements, which have failed to provide effective access to capital ownership among workers without whom corporate profitability and a free enterprise system cannot survive.

4. The ESOP method of finance is the exclusive method available under present Federal laws that provides a source of funding to corporations like ConRail to meet their financing requirements, while building equity ownership into all employees without any reduction in their present compensation levels, without invading their savings, and at no personal risk in the event any particular financing transaction under the ESOP turns out to be non-viable.

5. According to its Congressional supporters, the ESOP offered a new solution for reorganizing troubled industries in general, as well as a fundamental new direction in ownership patterns for the U.S. rail system and "the only alternative" politically to eventual rail nationalization. Not a single mention was made in the USRA report of the ESOP, when held up against conventional strategies for financing ConRail, as a safeguard against eventual nationalization and future bailouts of basic industries. Thus, the report was written without any regard to the basic Congressional purpose underlying the study of the extent to which ConRail should utilize ESOP financing.

6. Maximum application of ESOP financing principles would enable ConRail to be launched, from its inception, as a 100% employee-owned enterprise, with no outside stockholders. If successful, employees would share ConRail's profits in the form of stock accumulations and dividend incomes, an unexpected "bonus" over what they now had bargained for. If 100% employee ownership cannot make ConRail work, than the workers are no worse off than they are today. But none of USRA's consultants considered this as an option for Congress

and USRA, an innovative alternative to the status quo in labor-management relations and a practical way of placing in the hands of ConRail management and ConRail labor, maximum incentives as well as complete ownership responsibilities to make the enterprise highly competitive and profitable, after the initial start-up period without any taxpayer subsidies.

7. USRA's final system plan assumed that ConRail could not be re-organized in any way to make it profitable, at least for several years. In failing to consider maximum use of ESOP financing, USRA and its consultants proceeded upon a conventional course, not unlike the shaky path which led to the demise of railroads in the first place. (In fact, USRA actually completed its preliminary system plan even before it hired consultants to carry out Congress' ESOP mandate.)

8. USRA's consultants, by omission, offer no solution to the historic indifference of rail labor to management's problems of meeting competition and generating profits. If the ESOP cannot unite the interests of management with those of ConRail's unionized workers, what is their alternative?

9. USRA's consultants take for granted a bailout philosophy and reflect no sensitivity to the rising hostility among American taxpayers to the rising costs of bailouts and to the failure of new Government-owned corporations like the U.S. Postal Service. For example, E.F. Hutton assumes that the Federal Government will have to guarantee over $3 billion in

new loans to ConRail and further assumes that present creditors of bankrupt railroads are entitled to gain all equity increases from the new capital that is purchased with such Federal help. To E.F. Hutton, if the workers gained such equity through an ESOP, it would be an unfair "windfall", but E.F. Hutton has no similar reservations about providing risk-free credit to increase the net worth of existing creditors by over $3 billion.

10. The USRA's consultants' evaluation of the ESOP is entirely negative and is replete with tortured logic, gross distortions, and highly biased and short-sighted comments about the ESOP, a financing innovation which has been demonstrated successfully in over 100 U.S. corporations and has been widely hailed in technical journals as "a major advance in corporate finance." (See Part VI of this memorandum for a detailed point-by-point rebuttal of the USRA evaluation of the ESOP.) For example, the study:

a. Ignored the growing support for the ESOP concept on Capitol Hill and in the Administration (e.g. the Commerce Department's ESOP Development Bank loan to an ESOP at the South Bank Lathe Company) and the mushrooming use of ESOPs by large national corporations, many with unions. BARRON'S recently described the ESOP as an idea "whose time had come" and lauded it as "the first major answer to the Keynesian economic policy that has mesmerized much of American thinking since World War II".

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b. Failed to consider the "best case" for ESOP -- 100% employee ownership -- and instead evaluated only the implications of "token" use of the ESOP in a company owned 100% by creditors of the bankrupt railroads.

c. Was incorrect in its analysis of the tax and financing implications to ConRail under an ESOP.

d. Structured its profitability projections without assessing the potential of trading-off potential ESOP benefits for at least a portion of future wage increases, or the possibility of lower interest rate loans and additional tax incentives for ESOP financing under three new Federal laws plus several others now being considered by Congress to encourage ESOPs.

e. Failed to survey the attitudes of rank-and-file workers on the ESOP alternative despite the recent findings that American favor, by a 66% to 25% margin, workers owning most of their company's stock.

f. Conspicuously discarded a 20-year-old ESOP model with 100% employee ownership and six unions -- Peninsula Newspapers, Inc. -- by failing to recognize the nature of the ESOP as a new means of finance.

g. Found absolutely no negative evidence in the ESOPs it studied but still concluded that there were "serious motivational disadvantages" in undertaking an ESOP.

h. Is based upon a scientifically half-complete and outdated analysis of "productivity" concepts, which is still used to rationalize labor demands for inflationary wage hikes.

i. Reflect little political or philosophical understanding of the nature of "private property" in a corporate setting and the importance of broadening the base of corporate ownership.

j. Uncritically accepts the status quo in regard to present labor/management patterns in bargaining over compensation issues.

11. Congress should take new initiatives to encourage an ESOP in the planning and structuring of ConRail. (See specific recommendations in Part VII, below.)

II

INTRODUCTION

In promoting their stock brockerage services on TV, E.F. Hutton contends, "When E.F. Hutton speaks, everyone listens." Hence, when E.F. Hutton, as USRA's consultant on the ESOP as a financing alternative to meet ConRail's capital formation requirements, rendered its verdict on the ESOP, everyone must take it seriously. To the anguish of the proponents of the ESOP and the thousands of workers who have become capital owners through the ESOP -- many in 100% employee-owned companies -- E.F. Hutton signaled thumbs down. E.F. Hutton ruled that ConRail's profits would decline if the workers purchased their equity through ESOP financing.

USRA mobilized two other consultants to prove that employee stock ownership won't work -- Towers, Perrin, Forster & Crosby and Dr. Saul Gellerman -- but clearly E.F. Hutton is the heavyweight in the pack, because the ESOP is essentially, according to its proponents, a radically new thrust among corporate financing techniques. Hence, this response is heavily weighted to counter E.F. Hutton's critique. (See Section A of Part VI, below, for our point-by-point rebuttal of the detailed USRA Report.)

Geared as its operational philosophy suggests to a speculator's market -- largely manipulated by a small cluster of institutional investors -- E.F. Hutton can perhaps be excused for not recognizing the ESOP as a new investor's tool. Speculators buy to sell and sell to buy. Investors buy for the long haul, and they hold on to their investments, looking

toward their investments for their income potential. Since the ESOP provides a company its own in-house "stock exchange", companies with ESOPs have little need for E.F. Hutton's advice on how to gamble in the Wall Street casino.

If ConRail's profit potential will be decreased if its equity is owned 100% by its employees, as E.F. Hutton suggests, then the free enterprise system is in worse shape than its detractors suggest. If ConRail cannot earn a profit when each and every employee has his fair share of ownership in the company, then there is no legitimate market for ConRail's services and it should be abandoned at once.

While it is true that this industry has been badly neglected and abused in the past -- and drastic surgery is now in order to save the victim -- new disciplines are vital and must be imposed if a newly reorganized ConRail will ever again pay for itself.

Certainly, temporary subsidies are in order to ease the pain of the patient during the recovery process. But continuing subsidies and bailouts are like drugs, which must inevitably weaken the "muscle" and self-supporting discipline of the new ConRail and its employees. This discipline must be restored.

Workers can no longer ignore the fact that increases in labor costs must be passed on either to customers or to taxpayers. If taxpayer support is to be gradually withdrawn, as it should be, workers will have to be placed in a position where they will be disciplined in the future by the marketplace for rail services, by their ability to compete with alternate

means of transportation, and by their desire to maximize profits. They can no longer be left in the position where there is no self-imposed restraint to demanding more and more pay, unless they want to upgrade their skills and responsibilities or work longer hours. But a self-imposed lid on labor cost increases does not place any ceiling on the capital increases which can be made accessible to workers of a ConRail owned 100% from its inception by its employees. If labor costs become stabilized, or even reduced, the ESOP will provide workers new capital benefits in the form of annual increases in equity ownership and dividend incomes distributed to workers and retirees. . .at no extra cost to the company over its normal capital formation costs. Nothing is taken away from workers to which they are entitled, but something new has been added: an opportunity to own all the capital and receive all the profits of ConRail. . .if they and management can work together in the future. All revenues from ConRail customers will accrue to the benefit of of the worker-stockholders. But, by design, the workers will be "forced" (actually, by their own self-interests) to make the system profitable. No demand for economic justice can logically exceed the unique opportunity for workers to acquire -- through credit tools formerly monopolized by the rich -- 100% of ConRail's ownership pie and thus share, if they and management make the system work, 100% of the "wages" of capital to supplement their paychecks and retirement checks.

Like the laws of gravity, the laws of supply and demand cannot be repealed by human coercion. But through hard work, discipline, cooperation and reasoned action, the laws of the

marketplace can be harnessed to serve society and can gradually again govern economic values. By opening the door to capital ownership to rail workers, labor costs can again gradually be allowed to be set by free market forces. Labor incomes would no longer continue to be manipulated artificially by strikes and threatened strikes, by government edict, or by endless and self-defeating power struggles between organized labor and rail management.

USRA and its consultants never fully considered the potential of a 100% employee owned ConRail as an alternative both to continuing its ownership by a tiny class of absentee owners or to converting it into a new government owned corporation like the U.S. Postal Service. USRA and its consultants have had their chance, and they found nothing positive to say about the ESOP. Their critique is addressed in careful detail herein. Recommendations to the Congress for action on the ESOP are contained in Part VII. The responsibility to act on the ESOP again rests with the Congress.

III

WHAT IS AN ESOP?

An excellent description of the Employee Stock Ownership Plan (ESOP) and its companion trust (ESOT) is reprined below:

The Journal of COMMERCIAL BANK LENDING

April 1975

ESOT and the Commercial Banker

by Cass Bettinger
Assistant Vice President
Commercial Security Bank
Salt Lake City, Utah

EMPLOYEE STOCK OWNERSHIP TRUST (ESOT)—a new idea which, in its brilliant simplicity, sets one's mind reeling with its manifold implications!

Although many refinements and extrapolated applications of ESOT have been developed in recent years, the basic concept was the brainchild of attorney-economist Louis O. Kelso, author of numerous stimulating and highly original books. His most recent, *Two Factor Theory: The Economics of Reality*, is co-authored by political scientist Patricia Hetter and follows *The Capitalist Manifesto and the New Capitalists*, which Kelso co-authored with the well-known philosopher Mortimer Adler.

Kelso's theories propose affluence as the most desirable goal of any economic system and are based on the premise that there are two factors of production: (1) labor, mental as well as manual, and (2) capital, the nonhuman factor. Since most wealth is the product of capital in a technologically advanced economy and since the vast preponderance of capital is held by a minority of the populace with the majority relying solely on labor for its source of income, universal affluence is impossible. Welfare programs in Kelso's opinion perpetuate the basic problems rather than solve them, inasmuch as they are based on false economic premises.

"No man has ever achieved affluence on a dole, nor will he," states Kelso matter of factly.[1]

The answer in Kelso's opinion is to allow a greater percentage of the population legally to acquire capital ownership since affluence is the product of capital or capital plus labor, but never of labor alone. ESOT is nothing more or less than the technical vehicle whereby this universal affluence is made possible. For the commercial banker it is a mechanism which can greatly benefit many corporate clients while vastly improving the position of the lending bank relative to those clients.

Features of ESOT

ESOT is a highly sophisticated form of qualified stock-bonus plan authorized under Section 401(a) of the Internal Revenue Code. Qualified contributions are deductible from corporate income in the same manner as they would be to a qualified profit-sharing plan. Contributions may be made in amounts not to exceed 15% (or up to 30% in the event that less than the permissible maximum was contributed in past years) of the aggregate compensation paid or otherwise accrued during the taxable year to all employees covered by the stock-bonus or profit-sharing plan. Contributions may be made in stock, in cash or in a combination of the two.

Analysis of a hypothetical ESOT

To demonstrate how an ESOT can simultaneously benefit the corporate borrower and the lender, a hypothetical set of circumstances will be examined illustrating, first, increased cash flow and net worth and, second, facilitation of debt repayment, under the plan, as well as other important benefits.

Increased net worth and cash flow

Let us assume that XYZ Corporation is a good bank customer with total annual payroll of $1,500,000 and annual pretax earnings of $400,000. A comparison of operating results for one year with no qualified plan, a standard profit-sharing plan and an ESOT is shown in Table 1.

Under the ESOT plan net worth is increased to a far greater degree than with the normal profit-sharing plan since funds contributed to the trust are invested in the stock of the company itself. Nevertheless, an ESOT can, if and when shares of the employer corporation are not available, invest in mutual funds, bank certificates of deposit, insurance contracts and other qualified investments in the same way as a normal profit-sharing plan.

[1] Louis O. Kelso and Patricia Hetter, *Two Factor Theory: The Economics of Reality* (New York: Vantage Books, 1967), p. 26.

TABLE 1
COMPARISON OF OPERATING RESULTS

One Year	No Qualified Plan	Profit-Sharing Plan	ESOT
Net Before Taxes	$400,000	$400,000	$400,000
Contribution (15% × $1.5MM)	0	225,000	225,000
Net After Contribution	400,000	175,000	175,000
Est. Fed. and State Taxes (54%)	216,000	94,500	94,500
After-Tax Earnings	184,000	80,500	80,500
Tax Savings and Incremental Cash Flow	0	121,500*	121,500*
Incremental Net Worth	184,000	80,500	305,500**

*$216,000 − $94,500 = $121,500
**$225,000 + $80,500 = $305,500

Another difference between the ESOT and the profit-sharing plan *per se* which may well be of interest is that the ESOT may receive contributions from the corporation even though a tax loss results, thus making it possible to recover, by means of a refund, taxes paid by the corporation in prior years. For example, let us assume for simplicity that ABC Corporation has an annual qualified payroll of $2,000,000 and net income for current and prior years as follows:

Year	Pretax Income	Federal Taxes
1974	$100,000	$ 41,500
1973	80,000	31,900
1972	70,000	28,400
1971	50,000	17,500
	$300,000	$119,300

If, as in the previous examples, our corporation contributes an amount equal to 15% of payroll for 1974 ($300,000), the following would be appropriate in accordance with IRC Section 172:

Year	Income	Deduction Loss	Balance Loss Carryback	Net Taxable
1974	$100,000.00	(100,000)	(200,000)	0
1973	80,000.00	(80,000)	(120,000)	0
1972	70,000.00	(70,000)	(50,000)	0
1971	50,000.00	(50,000)	(0)	0
	$300,000.00	300,000		

The net result to the corporation is a fully allowable tax refund of $119,300. This hypothetical example is, of course, based on simplified figures. Bankers

and their clients with the usual professional assistance, augmented by the aid of an ESOT specialist, must carefully analyze all relevant data pertaining to each particular case to determine optimum feasibility.

Facilitation of debt repayment

Let us now assume that the XYZ Corporation decides to undertake a major expansion program requiring financing of $1.5MM repayable over a seven-year period. As the banker analyzes the feasibility of the project, management depth and competence, the customer's industry trends, cash flow and funds flow projections, ratios, money-market conditions, etc., it is determined that the risk is a sound one and that the loan can and should be made.

At this point the banker will endeavor to structure a package that will provide his bank the highest possible yield with the greatest degree of security, while at the same time meeting the client's needs to the maximum. If at this point the banker has in his repertoire of services a practical knowledge of the ESOT, he can work with his customer to determine what additional benefits might accrue through implementation of the plan.

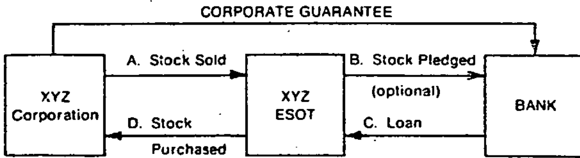
Further pursuing our hypothetical case, let us assume in addition to annual payroll of $1.5MM and pretax earnings of $400,000, an approximate 7% annual return on the invested equity (very conservative by SEC studies). On this basis the annual income of the corporation will be increased from $400,000 to approximately $500,000. If we also assume, as in our first example, aggregate effective Federal and state income taxes of 54%, liquidation of the entire $1,500,000 debt obligation would require the potential borrower to generate pretax earnings of $3,260,000. Therefore, with pretax income of $500,000, it would take slightly less than seven years to repay the loan, well within the company's guidelines (for simplicity we are assuming stable income and are not considering interest).

If an ESOT is structured for the XYZ Corporation, and the money is borrowed directly from the bank by the ESOT, with an appropriate corporate guarantee, as shown in Graph 1, the XYZ Corporation may then utilize the loan proceeds for its expansion program. As contributions are made annually to the ESOT, they are applied to debt servicing as shown in Graph 2.

Since the annual contribution in the foregoing illustration is $225M (15% of annual payroll of $1.5MM), it would take approximately the same amount of time to repay the loan. The important difference is that the debt has been repaid with *pre-tax* dollars. Therefore, it has been necessary for the corporate borrower to generate only $1,500,000, rather than $3,260,000. A seven-year analysis of comparative performance is shown in Table 2. The substantial increases in cash flow and net worth are readily apparent and vividly illustrate the tremen-

dous benefits to the borrower as well as the resultant improved position of the lender.

GRAPH 1
BORROWING STRUCTURE



GRAPH 2
DEBT-SERVICING STRUCTURE

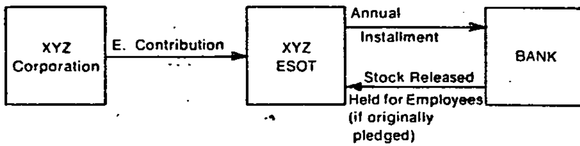


TABLE 2
ANALYSIS OF SEVEN-YEAR PERFORMANCE

Over Seven Years	Without ESOT	With ESOT
Net Before Taxes	$3,500,000	$3,500,000
Contribution (15% × $1.5MM × 7)	0	1,575,000
Net After Contribution	3,500,000	1,925,000
Est. Fed. and State Taxes (54%)	1,890,000	1,039,500
After-Tax Earnings	1,610,000	885,500
Loan Repayment	1,500,000	0
Net After Loan	110,000	885,500
Tax Savings and Incremental Cash Flow	0	850,500*
Incremental Net Worth	$ 110,000	$2,460,000**

*$1,890,000 − $1,039,500 = $850,500
**$1,575,000 + $885,000 = $2,460,500

Benefits to employees

Shares are held by the trust for the ultimate benefit of the covered employees, thus creating for them, through dividends from the shares, a "Second Income Plan," a vital part of the Kelso philosophy. In essence, the employees have graduated from mere laborers to laborer-capitalists. As Kelso states in *The Two Factor Theory*, "Thus, in the macrocosmic sense, the Second Income Plan is a method for building simultaneously (1) the individual power of the people to produce wealth and, therefore, (2) the legitimate power of the masses to consume it."[2] Employee motivation is thus vastly increased and the result should be improved worker productivity. Apparently persuaded by the Kelso philosophy, Senator Paul J. Fannin of Arizona introduced a bill in Congress last year to encourage consideration of the ESOT plan on a broader scale.[3]

Disadvantage

The only real criticism of the ESOT plan is the charge that it results in equity dilution. This is not usually the problem, however, that one might immediately assume. Although a given shareholder's percentage of ownership might decrease, given the rapid growth in net worth the actual value of the decreased percentage may actually be much greater. While numerous factors would regulate the actual dilution, an analysis by Kenneth P. Veit in *The National Underwriter* concluded with the statement that: "Generally speaking, however, it appears that the claim of no dilution is valid."[4]

Conclusion

ESOT offers numerous benefits, many of which are beyond the scope of this paper, as is an in-depth discussion of the full range of social, political and economic implications of Kelso's "Second Income Plan" and related theories. Our purpose has been to introduce the ESOT concept and to examine the potential benefits inherent to the plan for the corporate borrower and the lending institution.

When already bankable loans are made to an ESOT rather than to the corporation directly, repayment may occur with pretax dollars, with the substantial benefits previously identified. Dilution of stock is not normally a problem. Nevertheless, since an ESOT must be tailor-made to specific circumstances, the dilution factor may be fairly well quantified in advance.

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[2] *Ibid.*, p. 47.
[3] Michael T. Malloy, "Riches for All" in *The National Observer*, May 25, 1974, p. 20.
[4] Kenneth P. Veit, "Kelso Revisited: A Technical Look at Novel Plan for Raising Capital," in *The National Underwriter*, April 24, 1971.

It is, of course, imperative that the corporate officers, together with their banker, attorneys, accountants and an ESOT specialist analyze in depth the full implications of the plan. Inasmuch as ESOT is a sophisticated and complex tool, the importance of securing the counsel of a qualified ESOT specialist cannot be understated if it is to be implemented properly and utilized to its fullest potential. Where this procedure has not been followed, problems have resulted. Where this is accomplished it will, in many cases, be evident that the benefits to borrower and lender alike are substantial. □

Another highly informative discussion of ESOT, analyzing in greater detail the specific notes of both the Commerical Banking and Trust Departments, is that by John O. Todd, "Employee Stock Ownership Trust–Opportunity for Banks," in the August 1974 issue of Burroughs Clearing House.—Ed.

IV

WHAT IS THE LEGISLATIVE CONTEXT SURROUNDING THE ESOP PROVISION IN THE NORTHEAST AND MIDWEST RAILROAD REORGANIZATION LAWS?

The Regional Rail Reorganization Act of 1973 directs the United States Railway Administration (USRA) to design a final system plan for reorganizing the Penn Central Railroad and other bankrupt Northeast and Midwest rail systems in a manner which creates "a financially self-sustaining railway system in the region which also meets the service needs of the region and the Nation." (Sec. 206(e)(3)(F)).

In his floor statment of December 11, 1973, Senator Russell B. Long clearly outlined the choices available to Congress and the USRA in designing the financial architecture of the new regional rail system:

> "What an irony of history that our railroads -- the key to the rise of America to industrial and agricultural greatness, and now even more vital to the development of a freer, more prosperous, and more environmentally hospitable economy yet to be built -- took the wrong turn over a century ago, leading the rest of American industry headlong into pinnacle ownership, the concentrated ownership of capital.
>
> "Our railroads today have been the first to arrive at a deadend in that road. We, the members of this Congress, more than a century later, are now given a second opportunity to provide a prototype design for the pattern of ownership of the American economy.
>
> "We could take the first course and further exacerbate the already intensely concentrated ownership of productive capital in the American economy.
>
> "Or we could join the rest of the world by taking the second path, that of nationalization.
>
> "Or we can take the third road, establishing policies to diffuse capital ownership broadly, so that many individuals, particularly productive workers, can participate as owners of industrial capital.
>
> "Mr. President, the choice is ours. There is no way to

to avoid this decision. Non-action is a political decision in favor of continued, and indeed increased, concentrated ownership of productive capital.

"Which of these three ownership alternatives make the most common sense, the most political sense, the most social sense, indeed, the most moral sense?"

After Senator Long completed his statement, Senator Vance Hartke, Chairman of the Senate Surface Transportation Subcommittee and floor manager of this legislation in the Senate, responded:

"[T]his is probably one of the most innovative ideas presented in this bill. . . . Individuals that would, under normal circumstances, appear to be opposed to this kind of operation, seem to be sympathetic to it. . . . Not only is it possible that this could lead the way in the railroad industry, but also, this could be the beginning spot for giving to other major industries in the Nation." (CONG. RECORD, Dec. 11, 1973, p. S 22552.)

Senator Long provided USRA with a comprehensive new perspective to guide their planning of the ConRail final system plan, when he raised the question:

"Why did one of the most important railroad systems in the world, located in one of the most highly populated and highly industrialized areas of the world, possessing a labor force that was more than adequate both in numbers and in skills, fall into shameful disrepair and finally bankruptcy?"

He answered his own question:

"One must necessarily conclude that the causes lie within the institutional arrangements -- the financial designs -- of the railroads themselves, and within the institutional relationships between the railroads and governments, both Federal and State.

"It is not the task of Congress to restore the losses of stockholders of the bankrupt system. Rather, while protecting the property rights and values that remain, it is the task of this Congress to so guide the organization and restructuring of the railroad enterprises and of their relations with government, that they will in the future run efficiently and economically, will take full advantage of our internally available fuel supplies, and will provide a model of enterprise to which we can look for answers to the industrial malaise that mars

other areas of our economy." (CONG. RECORD, p. S 22548.)

In his floor statement, Senator Long advised the USRA:

"If our railroads fail to build substantial ownership incentives and the discipline of the profit system into its workers in the future, they will never again earn a profit. Nationalization will inevitably follow. And, since railroads have always been pacesetters in our industrial network, in the best and worst of times, we will have laid the foundation for eventual nationalization of our airlines, trucking, agriculture, mass media, telephones, energy development and production, manufacturing, and the rest of our enterprise system. Everyone will be on the Government's payroll. . . .

"I think it will be a grave error. . .to hand over automatically all new common stock to existing creditors and to delay in building substantial equity ownership into the railroad work force. How fast and how much ownership we build into workers will directly determine the odds that we can avoid nationalization. . . . .Only in this way can Congress demonstrate that the misguided and short-sighted notion that railroads cannot provide low-cost quality service at a profit, will not become a self-fulfilling prophecy. . . .

"In S. 2767, the Senate offered a new ownership alternative, an employee stock ownership plan or "ESOP", designed to correct defective corporate finance and concentrated ownership patterns in our railroads. Not enough of the conferees, particularly our House colleagues, had sufficient opportunity to study and fully understand this innovation and its far-reaching implications for saving our railroads. Organized labor and railroad management also need more time to acquaint themselves, the workers, and the public generally on this new thrust. <u>The ESOP, however, still remains a key feature of this legislation and will be studied and, hopefully, fully implemented</u> by the railroads covered by the final bill." (CONG. RECORD, December 21, 1973, p. S 23785.) (Underscoring added.)

Senator Hartke then reinforced Senator Long's point:

"This approach is not only a new approach, but it is a plan to make our democratic system work for people who work for a living. . ." (p. S 23785.)

Having mandated that USRA conduct a study of the ESOP as a means for saving the railroads from government ownership, Congress has since proceeded to provide even greater encour-

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to the ESOP and its unique ownership-spreading capacity. In the pension reforms signed by the President on Labor Day 1974, ESOP's were given special recognition within the tax laws as a unique technique of corporate finance, separate and apart from standard employee benefit plans. When the trade reform legislation was passed, preferential treatment was given to corporations receiving Government-guaranteed loans from a special $1 billion fund to aid companies locating or expanding their facilities in trade-impacted areas, provided that they established and used the ESOP as a conduit for at least a portion of those loans.

A major Congressional boost to encourage ESOP financing over traditional modes of corporate finance came in the Tax Reduction Act passed in March 1975, when a special ESOP investment tax "bonus" of 1% beyond the temporary 10% investment credit Congress provided to businesses that add qualified capital investments. Hence, what had always previously been a tax benefit to the capital-owning few, now contained a "carrot" to corporate management to try the ESOP as an alternative approach to their needs for new capital formation, an economically beneficial departure from the status quo in corporate financing patterns that few major corporations took note of until they saw how the winds on Capitol Hill were blowing.

Undoubtedly, the most important political advance for the ESOP concept is contained in the Accelerated Capital Formation Act, now before the House Ways and Means Committee with a highly diverse, bi-partisan base of 92 co-sponsors, including 10 members of the Ways and Means Committee. (H.R.

462, by Mr. Frenzel and Title III of the Jobs Creation Act, H.R. 7240, by Mr. Kemp.) Jerald ter Horst, President Ford's first Press Secretary, reported on August 30, 1975 in his nationally syndicated column that this bill provides a viable compromise between the Administration's proposed package of incentives to encourage corporations to add to their capital investments and those members of Congress opposed to providing new tax benefits for the rich. ter Horst found that people in normally opposing camps on Capitol Hill were supportive of the ESOP and had joined forces in backing the Accelerated Capital Formation Act, which so sweetens the incentives to working Americans and their employers that ownership-concentrating patterns of corporate finance would gradually wither away in favor of ownership-spreading methods of capital formation, starting with private sector employees through the ESOP.

It is interesting also to note that several Democratic aspirants to the White House have begun to make the ESOP and the goal of spreading capital ownership among working people a central focus of their campaigns. Former Governor Reagan is also waving the banner of the ESOP. And undoubtedly the political climate in Washington will be affected by the recent findings of the respected political pollster Peter Hart that Americans are seeking major changes in our economic system, that by a 66% to 25% margin, Americans favor workers owning most of their company's stock; yet, and this is important in the ConRail context, by a 81% to 13% majority, Americans reject Government ownership of major corporations.

It thus appears that the ESOP concept -- now increasingly accepted by labor and management -- is an idea whose time has arrived.

V

WHAT IS LABOR'S ATTITUDE TOWARD THE ESOP?

In MOTIVATION AND PRODUCTIVITY, Dr. Gellerman, one of the consultants hired by USRA, made one perceptive observation about most American labor unions. On page 270, he stated:

> "Finding themselves, so to speak, with their attacks repulsed and their home territory under mounting pressure, American unions are for the first time in their history becoming advocates of the status quo: They are now finding it to their advantage to attempt to control change or even to prevent it."

On page 286 of his book, written in 1963, Dr. Gellerman recognized the need for a new alternative to the status quo--which the ESOP provides--if long and bitter strikes are to be avoided in many industries:

> "The employees who are exposed to displacement. . .are likely to perceive the prospect as a life-or-death struggle in which no suitable alternative to the status quo is available to them. They will therefore insist that generating profits and meeting competition are management's problems and not theirs, and that the attempt to make them pay for technological progress by sacrificing their security is an injustice that must be resisted to the last gasp. Unless convincing and attractive alternatives are offered them, the not-too-distant future is likely to witness a series of long, bitter strikes in many industries." (Underscoring added.)

To persuade every labor leader in the United States that the ESOP is a "clear and convincing alternative", one that could bring management and themselves together on issues of competition and profits, is, of course, easier said than done. Those comfortable with the status quo have no motivation to listen to new ideas, let alone accept them. Nevertheless, pressures from the rank-and-file and the American people generally are now being directed at labor leadership, seeking constructive new alternatives to labor's former game plan.

Political pollster Peter Hart recently conducted a poll finding that 56% of Americans agreed with the statement, "The increases that labor unions have gotten for their workers are too large." Union members find that pay increases go right into higher prices. And by a 66% to 25% margin, Americans favor the development of "programs in which employees own a majority of the company's stock." (WASHINGTON POST, August 31, 1975, p. A21)

On July 21, 1975, BARRON'S announced in its lead article that the ESOP is an idea "whose time has come." Since the first ESOP was implemented in 1956 to achieve an employee buyout of Peninsula Newspapers, Inc., the concept has been long in coming. It is now widely being hailed among finance experts and the news media as "a major advance in capitalism." One labor leader, who approached the ESOP with the skepticism of an "unreconstructed wobbly" until he viewed the recent "60 Minutes" TV program on the ESOP, read more about it and decided: "Our next labor agreement will include an ESOP for our members (possibly after a lengthy strike or lockout." Since management also will share in the benefits of an ESOP, the probability of management resistance to the ESOP is slim. No unionized company with an ESOP has ever had a strike. Peninsula Newspapers, Inc. involved six unions. Union locals whose members receive stock through ESOPs include the UAW, the Machinists' Union, the Laborers' Union, the Steelworkers, and others.

Some labor leaders recognized the enormous potential of the ESOP long before it became popular and before Congress gave its official "stamp of approval" on the ESOP concept.

in the rail reorganization legislation and three subsequent major Congressional enactments.

In 1967, Walter Reuther, speaking before the Joint Economic Committee, supported "stock distributions to workers" as a means "to democratize the ownership of America's vast corporate wealth" and as an alternative to inflationary wage increases.

In 1968, Harry Bridges of the International Longshoremen's and Warehousemen's Union gave his nod of approval to the new alternative offered by the ESOP by joining the Board of Directors of the Institute for the Study of Economic Systems, a non-profit research and educational foundation devoted to spreading understanding of universal capitalism and various means, including the ESOP, for achieving a more democratic base of capital ownership throughout the world's economies.

In 1971, the Executive Committee of SETUFCO, the banana workers' union representing the 3,600 field workers of United Fruit of Guatemala, studied and adopted universal capitalism as their union's new game plan. United Fruit was under a U.S. anti-trust divestiture decree to sell its Guatemalan plantations. The banana workers wanted to buy the properties for themselves and management through ESOP financing. Del Monte, the competing bidder for the properties, gained approval from the Guatemalan Government over the the bid by the banana workers. A final resolution of this situation is still in the air, in the light of recent WALL STREET JOURNAL articles revealing possible payoffs by Del Monte to former top government officials in Guatemala.

In February 1972, Joseph Curran, then President of the National Maritime Union testified before the Senate Merchant Marine Subcommittee in favor of an ESOP for saving the passenger

ship industry. Six taxpayer-subsidized vessels, including the United States, the Independence and the Constitution, were up for sale to foreign buyers who wished to use them for carrying American passengers in the vacation cruise business, one of the fastest growing industry's on the Eastern seaboard. This involved a loss of 5,000 jobs directly, 250,000 jobs indirectly and millions of dollars in America's balance of payments. Having outpriced themselves in the world labor market, Curran stated that his members would be "prepared to reduce crew size and tighten work rules to increase worker productivity and reduce labor costs by as much as 50 percent", as the trade-off for Congressional permission to reorganize that industry through an ESOP. Curran lost that round, when he was unable to effectively communicate the ESOP concept to the subcommittee's chairman, Senator Russell B. Long, now the ESOP's most effective advocate on Capitol Hill.

The NMU has not dropped its interest in the ESOP. The National Council of the NMU held a two-hour discussion on November 6, 1974 on the ESOP as a possible bargaining issue. Shannon Wall, the NMU's present head, has written, "Our interest continues. It may well be that the ESOP principle can provide a much-needed stimulus to the free enterprise system. We are studying ways to apply the principle to some phase of the maritime industry to provide benefits to all concerned -- maritime workers, management and the nation."

Articles on the ESOP have appeared in a number of union journals. A series of excellently written articles on the ESOP went out monthly to the members of Great Lakes Seamen's Union, Local 5000 of the United Steelworkers of America. (July to December 1972 issues of COMPASS.)

Members of Steelworkers Local 1722 joined with the management of the South Bend Lathe Company, a name brand in the machine tool industry, to pull off a deal that is being widely heralded within the Ford Administation's Economic Development Administration as a major turn-around in national strategy for saving jobs in economically depressed areas. NEWSWEEK, BUSINESS WEEK, INDUSTRY WEEK, THE WALL STREET JOURNAL, BARRON'S, THE WASHINGTON POST, IRON AGE, the Mike Wallace "60 Minutes" TV program, and others have brought the South Bend Lathe Story into national prominence. According to the September 1, 1975 issue of NEWSWEEK, "Six months ago, South Bend Lathe seemed like a sure bet to join the dreary list of business failures that have turned that northern Indiana city into an economic disaster area. . . Amsted Industries, the firm's parent concern seriously considered liquidating the operation." Now, under an ESOP strategy orchestrated by the investment banking firm headed by Louis Kelso, the 500 employees were able to raise $10 million in cash to buy 100% of the equity, without taking a dollar from their savings or reducing their paychecks and at no personal risk to the workers. The workers were willing to take a 15% cut in pay to make the purchase, but this was unnecessary. So far, the ownership change is working smoothly. July production suddenly jumped 10% and expenses from poor workmanship plunged 70%. One interesting feature to this story that should be noted is the tremendous flexibility and keen sense of reality among union members and their leaders when they were put under pressure by what seemed like a hopeless case. Upon closing of the deal, Amsted

terminated the pension plan for employees, making them 100% vested in all benefits acquired in their behalf up to that point. But the new company could not afford to make payments both into a new pension plan and into an ESOP, if the acquisition loans were to be repaid. In the face of reluctance by officials higher up in the Steelworkers' Union, 100% of the local's membership came out in favor of the ESOP, thus allowing management to forego costly pension contributions, which are a staple in every collective bargaining packege. This is probably unprecedented in labor circles, but it is an indication of the problem-solving potential of an ESOP, when creatively designed and implemented. The attitude of SBL management regarding the ESOP is reflected in this statement by J. Richard Boulis, who is continuing on as president:

> "For the next couple of months my biggest job will be employee communications. I want the imagined wall between managers and other workers torn down."

Many already recognize the difference at SBL. BUSINESS WEEK interviewed 24-year-old Jon Mortrud as he wired a computer-controlled machine. He told the reporter:

> "The biggest fear was the liquidation. Now I feel very secure. And the harder I work, the more I'll get. Everybody will be watching everybody else to make sure they're working hard."

Then, according to the reporter, "feeling the stares of his fellow employees as they waited for him to finish the wiring, Mortrud turned quickly back to his work." (BUSINESS WEEK, August 11, 1975.)

What is the attitude of railway labor toward the ESOP?

No onehas ever put this question directly to individual members of the unions involved in ConRail. But if an impar-

tial survey was conducted, one would expect rail workers to respond enthusiastically, like union members who already own most of their company's stock and the 66% to 25% majority of Americans who favor employees owning most of their company's stock.

Among rail labor leaders there is a split over the ESOP. C.L. Dennis, President of the Brotherhood of Railway Clerks, representing about one-third of the union members affected by ConRail, is an enthusiastic supporter of employee stock ownership. When a group of employees purchased the Chicago & North Western Railway, Mr. Dennis sent this message to the WALL STREET JOURNAL:

> "In my opinion, the effort of the employe group is one of the most refreshing ideas to come down the tracks in a long, long time. Employe ownership, it seems to me, has much to offer in strengthening our railroad system in the areas of labor-management relations, and of giving the employes the opportunity to participate in a more meaningful way in the fruits of the capitalistic system. Certainly, it is an encouraging development in the midst of talks about nationalization of railroads, which I think is misguided and unfortunate.
>
> "In short, here's a new idea, a fresh approach that deserves to be tried. If it works, and I believe it will, everyone--the workers, the industry, and, most importantly, the general public--will be the winners. And isn't that, after all, what capitalism and free enterprise are all about?"

Other union officials involved in ConRail view the ESOP as a possible threat to the status quo in their relations with management. According to Mr. Al Chesser, President of the United Transportation Union, "It sounds good, but I'm no expert in finance and neither are most union leaders." But, without ever hearing an explanation of how an ESOP works and how it might be applied in the ConRail situation, the UTU and other rail labor executives (other than Mr. Dennis)

took a negative stand against employees' acquiring ownership of ConRail, when they met in February 1975 in Miami Beach. Feedback from the meeting indicated that the rail executives present feared the ESOP as a possible threat to the "wage system" and the "work rules" they were used to bargaining over for the past century. None of them took a stand against continuing taxpayer subsidies of the railroads or nationalization.

It is worthwhile noting that before the ESOP provision was injected into the ConRail legislation, the press reported that a few prominent railroad executives and a few rail executives worked out a deal on how the railroads would be re-organized, with the taxpayers picking up most of the tab. In fairness to those rail labor leaders involved, the introduction of the ESOP at the last minute, spoiled the deal. It was deliberately introduced as a way to overcome the traditional conflict patterns within this industry and build a true alternative to nationalization and perpetual bailouts by the taxpayers. Given their limited patience with new ideas and complacent attitudes toward the present state of the rail industry, those who fear the ESOP will have to be better educated by the Congress, the media, and, hopefully, by the rank-and-file workers. In a sense, their fears are justified. Inevitably, worker-shareholders would never tolerate some of the anachronistic and costly "work rules" being retained today. But the ESOP offers organized labor a much bigger "wage system" than they ever bargained for in the past; the ESOP adds the "wages of capital" to bargaining over the "wages of labor"; after 100% of the revenue pie, what is there to add? The ESOP offers new horizons and new benefits for labor leaders to seek for their members. To some, this is too

much of a challenge. But old-timers in the labor movement suggest that labor has always opposed innovation, at least initially. For example, pension plans and profit sharing were once forcefully opposed by labor leaders. Now they are accepted as a matter of course.

Under the ESOP, there will be a major structural advance in the evolutionary development of the business corporation as a social insitution. It will similarly produce important advances in the democratic labor union as a social institution. They are both in primitive stages of their evolutionary development, and, as a consequence, society is suffering and the economy is not working right. Reluctantly, those who view the future through a rear-view mirror may, by force of today's crisis of U.S. industry, have to learn new ways. They will have nothing to lose but their complacency.

Perry Prentice of TIME, Inc. observed:

> "Business and labor are both in the same boat and it is almost suicidal for workers to think they can prosper by making it less profitable (or completely unprofitable) to employ them. The most glaring example of this kind of suicide is the Maritime union which was so successful in getting all the wage increases it demanded that the American flag vanished from the seven seas. . . . Railroad labor has been almost equally successful in pricing itself out of the market. . . .
>
> "Admittedly these may be extreme examples of labor pricing itself out of work, but union leaders would be wise to recognize before it is too late that they are harnessing the profit motive to disemployment when they force wage increases far in excess of productivity gains. . . .
>
> ". . .[S]uccess will depend on . . .every worker [realizing] that his own bread is richly buttered on the same side as his employer's and will have a maximum incentive to maximize productivity and minimize waste in order to increase his own income."

VI

DETAILED POINT-BY-POINT REBUTTAL OF USRA EVALUATION OF THE ESOP

As stated in earlier sections of this rebuttal, the three outside consultants hired by USRA to evaluate "the extent practicable" an Employee Stock Ownership Plan or "ESOP" could be utilized for re-structuring the Northeast rail system, started from a position of limited appreciation and possible misunderstanding of the legislative background behind the ESOP provisions in the Regional Rail Reorganization Act of 1973. Leaving aside their lack of experience with the ESOP as a new financing vehicle (and in particular its applicability in a reorganization situation like the railroads here), none of these consultants even mentioned that both Senator Long and Senator Hatfield, the legislators spearheading the ESOP initiative in Congress, proposed the ESOP as "the only alternative to nationalization" of the deteriorating Northeast and Midwestern rail system. Without the ESOP "escape hatch", most astute political observers recognize that the remaining provisions of the rail act represent, at best, a bailout of creditors and workers displaced by automation and dwindling profits, and a continuing drain on Federal taxpayers--one small step before nationalization becomes inescapable. Others would suggest that nationalization has already occurred, in fact if not by name--but politically such a bold assertion is still untenable. None of the consultants concerned themselves with the political ramifications of nationalization, the threatening issue that motivated the unanimous adoption of the ESOP provision in the rail bill when it was first introduced before the Senate Commerce Committee on the final day of mark-up on this landmark legislation.

Being insensitive to the political context surrounding the ESOP's baptism as a legislative problem-solver, the USRA consultants gave no consideration whatsoever to the possibility that 100 percent of the initial common stock of CONRAIL could be financed through imaginative use of ESOP financing techniques, making the employees, as beneficiaries of stock acquired by their ESOP trust, sole owners of the new system from the outset. None of USRA's consultants saw the big picture, as presented by the proponents of the ESOP in the Senate floor debates of December 11 and December 21, 1973. Rather than basic innovation their eyes were glued to the status quo. To USRA's consultants the ESOP is viewed as some sort of a "gimmick", a "tax loophole" a "token fringe benefit", a threat to the interests of creditors, on the one hand, and rail labor leaders, on the other. To the Senators sponsoring the ESOP, it represented a "major innovation in corporate finance", a fresh approach to reconciling the interests of creditors, organized labor, rail users, and already overburdened American taxpayers. To the Senators ESOP offered a means by which 100 percent of future railroad profits would accrue to the benefit of railway workers, assuming good management and a totally new ConRail reorganization strategy based upon the built-in disciplines and responsibilities as well as the rewards of full employee ownership participation.

The USRA consultants also viewed the ESOP within a static political context. They assumed that Congress remained as unfamiliar with the ESOP as was the case when the rail bill passed in December 1973. Nowhere did their report note that Congress gave its "stamp of approval" to the ESOP on three major pieces of

legislation since then, in the pension reforms, in trade reform, and in the investment tax credit increases under the Tax Reduction Act of 1975. Further measures to improve the attractiveness of the ESOP to employees and corporations would have suggested themselves to USRA and its consultants, had they approached the ESOP in a more open-minded and creative way. For example, the provisions of the Accelerated Capital Formation Act, H.R. 462, and the Jobs Creation Act, H.R. 7240, now before the House Ways and Means Committee with 92 House co-sponsors, would offer additional tax incentives to rail workers and CONRAIL, which would overcome some of the limitations in the use of the ESOP under present laws. Suggestions for innovations in Federal Reserve policies, aimed at reducing interest rates on bank loans for meeting the capital needs of basic industries, like the railroads, are also being advocated by ESOP proponents. Limiting their argument to a synthetic "negative case" against the ESOP, none of the USRA consultants bothered to acquaint themselves with the creative possibilities for solving the structural problems that led to the demise of the Northeast rail system, if the ESOP concept was applied to the limit. Not a single good point was made in favor of the ESOP. Such unanimity among expert consulants is indeed a rarity.

When one reads the report of USRA's consultants against a background of the legitimate Congressional fears of nationalization of this basic industry and of a realistic possibility that, from its inception, CONRAIL could be owned 100 percent by its employees, legitimately and without taking a cent from their paychecks or savings, and without costing the taxpayers a single cent more in

subsidies than is now planned under USRA's current plan, then USRA's "Evaluation of the Employee Stock Ownership Plan as Applied to CONRAIL" falls like an elaborate castle of sand.

To assist the reader in this point-by-point rebuttal of the USRA's evaluation of the ESOP, we will divide this section into three main parts to conform to the reports of the three outside consultants hired to carry out Congress' mandate for an ESOP study. The first section will deal with E. F. Hutton's report on the ESOP as a method of capital formation for CONRAIL (Appendix B of the USRA Report, plus Exhibits III and IV.) The second section will deal with Dr. Saul Gellerman's report on the motivational implications of ESOPs in the CONRAIL situation. (Appendix C of the USRA Report.) The third section will deal with the report of Towers, Perrin, Forster & Crosby (TPF&C), who served as project coordinator and expert on employee benefits. Although TPF&C wrote a "Technical Review of the Employee Stock Ownership Trust" (Appendix A of the USRA Report) and the basic report itself, including all exhibits except Exhibits III and IV, which relate to E. F. Hutton's work), it is clear that TPF&C's analysis and conclusions rest heavily on the E. F. Hutton and Gellerman reports, and thus will be rebutted last.

A. THE E. F. HUTTON REPORT, "Evaluation of the Use of an Employee Stock Ownership Plan as a Method of Capital Formation for ConRail", dated May 12, 1975 (APPENDIX B OF USRA REPORT)

1. Bias against making corporate credit for capital formation accessible to workers.

On page 13, E. F. Hutton revealed its own pre-disposition toward the ESOP as an alternative to conventional kinds of corporate

In addition, present creditors would gain exclusively the benefits of equity enhancement of $3.5 billion as ConRail pays off the costs of its new capital formation made possible through the Federally guaranteed loans. Conventional debt financing creates new capital but adds no new owners after the financing process is completed.

In contrast, if the same government-guaranteed debt financing were channeled through an ESOP on a 100 percent employee-owned ConRail, the capital would still be expected to pay for itself, but with a difference: after the loans are repaid, the additional equity ownership and profits would be spread among all employees, while the value of preferred stock or debt securities held by today's creditors would not be diminished.

E. F. Hutton's double standard of what constitutes a "windfall" and a "free lunch" perhaps merely reflects its present constituency--the top 1% of the Americans who today own and trade through stock brokers like E. F. Hutton over 50% of all individually owned corporate stock. Rail workers--like others among the 95 percent of Americans who have little or no ownership stake in U. S. corporations--would under this double standard remain deprived of access to corporate credit and the benefits of the tools of corporate finance. Such access determines not only whether capital formation is feasible--that is, that it is a self-liquidating investment secured by its future earnings--but also who will own that capital after its formation costs have been paid for.

In fairness to E. F. Hutton, however, who should gain the benefits of capital ownership arising from Federal guaranteed loans

underwritings, which investment bankers, like E. F. Hutton, would normally be engaged to perform:

> "Since in the early years ConRail's viability will require massive Federal guarantees of debt, it is clear that the U. S. Government will have provided the means by which ConRail might ultimately achieve profitability. When profitable, the equity of ConRail could conceivably be worth many billions of dollars. For example, if ConRail were to earn the $381,736,000 it is projected to earn in 1985 and have a market price of five times earnings, the value of the equity would be $1.9 billion. This <u>would clearly be an enormous windfall for the 70,000 to 100,000 employees of ConRail,</u> who would never have contributed toward the purchase of the shares, even at the low price level which would currently be required." (Underscoring added.)

<u>COMMENT</u>: Clearly, E. F. Hutton has no aversion to massive Federal guarantees of ConRail's debt (estimated at $3.5 billion by 1985, page 10.)

Under any form of debt financing, these loans are expected to be amortized with future ConRail earnings. Otherwise, the loans are not "feasible" and therefore not made. In fact, all corporate financings, ESOP or otherwise, are predicated upon the prospects of the business being able to repay the costs of financing.

Under conventional debt financing, creditors of the bankrupt railroads would not only receive new ConRail securities equal to their bankruptcy-adjusted claims, but, in addition, would gain the "enormous windfall" of $1.9 billion that E. F. Hutton predicts in equity appreciation as ConRail's earnings improve; as sole stockholders of ConRail, the former creditors would be insulated from any personal risk for non-payment of ConRail loans and would not be required to make any cash contributions toward purchasing ConRail's new plant and equipment underwritten with Federally guaranteed loans.

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In fairness to E. F. Hutton, however, who should gain the benefits of capital ownership arising from Federal guaranteed loans

to ConRail--rail creditors or rail employees -- is a fundamental political and economic question, which E. F. Hutton was not asked to address. That E. F. Hutton does not speak for the majority of Americans is reflected in a recent finding by pollster Peter Hart that "only 17% favor the present economic system; 41% want major changes. [And] by a 66% to 25% margin, Americans favor employes' owning most of their company's stock." (WALL STREET JOURNAL, "Washington Wire:, August 22, 1975, p. 1)

2. Is the ESOP "the only alternative" to nationalizing bankrupt railroads?

E. F. Hutton was totally silent on this point.

COMMENT: The proponents of ESOP suggested that leaving the ownership of the rails in the hands of a relatively tiny absentee ownership group was no longer a viable alternative and would only perpetuate the artificial class divisions and conflict patterns between workers and capital owners and the breakdown in management accountability that crippled the profit potential of these railroads in the first place. (see arguments of Senator Long in the CONGRESSIONAL RECORD of December 11 and 21, 1973.) The industrial class struggle between U. S. labor and U. S. capital traces back to the origins of our railroads. Because of the primitive nature of conventional techniques for financing rail capital needs over the last century--the self-liquidating logic of investment finance was never extended to rail workers--there has never been a unity of ownership interests among rail workers, managers and owners. At times they have all pulled in separate directions, leading nowhere and allowing less

energy-efficient modes of transportation to leave the rails behind for serving society's needs. ESOP financing could have generated such a unity of interest had it been instituted by the railroads from the beginning, or, at least, when the first signs of decline began to appear. The very process of reorganization offers CONRAIL an opportunity to launch a new beginning.

3. Would the ESOP decrease the profit potential of ConRail?

On page 11, E. F. Hutton states that, "The establishment of an ESOP would decrease the profit potential and possibly lengthen the time before ConRail becomes a profitable entity. The magnitude of these effects would be in direct proportion to the size of the ESOP plan utilized." Earlier on that page, E. F. Hutton accepted uncritically the conclusion that, "In its projections USRA does not foresee ConRail becoming profitable until 1978."

COMMENT: E. F. Hutton carries the power of negative thinking to absurd heights.

As Senator Long stated on December 21, 1973, "When people plan for failure, the odds increase that they will fail. ... .If we assume that the rail systems. . .cannot be operated at a profit and therefore neglect to provide sufficient profit incentives for workers, they are unlikely to earn any profits. . . .In business, the formula for making a profit is simple: Maximize revenues and minimize costs. Being so capital-intensive and inherently efficient and low-cost energy users compared to competitive modes of transportation, railroads have been historically natural profit makers . . . . Clearly, not having the same opportunities to accumulate growing ownership stakes as the few who today own most of today's railroad

stock, workers have had no incentive to make the simple formula for profits work. In fact, our ownership system. . .was structured to lead to ever-decreasing revenues and services and ever-increasing, non-market-disciplined costs. And if our railroads fail to build substantial ownership incentives and the discipline of the profit system into its workers in the future, they will never again earn a profit."

Clearly, USRA and E. F. Hutton disagree with Senator Long.

Clearly, neither USRA nor E. F. Hutton can conceive of the possibility of rail management and non-management workers, including their union representatives, working together--out of enlightened self-interest and a shared stake in the goal of profit maximization--for such needed reforms as:

*Eliminating obstacles to more rapid rates of capital investments

*Procuring more highly automated rail equipment

*Rate de-regulation

*More flexible treatment by the ICC and state regulatory bodies

*Equalization treatment where competitive modes of transportation have received special subsidies or unfair economic advantages in the past (or in the alternative, make those competitors pay the costs of the capital advantages they receive)

*Reducing the interest costs of commercial loans on ESOP-financed rail capital to "pure credit" charges of about 3% to cover (a) risk to credit insurer that loan may not be repaid; (b) reasonable profit and loan administration costs for lenders; and (c) administrative costs of the Federal Government (See new Federal Reserve strategy proposed by Louis O. Kelso in his presentation to the White House Summit Meeting on Inflation on September 27-28, 1974 and in his testimony with Norman G. Kurland before the Senate Financial Markets Subcommitte on September 24, 1973)

*Lifting remaining tax barriers to ESOP capital formation (See The Accelerated Capital Formation Act, mentioned earlier, now before the House Ways and Means Committee with 92 co-sponsors)

Clearly, negativism and "tunnel vision" thinking impeded USRA and E. F. Hutton from ever fully understanding and grasping the far-reaching and comprehensive structural changes possible, where, again in the words of Senator Long:

> "Each worker would be placed in a position where his own efforts toward cost minimization and increased production would directly influence the size of his dividend checks and the value of the capital estate he can acquire during his working lifetime. From the public's standpoint, we could reasonably anticipate that strikes and slowdowns, antiquated work rules, featherbedding, resistance to automation, and unreasonable wage demands--all seemingly unsolvable problems up to now--would gradually disappear once workers are placed in a position to realize how these activities not only work against the interests of consumers as a whole, but also against their individual self-interests." (CONG. REC., December 21, 1973, p. S 23784-5)

In dealing with the issue of profitability, E. F. Hutton totally disregards the point that, if Congress and the USRA follow its recommendations, employees will have no more incentive to make ConRail a profitable enterprise, than they had under the railroads that went bankrupt. They will be faced with none of the disciplines and responsibilities that go along with the potential rewards of ownership. They will have no effective means to acquire sufficient ownership so that ConRail's profitability is directly relevant to each and every member of the work force. And, if Congress and USRA follows E. F. Hutton's recommendations, the workers will never gain such incentives and responsibilities. Nationalization will be inevitable and nationalization offers workers even less incentives

to make ConRail meet its costs than at present. The deep pocket of Uncle Sam will always be available to bail out the railroads. It will be like a bailout of New York City. The rail unions will become another form of public employees union. Certainly, this is not what Congress intended when it mandated the commissioning of an ESOP study.

4. <u>Is the ESOP more costly than alternative modes of financing ConRail's capital formation needs?</u>

From a technical standpoint, E. F. Hutton committed an even more serious error than in its short-sighted perspective on the implications to ConRail profitability of ESOP financing. On page 13, E. F. Hutton concludes:

> "There is no present financial advantage in the establishment of an ESOP."

And on page 11, E. F. Hutton states:

> "The costs [of ESOP financing] exceed any of the charges related to other financing modes."

<u>COMMENT</u>: ESOP financing, as explained in detail earlier, is the only technique in the field of investment finance, which both enables a corporation to (a) attract externally borrowed funds to meet its capital requirements and (2) treat the entire debt service payment--both interest and principal--as a tax-deductible business expense. Under a conventional loan only interest is deductible. For a company in a 50% tax bracket, each $1 for repaying principal can carry twice the debt load or repay a loan twice as fast through an ESOP as under any form of conventional debt financing.

ESOP financing, while resulting in the issuance of stock to the employee trust, <u>expenses</u> capital investment and so

lowers tax-reported or apparent income. Ordinary direct debt financing of corporate growth, in effect, capitalizes the investment (i.e., purchases it in after-tax dollars) and requires the corporation to pay corporate income taxes that would not be paid under ESOP financing arrangements. Straight debt financing thus takes disposable working funds out of the corporation that would otherwise be retained and presumably used productively for the proportionate benefit of all stockholders. In fact situations where management is presented with a comparable choice, it usually prefers the expense route over the non-expense route, because in such instances the apparent reduction in earnings is in fact an increase in tax savings and an increase in corporate disposable cash or equity dollars retained and at work in the corporation. An example is accelerated depreciation authorized by the tax laws.

The sophisticated investor is not mislead by apparent earnings per share, an academic accounting point upon which E. F. Hutton is resting its case against the ESOP. The experienced lender and corporate stockholder focus their attention instead on corporate disposable earnings or after-tax cash flow per share. Without cash flow there are no funds to repay creditors and no dividends for stockholders. For example, assume that XYZ Corporation reports earnings of $1.00 per share and has loans outstanding requiring annual repayments of principal equal to 50¢ per share. An intelligent appraiser would not value that stock based on the "gross" earnings per share of $1.00, but rather on corporate disposable earnings of 50¢ per share. It is misleading for E. F. Hutton to suggest otherwise.

If a company is in a 50% corporate tax bracket, the same $1 of pre-tax earnings can do the work of $3 if the company's debt requirements are serviced through an ESOP. It finances $1 worth of capital benefits for its employees' retirement, it re-captures $1 of taxes that would have been paid under conventional direct debt financing, and it pays $1 of principal on debt for meeting its needs for new plant and equipment or, in the case of ConRail, for paying off creditors of the Penn Central and other bankrupt railroads. With an ESOP, a company can handle twice the debt load or repay its debt twice as fast as conventional debt financing.

E. F. Hutton's claim that ConRail will not be profitable which would be refuted under the approach to reorganization proposed by Senator Long and others) and that therefore ConRail will not pay any taxes, is also based on dubious assumptions, to be discussed below. But even if the corporate income tax were rescinded entirely or integrated with the personal income tax, thus making all taxable corporate income taxable to individual shareholders, the financing of corporate debt through an ESOP would still "cost" no more than repayment of a conventional corporate debt, yet would still provide added capital benefits for allocation among ConRail employees.

5. Is equity financing a viable alternative for ConRail capital formation?

On page 4 of the E. F. Hutton report, listing the assumptions of Table I and Exhibit I of its report upon which E. F. Hutton based its comparative analysis of ESOP financing, debt financing, and equity financing, assumption 8 states:

"The corporation can avail itself of any of the three alternatives."

COMMENT: On page 6 of its report, E. F. Hutton contradicts the above assumption:

"At the present time, conditions in the equity securities markets are such that only major corporations can sell equity securities through the traditional underwriting channels. Under such conditions, for many companies the only practical equity financing is through an ESOP."

E. F. Hutton contradicted its own assumption again on page 10:

"The ability of ConRail to obtain capital from private sources independent of Federal guarantees depends on the credence placed by the financial community on the projections developed and in their assessment of the treatment of the creditors of the existing bankrupt railroads. It is our opinion that without a Federal guarantee ConRail as presently conceived will be precluded from raising funds (other than direct mortgage indebtedness) in the private sector until it has an operating history which demonstrates a capability of profitable operation."

Not only is the sale of new stock to the public totally unrealistic in the case of ConRail, by E. F. Hutton's own admission. It is a highly unpopular mode of finance for many reasons. Less than 5% of all new capital raised in this country in any year over the last several decades has involved primary offerings of common stock. The sale of new stock is a non-financeable transaction. An immediate cash payment must be made out of one's savings or earnings, thus effectively making it unaffordable for most Americans. Unlike corporate investments, common stock can never be purchased in the market under terms where it will pay for itself.

On page 11, E. F. Hutton states that "the creation of an ESOP will reduce the ability of ConRail to obtain equity capital through the sale of equity to the public." In see-saw fashion, E. F. Hutton continues to raise a straw-man unsupported by the facts . . .and then straw-by-straw demolishes its own argument and the basis of its own analysis. The ultimate objective of the reorganization process is to scale-down present claims of creditors to the point where ConRail can commence its operations on a viable footing. Assuming that ConRail's capitalization is properly structured at the outset, so that it begins as a viable operation, and assuming that any debt financing is based upon realistic projections of future ConRail earnings, any and all future financings may be transacted "in house" through the ESOP, without the need to go to the so-called public market. The ESOP constitutes ConRail's own "stock exchange" for raising its expansion capital and for purchasing outstanding securities issued to creditors of the bankrupt rails and from its retiring employees. Under a 100% employee-owned ConRail, it is far less expensive to sell new equity issuances to ConRail's ESOP than through an expensive and time-consuming public underwriting of new equity securities, should there ever be any advantage to ConRail of "going public" and subjecting the value of its stock to the whims and manipulations of outside speculators and large institutional investors.

Since an equity financing is unrealistic by E. F. Hutton's own admission and since ConRail employees are unlikely to be able to afford any significant amount of ConRail stock through payroll deduction plans, stock option plans, typical stock purchase plans,

or from public stockbrokers--all requiring purchase with after-personal-tax dollars rather than pre-corporate-tax dollars--E. F. Hutton's attempt to compare ESOP financing with equity financing (Table I and Exhibit I of the E. F. Hutton report and Exhibit III of the USRA report) is entirely an academic exercise. From the standpoint of future ConRail employees, upon whom ConRail's future profitability will rise or fall, the advantages of an ESOP should be obvious.

6. Does the ESOP limit the borrowing capacity of a corporation?

On page 9 of its report, E. F. Hutton states:

> "As an ESOP financing is categorized as a debt, it limits the borrowing capacity of a corporation. A lending institution or debt investor will consider the fixed nature of the corporation's obligations to the ESOP before lending it additional funds."

COMMENT: This statement is absolutely false. Loans to an ESOP, because of the company's guarantee of all ESOP debts, are always tied directly to the company's borrowing capacity. What the company can borrow is always less expensive if the ESOP borrows the funds and services that debt with tax-deductible cash contributions from the company. Because the ESOP increases the after-tax cash flow of the company, from which all debt repayment must originate, ESOP financing actually increases the company's borrowing capacity.

Among the ways that ESOP financing increases a company's after-tax rate of return, besides that of enabling the company to treat the repayment of loan principal as a tax deductible expense, are the following:

> *The same $1 saved in taxes for servicing debt saves the company $1 in added retirement benefits. Cash that would otherwise be siphoned outside the employee's

company for gambling in second-hand securities of other companies purchased from speculators in the open market, is available to meet the company's own capital needs. Under an ESOP all the savings accrue to the benefit of employees rather than institutional middle-men.

*The same $1, as a tax-sheltered benefit for employees, offers a potential trade-off for at least a portion of future demands for increases in wage levels, which would be immediately taxable to workers, would increase operational cost and would make the company less competitive.

*If ESOP objectives are effectively communicated to employees, without overselling it, corporate cash flow has a high probability of increasing from reduced waste, featherbedding, strikes, over-manning, and resistance to automation.

*The ESOPS puts all employees in a position where they have a property stake in increasing profits to the maximum, rather than keeping themselves in a permanent propertyless class whose interests must necessarily be antagonistic to corporate profits.

In actual practice, lenders recognize these advantages of ESOP financing over conventional debt financing and increasingly have been eager to increase the security of their loans by recommending the ESOP route.

7. <u>How will the ESOP affect ConRail productivity</u>?

On page 4 of the E. F. Hutton report, it is assumed that "no effect" should be "given to greater productivity resulting from the [ESOP] plan." This assumption, based upon Dr. Gellerman's report which will be dealt with below, was also a basis for E. F. Hutton's conclusions in Table I and Exhibit I that earnings under ESOP financing would be less than under equity and conventional debt financing.

COMMENT: The term "productivity" is a slippery term inasmuch as overall corporate productivity ("output per manhour") is a mix of capital productivity and labor productivity. Dr. Gellerman has placed himself in an analytical trap by attributing all output solely to the labor factor (management and non-management workers). Once in this trap, every increase in output due to more efficient rail equipment serves as a justification for higher wage levels. Yet increases in pay levels still go directly into costs and are therefore counter-productive for meeting the costs of new capital formation and for enabling the company to become more competitive. The ESOP allows company to escape from this trap by making the output of capital accessible to its workers, without raising labor costs.

It is somewhat surprising that an investment firm like E. F. Hutton, engaged as it is in capital formation problems, fell into the same trap as a consultant whose experience is limited to the far more inexact and unpredictable field as forecasting human behavior.

In terms of increasing capital productivity, as discussed above, the ESOP would increase cash flow for expanding rates of investment in new and more efficient capital instruments and, if properly communicated, should reduce labor resistance to automation and technological change. It is true that this is difficult to measure, since no one has yet studied the amount and efficiency of new capital formation that never takes place because of organized labor's understandable opposition to labor-saving technology where outsiders own all the capital. The ESOP, by connecting workers

directly to the yield and productivity of capital, while depriving worker-owners of the yield of capital during the period that the cost of their acquired capital is being repaid, should result in some increases in the productiveness of capital. As owners, all increases in capital productivity will legitimately belong to them.

Increasing the labor productivity of ConRail's labor force is another matter. That involves motivation, which to some degree at least should be improved by systematically connecting workers, as owners, to the capital formation process and to waste-reducing disciplines associated with being owner-employees, where all ConRail's profits will be shared among themselves. They will become less tolerant with inefficient and wasteful management and non-productive co-workers. Self-interest will also generate self-restraint regarding demands for higher wage levels and fringe benefits. Here again, however, academics have not studied the impact of employee stock ownership upon labor productivity.

Some insight on this issue can perhaps be gained from studies conducted by the Profit Sharing Research Foundation among 12 major department store chains. Based on Forbes 22nd Annual Report on American Industry (January 1, 1970), the Foundation reported that the 5-year annual earnings per share growth of companies which "quite heavily invested their profit sharing assets in own-company stock" exceeded non-profit sharing companies by 75%. (See "Does Profit Sharing Pay?" by Bert L. Metzger and Jerome A. Colletti, Table 48, p. 76 and letter from Mr. Metzger to the Institute for the Study of Economic Systems, dated July 19, 1973.)

In any event, E. F. Hutton's assumption that the ESOP will have "no effect" on increasing the productivity of ConRail labor and ConRail capital seems to defy both common sense and logic.

8. <u>Does the ESOP encourage a dilution of the company's stock relative to other ConRail stockholders?</u>

On page 7, E. F. Hutton states:

> "The principal financial disadvantage of the ESOP method is its impact on income and the dilution of the interests of existing shareholders. . .[T]he shares in an ESOP will dilute overall earnings per share as they are deemed to be outstanding for computation of earnings per share."

<u>COMMENT</u>: If ConRail is re-organized along the lines proposed by ESOP's Senate sponsors, this question would never be raised. Through the ESOP, 100% of ConRail's initial common stock could be acquired for the benefit of all ConRail employees and all newly issued ConRail common stock could also be acquired through ESOP financing to meet the growth and modernization capital needs of ConRail. What conceivable harm could result to ConRail employee-stockholders under these circumstances, no matter how dilution is defined? The employees have nothing to lose but their propertylessness. And there are no conceivable economic benefits an employee can gain from ConRail that will exceed his fair share of 100% of the company's capital pie.

E. F. Hutton, however, deserves a response for situations where employees have no ownership stake in their company or own less than 100% of its equity. (See also "Comments" to points 3 and 4 above.)

As E. F. Hutton knows, self-liquidating credit is the logic of corporate finance. Typically, capital pays for itself, in 3 to 5 years in well-managed businesses. Every financing involves making investments in assets that are expected to produce additional proceeds that will justify that investment.

Although there will be a temporary earnings dilution from the issuance of new stock for financing corporate growth through an ESOP, that dilution is soon restored by the expected yield on the investment itself (i.e. capital productivity increases), the tax savings compared to conventional borrowing, and the yield of any cash flow gains that are retained in the corporation.

As E. F. Hutton should realize there is no scientific or infallible way to predict the effect of ESOP financing with respect to any particular corporation. The relevant measure of earnings dilution is whether "after-tax cash flow per share" increases or decreases, as a result of an ESOP. Where corporate sales and earnings increase and corporate costs decrease as a result of ESOP financing, cash flow as well as earnings per share can mount steadily, benefitting current stockholders as well as worker-stockholders. And in the real world this has generally been the case. One example not involving an ESOP but still a case open to all employees was Overnite Transportation Company. It was done the hard way: the workers paid for company stock out of their after-tax wages; the company did not obtain a source for major financing of its growth on pre-tax dollars as under an ESOP; and the employees did not gain the opportunity to use the same rationale that the corporation itself uses for investing, namely investing in things which are

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expected to pay for themselves in a reasonable period of time. Nevertheless, here are the spectacular results, as reported in the Wall Street Journal of February 22, 1972: After two consecutive years of earning declines before Overnite sold stock to its employees in 1970, claims on damaged or lost cargo dropped by 80%; profits rose 75% to $1.28 a share; the next year profits rose another 95% to $2.46 a share; the price on Overnite stock registered an 125% increase on the New York Stock Exchange, the leading percentage gainer for 1970; in 1971, the stock soared another 145%; earnings as a percentage of revenue grew during that period from 4.6% to 11%, a striking improvement that can only be traced to improved operating efficiency.

The productivity improvements and operating efficiencies that one would expect from spreading ownership among workers is only part of the story of why an ESOP tends to improve earnings per share. Other factors that must be taken into account are: reduced costs, including tax savings, in meeting the company's financing needs; an easier way to remove worker opposition to automation and cost-saving technology; a less expensive retirement system not subject to the speculative fevers of the public stock market and the overhead costs and commissions of stock traders and large institutional investors; a built-in trade-off for inflationary wage and fringe benefit demands which lead to price increases and lost markets; a unique way of placing each worker in a position where his own efforts toward cost minimization and increased

production will directly influence the value of the capital estate which he can acquire during his working lifetime; reduced likelihood of strikes, slowdowns, and featherbedding; more harmonious union-management relations; and a permanent mechanism structured into the architecture of a corporation, which combines within a single package a means for comprehensive, long-range planning and resolving of financing, retirement, compensation, and employee motivation problems. These are only a few of the factors that should be taken into account in trying to predict any earnings dilution that might result from installing an ESOP. If the Overnite example is not persuasive enough, common sense will rule in favor of the ESOP.

Does the ESOP involve any other kind of economic dilution?

Not at all. If General Motors, for example, expands its productive capacity 20% and finances this new capital by sale of new stock at market price to its employees under ESOP financing, the equity of existing stockholders is not diminished in the slightest. Each new share of stock issued results in investment of the proceeds in new productive plant and equipment. The preexisting stockholders own exactly what they did before the expansion--namely, all the General Motors equity that existed up to the date of the new stock issue. For every dollar of new stock, a dollar's worth of new productive capital has been added.

There is, however, a possible dilution of voting power, if votes on ESOP-held stock are passed through to ESOP participants, an option which is open to management and employee representatives.

But one would think that this is a dilution that is socially desirable, particularly for the largest and most powerful of U. S. corporations. The great corporations of America, effectively owned by 2 million families, have a narrow voting control. Little wonder that they are so vulnerable politically, not only in this country but wherever their assets are located throughout the world. The same corporations--vastly expanded and owned by 60 million American households--would be accountable to a broadened ownership constituency and broad voting control. That is precisely what ought to be. Certainly, from management's standpoint, the more broadly ownership is diffused, the better.

The ESOP is a legitimate means for breaking up the monopoly access to new capital formation now enjoyed by existing capital owners. But when you stop to think about it, why should those who own the economy's existing assets automatically acquire ownership of all future assets forever and ever? Why shouldn't private and individual ownership of the means of production be as widely diffused as the power to vote? The ESOP is intended to protect existing ownership against dilution. Indeed, by tightening up the laws of private property, it is designed to reduce dilution suffered by existing stockholders. But it is also intended to create tens of millions of new stockholding families as it brings about the building of the future U. S. economy.

9. Will dividends on ESOP stock reverse the cash flow advantages to favor conventional debt financing over ESOP financing?

On Table I of its report, E. F. Hutton compares ESOP

financing with debt financing and points out that, under the ESOP, "Cash flow is reduced by dividend payments, if any, on the newly issued stock." Then in its Exhibit I, it compares ESOP unfavorably with debt financing with figures that show that "Cash Flow After Dividends" for ESOP financing would amount to $17,855 as compared to $18,010 under debt financing.

COMMENT: Notwithstanding the fact that a fair comparison of cash flow effects would be before dividends, E. F. Hutton's financial comparison is highly misleading from several standpoints. First, the analysis itself never takes into account the possibility of ConRail being 100%-owned by its employees from the outset. Second, although it is desirable that ConRail's ESOP begins to pay out dividends as soon as possible, if no dividends are declared until the ESOP repays a significant part of its debt obligations, after-tax cash flow will again favor the ESOP method. Third, dividends are frequently used to accelerate the repayment of the ESOP's debt, thus reducing interest costs and building equity ownership faster into ConRail employees. And fourth, cash dividends to employees may be necessary as a non-inflationary offset to pressures for pay increases. Cash flow is the source of proceeds to pay for a company's capital needs, or, to the extent that stock acquisition debt of the employees trust is repaid, to provide active and retired employees with second incomes in the form of dividend checks. E. F. Hutton's analysis omits any mention of these realities.

10. Are the tax advantages of ESOP financing nullified if ConRail has no earnings during its initial years?

On pages 10 and 11 of its report, E. F. Hutton states:

"The advantages of the ESOP method of financing over alternative methods stem primarily from the provisions of the Internal Revenue Code which enable a corporation to deduct contributions made to the plan from taxable income. Consequently, ConRail's expected tax position is a key consideration.

"The [Preliminary System Plan of USRA] indicates that based on expected results and the opportunities for favorable tax treatment, ConRail will be in a position to eliminate or defer taxes for most of the ten year planning horizon (1975-1985).

"Therefore, the tax advantages to ConRail of the ESOP financing are non-existant until ConRail becomes a tax-paying entity. Traditional debt financing will provide an equivalent amount of capital at the same cost. . . . .

COMMENT: A closer reading of USRA's Preliminary System Plan suggests there is no certainty that ConRail will be allowed to eliminate or defer corporate income taxes during its first 10 years of operation. Apparently, this decision is still in the hands of Congress, the Internal Revenue Service, and the courts. On pages 205-206 of the Preliminary System Plan, USRA states:

"The failure to indicate income taxes on the financial statements may not materially affect the cash flow requirements of the Company. . .because opportunities for favorable tax treatment could result in the substantial elimination or deferral of income taxes during that [10-year] period.

"If additional analysis determines that the tax basis of the acquired assets of the existing railroads exceeds the cost of these assets to the Company, and if under existing tax laws or through special legislation the tax basis of the acquired assets can be carried over to the Company, tax savings through increased depreciation and amortization deductions should be realized.

"*If* operating losses from early years of the Company's operations are projected, they *should* be available for carryover to reduce or eliminate income taxes in subsequent years. *If* the Company is permitted to maintain its tax records on a pure betterment accounting basis . . . .income for tax purposes may be considerably less than income for financial statement purposes for a considerable period of time. Also, tax liability may be further reduced, *if* accelerated depreciation methods are utilized for tax purposes. No provision is made on the financial statements for the deferral which would arise under these situations in which income for financial reporting purposes exceeds income for tax purposes because analyses estimating income for tax purposes cannot be completed until the tax basis has been established for the assets acquired.

"Under existing law, substantial investment tax credits should be generated during the rehabilitation program. Subject to carryover limitations, these credits should be available to reduce income tax liabilities in later years."

Given the many "if's", "could's", and "should's" in the above-quoted portions of USRA's financial projections for ConRail, the tax advantages of ESOP financing might still be crucial to the financial health of ConRail, particularly if the tax loss carryovers from the bankrupt railroads are not transferred to ConRail.

If ConRail does not achieve a positive cash flow, of course, it will have no funds to repay principal on its debts, whether through an ESOP or through conventional debt financing. If it does have positive cash flow to repay loan principal, repaying it through the ESOP will build equity into the employees rather than into the creditors of the existing railroads.

There also is a tax advantage that E. F. Hutton totally ignored. Pre-tax dollars are still preferable to after-tax dollars for repaying loan principal, even during years that ConRail pays no taxes. ESOP deductions can help reduce taxes in later years under the 7-year tax loss carryover provisions for regulated transportation companies.

11. <u>In the event of default on an ESOP debt, what happens to the stock purchased by the employees' trust?</u>

On page 3 of their report, E. F. Hutton states:

> "In the event of default by the Trust the lenders could sell the stock. If the proceeds are inadequate, the corporation is obligated to repay the balance of the loan. However, this security interest is not meaningful because the Trust's default would have been occasioned by a prior default by the corporation. In the event of such default the equity securities would have only nominal value. This problem is further compounded by the fact that most ESOP financings are done for either private companies or companies with extremely thin trading markets, making realization upon sale of large amounts of equity difficult."

<u>COMMENT</u>: These quoted comments reflect E. F. Hutton's inexperience with ESOP financing. For example, loans to an ESOP are never made on the basis of the credit-worthiness of the ESOP or that of its beneficiaries or on possible changes in the value of stock. Loans are always made on the general credit of the corporation, the quality of its management, and assets of the corporation that may be pledged as security to support the corporation's ability to generate enough future cash flow to make sufficient contributions to the Trust to enable the Trust to meet its capital acquisition debt. The corporation's obligation to the lender takes the form of a guarantee of the ESOP's debt. In general, therefore, the pledge of stock is irrelevant from the lender's standpoint and many lenders do not require that pledge. If an ESOP is properly designed, any outstanding debt of the ESOP cannot be secured by stock already paid for and allocated to the ESOP accounts of the employees. In other words, ESOP loans are non-recourse with respect to other assets of the ESOP or with respect to the employees themselves. What E. F. Hutton

fails to point out, however, is that non-recourse self-liquidating corporate credit has always been used when a corporation adds new assets. Under conventional modes of finance access to corporate credit is limited to former owners. Through the ESOP, access to such credit, for the first time, has been extended to a corporation's employees. No more, no less. In the event of default on such corporate credit, problems between the lenders and the corporation are no more difficult to handle than if the loan had been made directly to the corporation. Whether the stock is not traded, thinly traded or heavily traded is of minor significance to ESOP creditors.

12. Is stock sold to an ESOP before the ESOP's capital acquisition loans have been arranged?

On page 11 of the E. F. Hutton report, it states;

> "Again, further sales to the ESOP would be limited by debt capacity of ConRail in the absence of Government guarantees, and the I. R. S. requirements that the corporation have the ability to borrow equal amounts in the capital markets."

COMMENTS: Here again, E. F. Hutton reflects its unfamiliarity with ESOP financing. It has put the cart before the horse. Stock is never sold to an ESOP until the ESOP has the cash to pay for it. The loan and corporate guarantee must always be arranged first, which, incidentally, is one of the vital safeguards that the ESOP financing meets conventional feasibility standards. Furthermore, there is no I. R. S. requirement that the corporation have the ability to borrow; no lender will make a loan to an ESOP if the corporation lacks borrowing ability. And it makes no difference

if the ESOP borrows in the conventional capital markets or from the Government, as will be the case for ConRail.

13. If existing unsecured creditors receive some of the initial ConRail common stock, with the remainder sold at "fair market price" to an ESOP, will the ESOP lose its I. R. S. qualification, if the value of the creditors' stock is reduced in a subsequent adjudication of their claims?

According to E. F. Hutton, on page 12 of its report:

> "In such a case, the sale to the ESOP, which must be at 'fair market value', would have to be the same price utilized in determining the value of the shares given to the creditors. If this value were to be reduced by subsequent adjudication it would presumably have to be lowered for the ESOP. At the very least, the plan would lose its I. R. S. qualification." (Underscoring added.)

COMMENT: Here E. F. Hutton displays either excessive anxiety or lack of imagination, or possibly both.

If the issuance of common stock to creditors is handled properly and the ESOP is properly designed in integration with the issuance of securities to existing creditors, there should be no problem in terms of possible I. R. S. disqualification of ConRail's ESOP. The I. R. S., quite properly, scrutinizes ESOP financing to protect employees. It is not unreasonable and does not act to deprive employees of benefits made available to them under Federal laws.

There are several ways to prepare for the contingency that creditors' claims might be subsequently reduced by a future adjudication. First, if the number of creditor shares are kept constant and therefore the value of individual shares outstanding

declines, the company will simply have to issue more shares to the ESOP to adjust the value of all shares issued to the ESOP to the amount of the loan proceeds that were invested in newly issued ConRail stock. Another option is to keep the value of all initially issued shares constant and place in an escrow account the number of shares whose value is equivalent to the value of the creditor's claims that remain in dispute until a final adjudication has been rendered. Thus, shares left over in the escrow account can be returned as Treasury stock, without affecting the value of the stock sold to the ESOP. Other options might also have suggested themselves to E. F. Hutton had it been more motivated to see the ESOP in a more positive light.

B. THE SAUL GELLERMAN REPORT, "Analysis of Probable Motivational Effects of Employee Stock Ownership Plans on Railways in Reorganization", dated April 25, 1975 (APPENDIX C OF USRA REPORT)

1. Gellerman's attitude toward innovation in the field of employee motivation.

Before undertaking his analysis of the ESOP, Dr. Gellerman might have taken this word of advice:

> "To understand an opposing viewpoint opens the possibility that one's own ideas may have to be re-examined, and for many people this is too disquieting a prospect to be risked."

The author of these pearls of wisdom is none other than Dr. Gellerman himself in his book, MOTIVATION AND PRODUCTIVITY (page 292).

Dr. Gellerman's credentials are closely tied to the approach to employee motivation upon which he has built his reputation as a consulting psychologist. On page ii of the Gellerman Report, his solution for saving the Northeast rails is revealed:

> "Apart from whether ConRail adopts ESOP or any financial incentive plan, the purposes of the Act are more likely to be achieved if one sets out to establish a modern, sophisticated personnel department."

Dr. Gellerman's expertise on the subject of how to motivate working Americans is reflected again in his conlusions. On page x he states:

> "In the long-run, non-financial motivators--unglamorous as they are--probably represent the most effective approach for achieving the motivational purposes of the Act.
>
> "For this purposes, it is recommended that ConRail develop a modern, fully professional personnel department with several specific capabilities--one that could be a model for the industry.
>
> "Financial motivators should not be introduced for several years." (Underscoring added.)

To his credit, Dr. Gellerman is much too modest to suggest who

ConRail should hire to design such "a modern, fully professional personnel department", which would operate on the premise that "financial motivators should not be introduced for several years."

Clearly, Dr. Gellerman's reputation as an expert on "non-financial motivators" is threatened by the ESOP. It takes him 179 pages of text, plus 10 more pages of "Executive Summary", to make his case that:

> "ESOPs would probably be ineffective in ConRail and it is recommended that it not be used." (Page x of the "Executive Summary".)

His attack on the ESOP as it has been applied, on the political and economic theories underlying the ESOP, and on the motivations of its proponents, is full of omissions, distortions, innuendos and emotionalisms. As will be pointed out in this rebuttal, Dr. Gellerman's report is hardly an objective analysis of the ESOP. It is rather a non-scholarly and feeble attempt to state "the negative case" on a highly complex but radically new subject on which he has been superficially exposed.

Dr. Gellerman's bias against the ESOP is best illustrated by the non-scientific procedure he used to prove his point that the ESOP will be ineffective in motivating ConRail workers, indeed, that building the benefits of capital ownership into rail workers at no personal cost or risk might be worse from a motivational standpoint than providing them no capital benefits at all. He never bothered to learn the opinions of rail workers on the subject. (Given his pre-disposition, it is just as well

that he did not.) He never even surveyed the opinions of other American workers who own no significant capital in the companies for which they work. In fact, he did not even bother to survey workers from over 100 companies which have applied the concept of ESOP financing, one as early as 20 years ago.

Significant employee ownership of stock in their companies has been achieved in thousands of cases by means vastly less effective and more costly than through ESOP financing. However, since the goal of employee stock ownership is the same as under the ESOP, though the means are different, one wonders why Dr. Gellerman never bothered to interview or survey employees who acquired their company's stock through such profit sharing trusts as Lowe's Companies, Inc. of North Wilkesboro, N.C. (where a warehouse laborer who never earned more than $125 a week in his 17 years with the company recently retired with $660,000) or Sears Roebuck (where at the end of 1971 the employees' trust held $3.3 billion in Sears' stock or 20.7% of all Sears stock and the _average_ Sears retiree had an account valued at $73,000). From Dr. Gellerman's standpoint, it is fortunate that he did not ask the right questions to the people who might benefit from ESOP financing. Much to his dismay, he would have discovered what pollster Peter Hart learned:

> "Only 17% of Americans favor the present economic system; 41% want major changes. By a 66% to 25% margin, Americans favor employees' owning most of their company's stock." (WALL STREET JOURNAL, August 22, 1975, page 1.)

Dr. Gellerman would have gathered considerable evidence on the motivational impact on employees of equity ownership participation by consulting with the Profit Sharing Research Foundation. In the Foundation's publication, DOES PROFIT SHARING PAY?, a survey of 10 major department store chains revealed that companies that quite heavily invested their profit sharing assets in their own stock greatly out-performed the non-profit sharers (a superiority of 152% in company earnings per employee and 105.4% in the earnings per share index). The head of the Foundation, Bert L. Metzger, has stated that "eight to nine million employees are already participating in equity ownership through 150,000 deferred profit sharing plans" and that "Kelso's concepts can speed up this process." In Mr. Metzger's view, "To the extent that workers' shares of profits can be channeled back into stocks to give the workers ownership and [dividend] income (without interferring with his consumption patterns)--to that extent the motivational impact is doubled or tripled." Mr. Metzger could have supplied Dr. Gellerman with substantial evidence to support these conclusions. But Dr. Gellerman did not want to be bothered with the facts.

Dr. Gellerman claimed that there are many "serious motivational disadvantages for ESOPs in this case", citing, among other things, "lack of evidence of effectiveness." (p. x of Gellerman's Executive Summary.) Dr. Gellerman discredits himself on pages 105-112 of his report, covering his survey of 12 ESOP companies. Not a single shred of negative evidence is offered against any of the cited ESOPs. Of the 5 companies with unions, 3 "never had a strike" (p. 105) The 2 which suffered strikes "prior to ESOP have not had any since." (p.107) "The principal tangible change reported was a reduction in turnover." (p.108) "A few disadvantages were cited but they were negligible." (p.106) Employees "are willing to work longer hours and harder than before" and "job applications have significantly increased)" (p.111)

Dr. Gellerman conveniently studied ESOPs that were only recently established, which is not surprising given the bold departure of ESOPs from conventional employee benefit and capital financing programs. All innovation involves a period of gestation. Because of the limited nature of his sampling, he concluded:

> "[E]xperience with the ESOP has not yet offered convincing proof of motivational advantages. Whether they ever will is moot. Therefore, claims for the motivational prowess of ESOPs are, at best premature. (Underscoring supplied by Gellerman) On the other hand, they don't seem to have done any motivational harm, either. The best that can be said for them--and this is important--is that they have probably achieved the primary purpose for which they were established, which in most if not all cases was financial, not motivational." (p. 107)

This is a far cry from scholarly evidence of "serious motivational disadvantages", as Gellerman asserted on page x of his Executive Summary.

Gellerman's relentless pursuit of the negative case against the ESOP, blinded him to a study of the one ESOP that could have provided him a case study with almost 20 years of experience. He dismissed the case of Peninsula Newspapers, Inc., the first application by Louis O. Kelso of the ESOP concept, merely because the financing vehicle in that case was the employees' profit sharing trust, rather than the more effective ESOP vehicle, the stock bonus trust. The company is 100% employee-owned. What makes it an ESOP is that it is a technique of finance which enabled the employees to buy-out close-holding owners on corporate credit, without taking money out of their pockets or paychecks. The plan covers 500 workers, including members of six separate unions. (See PROFIT SHARING, August 1973, published by the Profit Sharing Council of America.) Dr. Gellerman might have learned something about motivation had he interviewed the workers of that company. But apparently in the 12 years since he wrote MOTIVATION AND PRODUCTIVITY, Dr. Gellerman forgot the "possibility that one's own ideas may have to be re-examined, and for many people this is too disquieting a prospect to be risked."

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2. An independent scholar's assessment of the Gellerman Report.

Dr. Raymond A. Ehrle is the Associate Director of New Project Development of Teledyne Economic Development Corporation and Professional Lecturer at George Washington University. He has authored more than 70 articles, reviews, research reports and monographs covering a variety of topics, including several on manpower and motivational issues. After reading the Gellerman Report, Dr. Ehrle wrote:

> In going through his comments, I find that I might agree with some of them and disagree with others and could make comments accordingly. But if I did, I would fall into the same trap thinking, i.e., either analytic or synthetic. Gellerman uses an analytic approach and succeeds in looking at all aspects in a piecemeal manner. This is the essential problem with the ESOP concept. In order for most people to understand it, they must break it down into small parts and in so doing, destroy it. People are either able to grasp the totality of the ESOP point of view from a global perspective, or not at all.

3. The Myth of Rising Labor Productivity: A Convenient Moral Rationalization for Income Based on Clout, Not Reward Based on What One Produces.

The following comments on Con Rail productivity are intended to supplement those made previously in point 7 of our rebuttal to the E.F. Hutton Report.

In Chapter 7 of the Gellerman Report (pages 113-114 of the full report and pages vi-viii of his Executive Summary), Dr. Gellerman literally loses his academic head. This involves his critique of Two-Factor Economics, the theoretical justification for ESOP financing which challenges many basic assumptions that economists and social scientists like Dr. Gellerman have based most of their writings.

In treading on their theoretical assumptions, Kelso has hit a raw nerve. If he is right, those who advise policy-makers on basic economic issues are wrong.

Two-Factor Economics deals with how wealth is actually produced and how it should be distributed--if a free society is to remain productive and free--not how wealth becomes redistributed when basic economic institutions operate defectively. Two-Factor Theory offers logic and theoretical order in a subject ruled by theoretical disorder, mythology, and inability to make accurate predictions and provide reliable information about the future.

One such myth dispelled by Two-Factor Economics is the myth of rising labor productivity. To Dr. Gellerman, the word "productivity" and "motivation" are virtually synonymous.

Dr. Gellerman has lost touch with the realities of "productivity". He seems incapable of understanding that, economically, machines are not the extensions of the workers who operate or tend them, but of the people who own them, and as a consequence of their ownership, are entitled to receive the income their property produces. Unless the worker is identified with these capital instruments, they are not his friends and helpers but his enemies and competitors. This is why workers take a dim view of conventional attempts to raise productivity and why the very word has negative connotations in the public mind.

Peter G. Peterson, former Secretary of Commerce, was quite right when he wrote: "It appears that most Americans harbor a deep mistrust of schemes to raise productivity, associating them with speed-ups on the assembly line and harder work for the same pay." And Frank Pollara, the AFL-CIO's Assistant Director of Research, told The Wall Street Journal: "But when you're talking about productivity, you're really talking about cutting the number of jobs, so workers will look on this with suspicion." Here speaks the gut knowledge of American workers, learned from long, bitter personal and class experience. It will not be overcome by slogans and education campaigns but by different institutional arrangements.

To Gellerman, if overall productivity levels increase, organized labor is automatically justified in negotiating for higher wages and fringe benefits. But under Two-Factor Economics, such a demand may be counter-productive and unjustified. Such a demand may be inflationary. Such a demand may violate the basic principle of economic justice that one's rewards should be based wholly on what one produces, and not on one's "muscle power" to make a claim over the fruits of someone else's capital or labor.

Overall corporate productivity (defined as "output per man-hour") involves a binary, two-factor process. Wealth is produced, in other words, by both labor and capital -- and only capital's productivity is affected by technological advance. (It is one's ownership of his labor power or of his "tools", i.e. capital, that determine the rewards that he is entitled to receive for his participation in production

Redistribution is a direct attack on one's ownership of capital or one's ownership of his labor power).

Output is a blend of labor productivity and capital productivity. (The Bureau of Economic Analysis of the U.S. Department recognizes this distinction; see article by John A. Gorman in the March 1972 issue of SURVEY OF CURRENT BUSINESS.)

On page 118 of the Gellerman report, he totally misrepresents Two-Factor Economics by asserting that it holds that "the only way for people to be productive is to own capital." Two-Factor Economics, as noted earlier, recognizes both capital and labor as essential co-equal factors of production. In contrast, Dr. Gellerman himself is a one-factor thinker. There is nothing in Dr. Gellerman's writings that recognizes capital as a co-factor of production, or that a person may just as legitimately participate in production through his ownership of productive capital as through his productive toil. To Dr. Gellerman, capital ownership is irrelevant as a means for legitimating one's income.

Dr. Gellerman traps himself analytically by attributing, by his omissions, all output solely to the labor factor, that is, to the inputs of either management or non-management employees. Once in this trap, there is no rational limits to one's share of corporate revenues labor automatically is entitled to the whole pie, with nothing left over to pay the costs of capital formation or to reward capital owners after those costs are met.

But, contrary to Dr. Gellerman's mono-factor, myopic view of the industrial world, increases in productivity may or may not have anything to do with whether employees have become more highly motivated. It may come about where jobs are eliminated. It may come about when the company adds more efficient plants and equipment. It may result from improving the "invisible structure" of the corporate organization itself or by adding new patents or marketing techniques. It may result from new routing decisions by the ICC.

Why is this two-factor division of productivity so crucial?

Two-factor economic analysis offers a more realistic and less conflict-prone basis for dividing up corporate revenues between labor and capital. By opening up genuine opportunities for workers to gain legitimate access to the "wages of capital", it then becomes possible to gradually restore the laws of supply and demand as the means of governing a corporation's internal reward system. Under an ESOP, the discipline of profits replace the anarchy of force and counter-force in the division of the fruits of industry. Every employee's rewards could, as was once the case, be based upon values objectively determined by the free, open and democratic forces of the marketplace, rather than on loose, subjective standards or by one's ability to wield economic or political clout.

Under an ESOP organized labor will no longer be justified in squeezing income from someone else's capital (where the division of a company's profits is at stake) or from someone else's labor (where union pressure is exerted on government to redistribute taxpayers'

incomes in the form of higher subsidies, "created jobs", training grants, etc.), simply because union members want "more".

Two-factor economic tools, like the ESOP, do not limit a worker from increasing his income based upon true increases in his labor productivity. Uniquely, without raising labor costs, the ESOP makes accessible to each worker the fruits of his own capital. As a worker, he can increase his wages in increasing the value of his human efforts. And, by acquiring the ownership of additional capital formation, he will also share automatically in the productivity increases of capital. Thus, workers can get "more" when either their capital or their labor produces more, not otherwise. For Dr. Gellerman to suggest otherwise is to relegate workers indefinitely to a propertyless status and to endless class warfare, subject only to the laws of the jungle, where rule by force replaces rule by reason.

4. Does Labor's Share of GNP Reflect a Just Income Distribution System to be Followed by Con Rail?

In his attempt to discredit Louis Kelso's contention that" the more technologically advanced the economy, the greater the input contribution of capital to total output", Gellerman (on p. 115) turns to Dr. Paul Samuelson, winner of the Nobel Prize for his contributions to economics.

When Kelso was asked by former Governor Luis Ferre to design a Proprietary Fund for the Progress of Puerto Rico, Dr. Samuelson challenged Kelso on his insight into how wealth is produced and how income distribution policy should be structured.

Samuelson and other leading economists maintained that "the contribution of labor to the totality of GNP is in the neighborhood of 75 percent, with only 25 percent attributable to land, machinery and other property (and) an increasing proportion of labor productivity is attributable in modern economics... to investment in 'human capital' in the form of education and skill enrichment." (Cong. Record, June 8, 1972, p. S9053) Because this argument should directly affect the structuring of the reward system of Con Rail and the legitimacy of rail labor's future demands on Con Rail management and on the American taxpayers, it is important to offer Kelso's rebuttal to Samuelson, as that debate appeared in the CONGRESSIONAL RECORD of June 8, 1972 (pages S 9052-7)

Unfortunately, Prof. Samuelson has either dashed off his statement in careless haste, or entrusted its preparation to one of his students. For he neglects to identify two-factor economics' central tenet. He implies that it is the opposite of what empirical "economic science" has found, namely that labor contributes about 75% to the total GNP, and land, machines and other property only 25%. If Prof. Samuelson means that labor receives about 75% of the total income in the economy, while capital owners receive about 25%, this is such a universally-known fact that no one would bother to dispute it. This statistic is not the central tenet of two-factor economics, however. Since Prof. Samuelson does not seem to be able to locate its central tenet, perhaps he will not be offended if we venture to enlighten him.

The central proposition of two-factor theory is simply that there are two factors of production, people and things, and that the function of technology is to shift the burden of production from the human factor to the non-human. Each factor produces wealth in exactly the same sense—physical, economic, political and moral. An individual can legitimately and effectively engage in the production of wealth through the ownership of either factor, or, as common sense suggests, through a combination of both.

... Keynesian "scientific economists" assure workers that technology causes the productivity of their labor to rise, although the facts are just the opposite. The Keynesians, in short, with their one-factor myopia, have put the workers and their unions in a position where, as inevitable technological change robs them of the adequacy of their labor power, their Keynesian-misguided institutions do not restore and enhance that productive power by building capital ownership into them. Keynesian doctrine forces labor to demand more pay for less work—a short-term gain that is quickly offset by the resulting rise in the cost of living.

Prof. Samuelson frequently invokes the "findings of economic empirical science" based on "statistical study of macrocosmic trends." But a real scientist looks behind observed phenomena for the explanation or cause. To ignore the role that coercive redistribution plays in the national income statistics, and to assert that all the income diverted to labor represents real productive input, is about as "scientific" as reading a thermometer while holding a blow torch under the mercury bulb.

... The Proprietary Fund envisioned by Gov. Ferre is not designed to create just any kind of "non-wage income." It is specifically designed not to create any of the kinds of non-wage income that the Keynesians rely so heavily on to accomplish redistribution. Indeed, it is precisely such kinds of non-wage income that bloat the statistics Prof. Samuelson cites as evidence that labor *produces* 75% of the economy's goods and services. That labor *receives* 75% of the economy's income does not mean that labor produced it. The statistics include income obtained through organized coercion, doles, unemployment compensation, redistributed income removed from the productive sector through taxation, governmentally subsidized boondoggle paid for by taxpayers (income channeled through boondoggle is disguised to look like "wages," but actually represents non-productive make-work grants, subsidies, or other types of hand-out).

Not a trace of criticism is due labor unions or individual wage-earners for this development. The responsibility rests squarely on Keynesian "scientific economics" which lie, misrepresent or equivocate about technology's logic and function.

Keynesian doctrine is totally oblivious to the concept of private property. It is indifferent to ownership—to its legal attributes, to its personal, social and economic benefits, to the relationship between private property and freedom, to the economic and social consequences of the concentration of ownership of industrial wealth (with only a handful of [illegible]), and to the role of private property in power diffusion. To the Keynesian, the income produced by capital exists only to be redistributed. Property, like freedom, independence, leisure, affluence, love of peace, and other human desires, are "values," and "ethical judgments," and the Keynesian economist is not concerned—to quote Prof. Samuelson's best selling economics textbook—with "basic questions concerning right and wrong goals." These are beyond the realm of their "science."

Property, of course, is a supreme value—it is only private property in one's labor power that distinguishes the free man from the slave. Being oblivious to property, the professional economist also ignores the evidence that most human being are fiercely attached to their property, resent parasites, and strenuously resist all the plans of the professional Keynesian economist to redistribute their property income, from labor or from capital to the less productive or the non-productive. In the 8th edition of Prof. Samuelson's textbook, Economics, the concept "property" appears in the index only twice, one of these entries being "Property taxes." A total of 71 pages is devoted to employment, full employment and unemployment. This emphasis eloquently reveals the Keynesian blind spot.

But the American economic dream—indeed, the universal economic dream—has never been toil, but a defensible property relationship between the individual and the productive land, structures, and machines on which economic wellbeing depends. The Keynesian "scientific economist," who considers the realm of value judgments none of his affair, does not understand that his sacrosanct goal of full employment is itself a value judgment, for if capital instruments are the source of affluence and leisure, why should men and women be condemned to make their productive input solely through toil and labor? Why should economic policy fly in the face of technological facts? Why should the rich get more capital and the poor stay capital-less?

The important truth is that all schools of one-factor economic thinking—the "scientific economists"—are obsolete. The "scientific economists" of the Keynesian or Keynesian-Samuelson schools, like "scientific Marxism," are as non-scientific and as contrary to reality as it is possible to be. Their theory of the "rising productivity of labor" (a more grotesque version is called "increasing human capital") is a hoax. It consists of measuring the output of two factors of production (the human and non-human) in terms of the input of one (the human) and attributing all gains, where comparisons are made, to the human factor. In reality, the gains in productiveness are not in the human factor but in the non-human factor. It is capital that is the source of our increasing affluence, and when "scientific economists" deprive most men of the legitimate, effective and speedy means of acquiring the ownership of capital, they deny them the right to freedom, to leisure, to peace, and to affluence.

Under the tutelage of one-factor Keynesian "scientific economics," the economic policy of all the Western nations is exactly the same. Full employment of the labor force alone is relied upon to enable all people to produce an adequate income. It is full employment that is the number one goal—not the highest level of affluence attainable with current technology and consistent with environmental protection and wise resource use. The Keynesian economic goal is indistinguishable from that of the Soviet Union, and its imitators in Cuba, China, etc. Its spirit may be summarized in a phrase: Full toil for all forever.

Puerto Rico, through the Ferre Plan, would be the first government in the world to recognize that things produce wealth as well as do people and that in an age of accelerating technology, a family can rarely produce an affluent standard of living for itself through labor alone, even if all of its members are employed. Each consumer unit must have the opportunity to produce some of its income through ownership of productive things, as well as through employment. No Keynesian has ever suggested such a policy, nor could he, for his pre-industrial tunnel mind is focused on just one factor of production, labor, and his ideal for humanity is to make a toiler out of every human being not confined to his crib or his bed, and to leave the ownership of proliferating and ever-more productive capital to the already rich.

5. <u>Is the ESOP A Free Gift?</u>

On pages 89-93 and page 140, Gellerman suggests that because the ESOP involves no personal risk, Con Rail employees would not be as concerned with Con Rail's profitability as investors who buy their stock for cash. What Gellerman does not realize is that all capital formation acquired by debt financing is a "free gift" in the same sense that employees gain equity through ESOP financing; in both cases equity is gained at no personal sacrifice or risk to their eventual owners.

Here is Mr. Kelso's response to the "free gift" charge as made by Professor Samuelson:

"You cannot get something for nothing in economic life," says the professor. What the professor implies here is that (1) one who does not own capital can legitimately acquire it only to the extent that he foregoes the use of current income for consumption and (2) that one cannot acquire income without personal toil. The first point, as noted before, happens to be contrary to the basic self-liquidation logic of financing capital formation that is standard operating procedure in well-managed businesses everywhere. The second implication happens to be a variation on a favorite phrase that Prof. Samuelson repeats over and over again in his writing and in his lectures: "There is no such thing in economics as a free lunch."

In the pre-industrial past, the "no free lunch" assertion was true for most men. Today, it is not true except to the extent men continue to be victims of one-factor Keynesian thinking. The essence of two-factor theory is that there are two factors of production, the human factor or labor, and the non-human factor or capital. In the sense that men may legitimately and properly enjoy income produced by their privately owned capital, there is such a thing as a toll-free lunch. Indeed, the industrial world lives primarily on toll-free lunches, and as technological advance progresses, it will increasingly do so. In the sense of saving toil, you can indeed get something for nothing in economic life, and it is the purpose of the Proprietary Fund to make this advantage of technology available to those who traditionally do not own capital.

If equity acquired by workers through ESOP financing is a "free gift", then what would Professor Samuelson and Dr. Gellerman call the wages of firemen on diesel locomotives? On page 11 of the Gellerman Report, it states that since 1964 "railway employment (industry wide) shrunk by more than 20% while total railway wages rose by more than 40%. In other words, wage cost increases more than cancelled out employment cost decreases." Since there is no evidence that labor productivity in the railway industry increased in that period, would Professor Samuelson and Dr. Gellerman characterize these wage cost increases as "free gifts"? There is a difference, however, between wage increases and ESOP benefits. ESOPs do not increase operating costs. Wage costs do and are therefore inflationary.

6. <u>Gellerman's View of Employee Motivation If Con Rail is Nationalized.</u>

Like E.F. Hutton and Towers, Perrin, Forster & Crosby, Dr. Gellerman totally ignored the probability that Con Rail will eventually become nationalized, if present labor-management relations continue on their present course. He never explains how his approach--non-financial incentives and a more modern personnel department--would help or hinder

the railroad from becoming self-sustaining and avoiding nationalization.

His head-in-the-sand attitude toward the ESOP as a buffer against nationalization reminds one of the story of the ARAMCO executive when he was asked how he felt about his company being nationalized by Saudi Arabia. He replied, as might be expected from any non-owning bureaucrat, "What's the difference who signs my paycheck?" If Con Rail executives take on a similar attitude when it gets underway, why should Congress expect anything less from non-management workers? If Con Rail cannot be operated so that it can cover its own costs, if Gellerman has his way, there is always the American taxpayer to make up the difference.

7. Is there an analogy between the distribution of stock under the ESOP and the distribution of land under the Homestead Acts?

On pages 125-8 of his report, Gellerman attempts to refute Senator Long's description of the Esop as a"Homestead" program for industrial workers:

> "The analogy is attractive since Americans tend to romanticize the yearsof the Homestead Acts. But is does not hold up under close scrutiny. The way homesteading farmers behaved is not a reliable guide to how today's industrial worker will behave under the ESOP."

Gellerman here missed the point being made by Senator Long. The Senator used the Homestead analogy to illustrate that when Government directly intervened to influence the patterns of capital ownership in the economy, the American economy flourished like never before and never since.

The thirty year period from 1865-1895 was a period of full employment, hardening of U.S. currency, a rising sense of individual self-determination and hope, and a flowering of industrial innovation. The distinguishing feature between agricultural development in the United States as opposed to that of Latin America and Old World societies then at the same level of economic development, like Czarist Russia was that the Homestead Acts enabled ordinary people, for the first time in history, to acquire ownership of the means of production, which in an agrarian society is principally land.

In his floor speech of December 11, 1975, Senator Long suggested that this "private property" approach to agricultural development explains why American farmers were motivated to become more efficient and raise their productivity to heights far beyond that of their European ancestors and of their counterparts in Latin America and Russia where crop conditions were virtually identical. American family farms and American farm corporations have today become so efficient that with less than one-tenth of one percent of the agricultural workers of the entire globe, America farmers produce about 25% of the world's agricultural output. America's privately owned agricultural base, though not without its difficulties, is still the root source of our affluence.

Senator Long pointed out that land is necessarily finite. But the industrial frontier, made possible when our highly productive farmers were able to free others from farm work, offered a frontier bounded only by the limits of our technology, creativity, energy potential,

still abundant resources, willingness to work, and our desire to overcome economic scarcity in our midst. The Senator pointed out that we missed a great opportunity when the industrial frontier was first opened--particularly when railroad corporations were first granted land and assisted in their initial financing--to have launched an industrial counterpart of the Homestead Acts, which would have widely diffused the ownership of newly formed industrial capital. Having missed this opportunity then, the era of industrial warfare in America began. Instead of Americans pulling together, our railroads, and the rest of industry which followed their financing patterns, created billions of dollars of new and more efficient plant and equipment for over a century without broadening its ownership base, thus dividing the owners of capital from workers without property. Today the top 1% of Americans own over 50% of all individually owned corporate stock. Most Americans have no stake in the corporations that produce most of our wealth. Is it any wonder that not just our railroads, but modern corporations all over the world are in political trouble? Few workers have any stake in their profitability. Gellerman is apparently totally oblivious to these realities when he refuses to consider the possibility of the ESOP achieving for Con Rail what the Homestead Acts did for U.S. agriculture.

8. It is true that Con Rail employees have no control over their shares held by an ESOP trust?

On page 174, Dr. Gellerman asserts that "the inability of employees to control their share would significantly dilute whatever positive motivational effects ESOPs might have."

COMMENT: Here again Dr. Gellerman shows his ignorance about the ESOP. The main advantage from the employees' standpoint for keeping the shares in the trust until they retire is because the trust shelters them from personal income taxes on their capital accumulations. Stock continues to accumulate in their ESOP accounts while they work. When stock is actually disbursed, workers, who can then sell their shares back to the ESOP if they desire, must then pay taxes on their stock as they would for any type of "deferred compensation."

On the other hand, the question of who votes the stock in the employees' trust accounts varies from company to company. In large companies with significant employee stock ownership, voting power on ESOP-held stock is generally passed through to the employee-stockholders as the stock is paid for. The issue of voting pass-through, in any event, is a negotiable issue between labor representatives and management as it should be.

From a motivational standpoint; dividend payout policies are vastly more significant than the issue of who votes the share, in terms of measuring management's effectiveness to their employee-stockholders. The so-called "bottom line" of the company's profit-and-loss statement

becomes a matter of personal concern under an ESOP to each and every worker when he accumulates enough stock that his potential "second income" will make a difference to his standard of living. And along with the benefits go the responsibilities of ownership, which Gellerman paternalistically ignores.

9. <u>Are railroad workers willing to trade-off paternalistic "guarantees" of "job security" for an opportunity to participate in ownership and work toward potential self-sufficiency through the ESOP?</u>

"Most people simply do not worry about post-retirement economic security until retirement comes into view, "Gellerman stated on page 123 of his report. The criteria for this statement are so subjective that even Gellerman has contradicted his own earlier view. In his book, MOTIVATION AND PRODUCTIVITY (1963, p.67) Gellerman remarked:

> "The worker's time perspective is longer than the incentive planners believe it is: he thinks ahead to the effects of increasing his production..."

Elsewhere in his book (M&P, p.68):

> "...workers simply do not sell their labor without reference to the future or to non financial consequences."

Yet in discussing future benefits under an ESOP (p.88 of the Gellerman report) he commented: "The asset will probably be a mere abstraction for people unfamiliar with assets, until it is within reach."

Why Gellerman has changed his attitudes toward workers in the 12 years since he wrote MOTIVATION AND PRODUCTIVITY is not clear. His present class bias is clearly that of an anti-labor executive. Throughout his critique of the ESOP, he is condescending and patronizing toward rank-and-file workers. He doesn't believe rank-and-fine workers want to own Con Rail through an ESOP. After having been hired by USRA

to look into the question, as we pointed out earlier, Gellerman never bothered to approach rank-and-file workers directly on the question. Apparently, a railroad worker is a breed of American different from the 66% to 25% majority who favor employees owning most of their company's stock. Gellerman would place Con Rail employees in the 13% to 81% minority who favor government ownership of large corporations. (WASHINGTON POST, August 31, 1975.)

10. How important is a program of education and follow-up communications to gaining maximum effectiveness and motivational advantages out of an ESOP?

On one point, we agree with Dr. Gellerman. On page 75 of his report, he states that "any novel and/or complex plan will require an elaborate, carefully planned program of education and follow-up communications." He could not be more right with respect to the ESOP.

The basic idea behind the ESOP is childishly simple. Ownership for workers now. How to achieve that result calls for highly skilled professionals. Certainly, the kinds of "experts" hired by the USRA have so little experience in implementing an ESOP, particularly in situations where there has been a long history of labor-management confrontation, that they could only confuse workers and cause them to view the ESOP more as a threat than a benefit. No doubt that among propertyless workers there is considerable suspicion to overcome. But it is unfortunate that USRA and its consultants have in this report added to that problem. Hopefully, in the future USRA will be more careful.

C. THE TOWERS, PERRIN , FORSTER & CROSBY (TPF&C) REPORT, "An Evaluation of the Employee Stock Ownership Plan As Applied to ConRail", dated May 12, 1975 [Basic USRA Report, Including APPENDIX A ("A Technical Review of the Employee Stock Ownership Trust") and "Final System Plan Draft", dated June 13, 1975]

Towers, Perrin, Forster & Crosby (TPF&C) is a national consulting firm specializing in the area of executive compensation. As might be anticipated, like the two other USRA consultants on the ESOP, TPF&C's viewpoint reflects that of corporate management, not one that is oriented to finding new ways of overcoming the traditional "we/they" barriers between management and organized labor. Since the ESOP is new and did not fit into TPF&C's conventional approach to corporate compensation problems, they were put on the spot of having to justify to their clients why--if the ESOP was so good--they never proposed ESOP financing as an alternative to typical compensation schemes. As might be predicted, TPF&C tried to make a negative case against the ESOP and, like their colleagues in this USRA project, missed their target completely.

As mentioned earlier, TPF&C served as project coordinator but rested its analysis and conclusions heavily on the E.F. Hutton Report and the Gellerman Report. Hence, its rebuttal comes last.

TPF&C's primary bias toward rewarding executives, as opposed to rank-and-file employees, is amply demonstrated throughout its report. For example, on page 41, TPF&C states:

> "Another significant feature of ESOPs is the fact that shares of stock are generally allocated in proportion to earnings. A successful ESOP would therefore increase the impact of salary differentials. . . .It could also result in the union's bringing pressure to bear on

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> management to restrict management salaries in order to increase short term earnings. This pressure would ironically be more likely if the ESOP were indeed successful in encouraging employees to seek ways in which corporate costs could be reduced."

It is interesting that like all compensation specialists, TPF&C is less interested in cost reductions than in pressing their favorite compensation package. Any restraint on executive salaries and fringe benefits that resulted from widespread employee stock ownership is obviously threatening to TPF&C's approach to the problem of who gets what. Had TPF&C been more interested in saving ConRail from becoming nationalized and safeguarding the interests of American taxpayers, they might have welcomed such restraints on excessive management salaries, while recognizing that once all rank-and-file workers become profit-oriented, good management is more crucial to them than ever before. Out of self-interest, employee-stockholders will support top pay for top management talent. But TPF&C's excessive concern for management's interests is self-evident.

On page 32, TPF&C again revealed its pro-management bias. In support of its recommendation that a qualified Employee Stock Purchase Plan allowing up to a 15% discount to those paying cash for their company's stock, TPF&C admits that "under normal circumstances, this approach results in participation of approximately 20% of the eligible group. It is important to note, however, that this 20% would probably represent the more highly motivated individuals at ConRail and would therefore maximize the plan's impact." (Emphasis added.) Not only is TPF&C insensitive to the motivational importance of ownership to all employees, but they add insult to injury by treating

employees as second class citizens, inherently less motivated than top executives. It hardly occurred to TPF&C that lower-paid employees could not afford to buy their company's stock, no matter how motivated they were.

TPF&C, given its background as compensation experts geared to traditional employee reward systems, could hardly be blamed for not recognizing that ESOP benefits do not add to corporate costs and are not really "compensation" in the sense of pay for one's work. The ESOP is tied directly to the debt service obligations for meeting the company's capital requirements. It is realistic (and theoretically sound) to look at payments made by the employer into the trust (along with dividends) as part of the yield on the trust's original investments. Thus, in economic theory (as distinguished from tax theory), the contribution is simply the preferential dividend that enables the investment on non-recourse credit (as to the employee) to pay for itself in pre-tax corporate income tax dollars. It amounts to a relatively full payout of the "wages" of capital to enable the new beneficial owners--the employees--to pay for their new capital out of what it produces. It is not a corporate cost since corporate growth financed in the conventional way would cost as much or more--and would not benefit employees at all. (Note that TPF&C treats ESOP erroneously as an additional expense on pages 15 and 27 of its report and on page 22 of APPENDIX A.) In a nutshell, the ESOP merely extends to working people what top wealthholders have always had working for them: access to non-recourse corporate credit for gaining equity ownership of self-liquidating investments.

In the sections of TPF&C's report relating to the mechanics of ESOP financing, corporate finance and tax issues TPF&C simply followed the criticisms of E.F. Hutton. Our rebuttal of E.F. Hutton's report covers the same ground and will not be repeated. In the portions of TPF&C's report on issues of employee motivation, the same errors committed by Dr. Gellerman were made and need not again be refuted. Additional shortcomings in the TPF&C report are as follows:

1. Are "second incomes" through ESOPs a means of redistributing wealth in America?

TPF&C's comment that the ESOP is a means for redistributing income and wealth (page 35) suggests that it cannot distinguish between socialism and capitalism. Paying higher salaries for no additional work is redistribution. The ESOP takes no wealth or income away from those who produce it and therefore is not redistributive. The ultimate result of producing new capital formation along with new owners gradually will bring about a more equitable distribution of capital ownership and capital incomes, not a redistribution of present wealth.

2. Is the ESOP geared to "increasing productivity through stimulated consumer demand"? (Page 35 of TPF&C Report.)

Here again TPF&C shows its ignorance of Two-Factor Economics and the purpose of the ESOP. The ESOP aims at stimulating increasing rates of capital investment in the private sector, thereby stimulating production. The last thing we would advocate is artificial stimulation of consumer demand, which like TPF&C's recommendations is inherently inflationary. Under the ESOP, second incomes are directly tied to incomes generated from the productivity of capital and are therefore deflationary.

VII

RECOMMENDATIONS TO CONGRESS

1. The Regional Rail Reorganization Act of 1973 should be amended by deleting the requirement of Section 301(e) that common stock be issued in the initial capitalization to the estates of the railroads in reorganization. Instead, these estates should be issued "securities other than common stock of equivalent value in exchange for rail properties conveyed to the corporation pursuant to the final system plan." All initial common stock should be issued to an ESOP for the benefit of ConRail employees.in amounts equal to initial capital loans.
2. USRA's valuation of creditors' claims should be approved and creditors would be issued new non-voting preferred stock or new debt securities of ConRail equivalent in value to their claims. Additional securities equivalent to disputed claims would be placed in an escrow pending final adjudication by the courts on the valuation issues.
3. All Federally guaranteed loans to meet ConRail's capital requirements (including working capital, modernization, expansion, rail repair, and even debt securities to creditors) should be financed through ConRail's ESOP so that 100% of initial ConRail common stock will be acquired immediately by the employees' trust and allocated to individual employee accounts as those loans are repaid. Because of present Federal tax deduction ceilings on the amount of such debt service payments (15% of covered payroll), debt repayments above the ceiling can be made directly from the corporation rather than through the ESOP without impairing the employees' 100% ownership status.
4. Congress should consider amending the Internal Revenue

Code to permit unlimited corporate tax deductions (to the extent that external corporate loans and future cash flow for amortizing those loans are available) to ConRail for

(a) Debt service payments paid as ConRail contributions to its ESOP; and

(b) Dividends paid on ESOP-financed stock which are channeled either for accelerating repayment of stock acquisition debt of the ESOP or, after such stock is paid for and allocated to the employees' accounts, for providing taxable "second incomes" to ConRail employees and their families while they work and after their retirement.

(Similar provisions are contained within the Accelerated Capital Formation Act, H.R. 462, and Title III of the Jobs Creation Act, HR. 7240, which now have 92 House co-sponsors, including 10 Ways and Means Committee members.)

4. Congress should permit private lenders to have included in the interest rates charged to ConRail on government-guaranteed loans an amount to cover a special government premium for insurance to cover the risk of non-feasibility of any of such loans, with the investment risks on each issuance of ESOP or ConRail debt securities determined actuarially by competent private insurance and bond security analysts.

5. Congress should require a reduction in interest rates on capital formation loans to meet ConRail requirements, through methods which do not affect taxpayers and would not be included in the Federal budget. For example, Congress should permit qualified banks that make capital acquisition loans to ESOPs, to discount the ESOP loan paper directly with the Federal Reserve at a discount rate not exceeding 0.25% (to cover the Federal

Reserve's administrative costs), thus enabling ConRail to borrow at low "pure credit" interest rates, probably 3% to 5% at the maximum. [Since accumulated savings are not involved when the Federal Reserve generates "pure credit" into capital investments of well-managed basic industries, the "cost of money" or interest will consist only of (a) risk (to be covered by the proposed credit insurance premium), (b) profit for lenders accepting and administering loans, and (c) the Federal administrative costs (covered by the proposed Federal Reserve discount rate). Lower interest rates will speed up ConRail's recovery to a profit-paying status and the rate of diffusion of employee stock participation in ConRail.]

6. Congress should remove the rate regulation authority over ConRail by the ICC and State regulatory bodies in order to provide ConRail management with complete flexibility for competing with alternate modes of transportation and restoring profitability to the Northeast and Midwestern rail systems.

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EMPLOYEE STOCK OWNERSHIP PLAN FINANCING TO GET U.S. RAILROADS BACK ON THE TRACK AND IN THE BLACK

February 4, 1974

EXHIBIT 2
to Testimony of Louis O. Kelso

Joint Economic Committee
Hearings on Employee Stock
Ownership Plan (ESOP) Financing

December 11 and 12, 1975

BANGERT & CO.
INCORPORATED

The Washington Post
WEDNESDAY, JANUARY 2, 1974

Rail Act to Spur Worker Owners

By William Jones
Washington Post Staff Writer

President Nixon plans to sign into law today a $2-billion measure that is designed to rejuvenate railroads in the northeastern states and which provides for potential ownership of the new system by its employees.

Inclusion of the unpublicized stock ownership section apparently marks the first time Congress has gone on record endorsing employee ownership of a key industry.

The idea came from Sen. Russell B. Long (D-La.), who argued that the entire economic system is threatened unless the "wisdom" of the Homestead Acts—spreading out wealth by making land available to many in the last century—is not applied to the nation's major economic enterprises.

"I am convinced we cannot retain our economic greatness," he said, "if we do not . . . institute steps that will make it possible within a few years, for every household and individual in America to become an owner of a viable holding of productive capital."

Long's basically Populist idea won quick support from a diverse group that included Senators Mark O. Hatfield (R-Ore.), Clifford P. Hansen (R-Wyo.), Hubert H. Humphrey (D-Minn.) and Lee Metcalf (D-Mont.), who helped in the drive to incorporate employee stock ownership in the rail legislation.

They argued that the fundamental and unprecedented reorganization of bankrupt railroads is likely to fail, and prompt more requests for government bailouts, unless railroad workers are given a piece of ownership in the surviving system.

Under the legislation, a new for-profit railroad will begin business about two years from now, supplanting six major bankrupt systems of today—the Penn Central, largest in the nation, and Lehigh Valley, Reading, Central of New Jersey, Boston & Maine and Erie-Lackawanna.

A United States Railway Association will be created to draw up the new railroad network and to finance an overhaul of outmoded equipment and facilities with up to $1.5 billion of government-guaranteed loans.

In addition, the legislation includes some $560 million of direct federal payments—money to pay salaries for up to 30,000 workers who may lose employment in the reorganization, money to underwrite continued rail operations while the new system is designed, and subsidies to keep unprofitable branch lines in business where local governments want to share the losses.

Creditors of the Pennsy and other bankrupt railroads, if federal judges approve the plan, are supposed to receive stock in the new railroad firm in exchange for rail properties now owned but needed for the future system.

These shareholders would have no say in running the new railroad, however, until and unless the system becomes profitable and no more federal money is needed.

What supporters of employee ownership are aiming for is a decision by the bankruptcy judges to exchange only preferred stock for the rail properties, opening up the opportunity for selling common stock to employees—while at the same time raising needed capital for operating and expanding the service.

The legislation requires that U.S. Railway Association, in designing the final rail system, must set forth the manner in which employee stock ownership is to be used to raise capital.

The U.S.R.A. must take into account, according to the legislation, the "relative cost savings" compared to conventional methods of raising corporate funds, labor cost savings, a potential for minimizing strikes and producing more harmonious industry-labor relations, projected employee dividend incomes, the impact on quality of service and costs to consumers, and meeting the objective of a self-sustaining business.

Although the rail bill merely permits and does not require use of employee ownership, Long said it represents the "greatest advance Congress has made in this area."

A long-range benefit for taxpayers and the nation, he said, is that Congress might have an answer the next time some bankrupt firm asks for a bail-out. "It may be that we can say, 'If you work this out so that your employees have a substantial piece of the action, our experience is that that type thing tends to work," he said.

"It is indispensable that we ask ourselves a basic question," said Long recently, when the Senate was considering the rail bill:

"Why did one of the most important railroad systems in the world, located in one of the most highly populated and highly industrialized areas of the world, possessing a labor force that was more than adequate both in numbers and in skills, fall into shameful disrepair and finally bankruptcy?"

One must conclude, Long argued, that the existing financial structure was the culprit because it concentrated ownership of the entire railroad system within the hands of an elite that represents only 5 per cent of the nation's wealthy citizens.

This led, for example, to a situation where the ailing Penn Central was distributing regular cash dividends on its stock in the late 1960s, even while sowing the seeds for future disaster by ignoring long overdue modernization and repair expenses.

Sen Hatfield said: "Our railroad crisis is merely one more in a growing parade of examples where a bankruptcy in leadership and vision has led to a vacuum in our corporate structure which, not surprisingly, has been filled by increasing government powers and controls and new and more costly bureaucracies."

In addition to government-guaranteed loans to the Penn Central following its mid-1970 bankruptcy, the federal government in recent years has assisted Lockheed Aircraft Corp. and other defense contractors faced with failure.

The energy crisis has brought renewed worries about the ability of Lockheed to survive and has led Pan American World Airways to warn that it may have to have a federal subsidy to keep free of bankruptcy courts.

There are a variety of employee ownership concepts, but the driving force behind Long's enthusiasm is the Kelso plan, named for Louis O. Kelso, a lawyer who specializes in corporate finance and author of "The Capitalist Manifesto" and "The New Capitalists," written with philosopher Mortimer J. Adler.

Kelso's concept would permit rail employees to retain all resent pay and fringe benefit levels, with the added opportunity to buy and pay for a sizeable chunk of stock in the new railroad ($10,000 on average per worker, assuming 70,000 of 100,000 current workers are given new jobs).

These holdings of stock would be protected en masse, through beneficial holdings in a trust, much the same way as wealthy Americans accumulate more wealth and isolate their risks. No taxes would be paid on any worker's property acquired through the plan, on any appreciation of the stock or dividends, so long as the assets remain "sheltered" within the overall plan.

One large railroad was sold last year to its employees, the Chicago & Northwestern. But less than 10 per cent of employees are involved and mostly they are management personnel.

EMPLOYEE STOCK OWNERSHIP PLAN FINANCING TO GET U.S. RAILROADS BACK ON THE TRACK AND IN THE BLACK

In December, 1973, Congress passed, and on January 2, 1974, the President signed, a law that could accelerate the adoption by U.S. business corporations of a financing strategy of expanded equity ownership for employees. The Regional Rail Reorganization Act of 1973 (Public Law 93-236) (the "Act") provides, among other things, that Consolidated Rail Corporation ("Conrail"), the private enterprise corporation which will acquire the assets of the Penn Central and other bankrupt railroads in the Northeast and Midwest, be financed, to the extent found by United States Railway Association ("Unirail") to be practicable, through Employee Stock Ownership Plan ("ESOP") trusts that build some portion of equity ownership into employees.

Section 102(5) of the Act adopts a definition of an "employee stock ownership plan" that conforms to the objectives of the ESOP financing trusts designed by Bangert & Co. The definition reads:

> (5) "employee stock ownership plan" means a technique of corporate finance that uses a stock bonus trust or a company stock money purchase pension trust which qualifies under section 401(a) of the Internal Revenue Code of 1954 (26 U.S.C.401[a]) in connection with the financing of corporate improvements, transfers in the ownership of corporate assets, and other capital requirements of a corporation and which is designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees.

ESOP financing, despite its application primarily through efforts of Bangert & Co. in at least fifty U.S. business corporations, is still a little-understood innovation. Consequently, the Regional Rail Reorganization Act of 1973 will almost certainly have special significance for the history of corporate finance.

The ESOP financing provisions of the Act began with testimony introduced on behalf of Bangert & Co. into hearings of the Surface Transportation Subcommittee of the Senate Commerce Committee on February 28, 1973, by Louis O. Kelso, General Counsel, and Norman Kurland, Washington Counsel. The text of their oral testimony is Appendix II to this memorandum.

In oral and written testimony, Bangert & Co. stressed that, notwithstanding the widely-known deficiencies in the operation and governmental regulation of the railroads, only a monstrous error in the financial structure of the railroads in question could have made their bankruptcy *possible*. Bangert insisted that only by *identifying* and *correcting* that structural error could a new enterprise taking over the operating properties of the bankrupt railroads expect to achieve different financial results.

That structural error, Bangert's testimony explained, was that by placing the entire labor force of the railroads, from top management down to the track inspectors and clerks, in a position where their economic interests were not identified with those of the stockholders; where the only way they could acquire increased income to offset inflation, rising taxes, and rising expectations was to demand progressively more pay for progressively less work, bankruptcy was inevitable and the only uncertainty was in the time.

Only by placing all railroad employees in a position to buy equity in their employer, using the self-liquidating logic of investing in capital through access to credit and on terms where the capital will pay for itself — which logic corporations themselves have used from time immemorial — could this identity of economic interests between management, stockholders, and labor be created, said the Bangert witnesses. And the only financing technique capable of meeting these criteria, they pointed out, is ESOP financing pioneered by Bangert & Co.

THE EVOLUTION OF THE ESOP FINANCING PROVISIONS OF THE ACT

The background facts present a study in mega-crisis. Seven Class I railroads, as well as one Class II carrier, were in bankruptcy. These included the Penn Central, the largest railroad carrier in the United States. In the words of Senator Vance Hartke, Chairman of the Surface Transportation Subcommittee,

> Their services are not only essential to the prosperity and well-being of the people and industry in the Northeast and Midwest, but they are essential to the well-being and prosperity of the Nation as a whole...Forty-two percent of the Nation's population lives in the northeast quadrant, and most of the major centers of the automobile, steel and machine industries are centered there. The geographic zones served by the bankrupt properties account for more than fifty percent of the Nation's total industrial production
>
> The entire economy of the United States would suffer drastically if railroads in the Northeast and Midwest shut down operation.

CONGRESSIONAL RESPONSE TO THE ESOP IDEA

When the Bangert analysis and recommendations were presented to the Senate Surface Transportation Subcommittee, the Chairman of the Subcommittee, Senator Vance Hartke, was sympathetic but skeptical as to whether Congress would consider such a radically innovative proposal. Senator Hartke said he was in substantial agreement with the analysis and recommendations, but, he added, "I just do not think you can sell it to Congress."

On November 5, 1973, Senator Mark Hatfield wrote to his Senate colleagues urging that they support an amendment to the Rail Services Act of 1973* to provide for use of Employee Stock Ownership Plan financing to build the ownership of the proposed private railway corporation into its employees. (The letter is quoted below.)

On November 29, 1973, Senator Russell Long wrote to Senator Warren G. Magnuson, Chairman of the Senate Commerce Committee, with copies to other members of the Committee, urging the amendment of the Act by the Senate Commerce Committee as proposed by Senator Hatfield. Shortly thereafter, the Senate Commerce Committee unanimously approved the amendment and approved the Bill as amended. It went to the floor of the Senate on December 11, 1973, and, at the conclusion of a long day of discussions (and some floor amendments) the Senate passed the Rail Services Act of 1973,* including the provisions for financing Consolidated Rail Corporation "to the extent practicable" through an Employee Stock Ownership Plan Trust.

PROVISIONS OF THE REGIONAL RAIL REORGANIZATION ACT OF 1973 RELATING TO ESOP FINANCING

The Act sets up a non-profit government corporation to be called "United States Railway Association," which we will call "Unirail" for short, with functions somewhat reminiscent of the Reconstruction Finance Corporation of the Depression days, except that its activities are confined to railroads. The functions of this corporation include initially the planning of the general financial and physical structure of a new private business enterprise, "Consolidated Rail Corporation" or "Conrail," which will take over the operating assets of the bankrupt railroads and will operate them in the

The Conference Report of the House-Senate Conference Committee on the Bill (93rd Congress, 1st Session, Report No. 93-744) has this to say on the final form of the Bill:

EMPLOYEE STOCK OWNERSHIP PLAN

House bill

No provision.

Senate amendment

The Senate amendment required that the final system plan adopted by the Association evaluate the practicability and the manner in which, if practicable and recommended, employee stock ownership plans were to be used by the Corporation for meeting its capitalization requirements. Special consideration was to be given to railroads requesting loans from the Association if they have an employee stock ownership plan. Such a plan was defined in the Senate amendment as a corporate finance technique that uses a tax-code-qualified stock bonus trust or company stock money purchase pension trust in connection with any capital requirements of a corporation and which is designed to build a stockholder interest in the employer corporation into each of the employees in relation to their incomes but which does not require the employees to make any cash outlay or to suffer any reduction in pay or other benefits or rights.

Conference substitute

The conference substitute adopted the Senate definition of employee stock ownership plan, but made clear that the Association's study of the practicability of such a plan for the new Corporation does not require that any such plan be established. The conference substitute amended the House-adopted section on initial capitalization of the Corporation to permitting it to repurchase common stock initially issued through payments out of profits in order to establish an employee stock ownership plan. The conference substitute does not require that special consideration be given to railroads requesting loans from the Association which have an employee stock ownership plan. (p.46)

Thus it is the decision of Unirail, *as ultimately approved by Congress*, that determines whether the Government guaranteed initial financing will be made through a Conrail ESOP. Unless Unirail and Congress can find a better answer than ESOP financing to enable the employees of Conrail to do in the future what the employees of the bankrupt railroads failed to do in the past, the chances for ESOP financing seem very good.

THE SENATORS SEE 'THE LONG-HATFIELD AMENDMENT AS HERALDING A CHANGE IN THE DIRECTION OF CORPORATE FINANCE IN THE U.S. ECONOMY

The following letters from Senator Mark Hatfield and Senator Russell Long, and the following extracts from the Congressional Record of December 11th and 21st, 1973, reflect the significance placed by the sponsoring Senators and by Senators Vance Hartke and Jacob Javits on the Long-Hatfield Amendment to the Regional Rail Reorganization Act of 1973.

future. Unirail is given three hundred days from January 2, 1974, to deliver the final system plan to Congress. Unirail will also be the agency which, with government-provided funds, will initially finance Conrail. Congress retains the right to approve any final plan before appropriating additional funds for the financing of the reorganized rail enterprise.

The planning and implementation process by Unirail starts immediately upon the date of enactment of the bill — January 2, 1974. Special functions are assigned to the Secretary of Transportation and the Interstate Commerce Commission to keep rail service going in the emergency region. Pending the development and approval of the final system plan, Congress appropriated $85 million to the Secretary of Transportation in order to provide assistance to the trustees of the railroads in reorganization and the Secretary of Transportation may direct Unirail, with its approval, to issue up to $150 million in obligations to forestall deterioration of the plant and equipment of the bankrupt railroads pending completion of the final system plan.

Unirail, in cooperation with the Secretary of Transportation and the Interstate Commerce Commission, will prepare the final system plan, including the financing plan, subject, of course, to ultimate review and approval by Congress.

Common stock of Conrail is to be initially issued to the bankrupt estates of the constitutent railroads in exchange for the assets to be acquired by Conrail:

> (c) INITIAL CAPITALIZATION. — In order to carry out the final system plan the Corporation is authorized to issue stock and other securities. Common stock shall be issued initially to the estates of railroads in reorganization in the region in exchange for rail properties conveyed to the Corporation pursuant to the final system plan. (Section 301[c])
>
> But the final system plan is required to set forth, among other things:
>
> (3) the manner in which employee stock ownership plans may, to the extent practicable, be utilized for meeting the capitalization requirements of the Corporation, taking into account (A) the relative cost savings compared to conventional methods of corporate finance; (B) the labor cost savings; (C) the potential for minimizing strikes and producing more harmonious relations between labor organizations and railway management; (D) the projected employee dividend incomes; (E) the impact on quality of service and prices to railway users; and (F) the promotion of the objectives of this Act of creating a financially self-sustaining railway system in the region which also meets the service needs of the region and the Nation. (Section 206[c][3])

Thus not only must ESOP financing be used to meet the initial capitalization requirements of Conrail if Unirail finds, on the basis of the criteria indicated, that it is practicable, but the Act also contemplates possible ultimate repurchase by Conrail's ESOP trust of some portion, perhaps eventually all, of the Conrail stock originally issued to the estates of the carriers:

> Nothing in this subsection shall preclude the corporation from repurchasing the common stock initially issued through payments out of profits in order to establish an employee stock ownership plan; and nothing in this subsection shall preclude the recipients of common stock initially issued from establishing an employee stock ownership plan. (Section 301[c])

*Renamed ultimately by the Conference Committee the "Regional Rail Reorganization Act of 1973."

[SENATOR MARK HATFIELD URGES HIS COLLEAGUES TO CONSIDER ESOP FINANCING OF CONRAIL CORPORATION]

United States Senate
COMMITTEE ON APPROPRIATIONS
WASHINGTON, D.C. 20510

November 5, 1973

Dear Colleague:

Soon the Senate will begin consideration of legislation to revitalize the bankrupt rail system of the Northeast. I believe this offers an opportunity for a full discussion of possible alternatives to nationalization.

Increasing federal subsidies are not sufficient to prevent continued deterioration and future labor-management conflicts. Federal solutions, in their present form, are an open invitation to bailouts of other ailing railroads and industries. Our railroad crisis is merely one more in a growing parade of examples where a bankruptcy in leadership and vision has led to a vacuum in our corporate sector which, not surprisingly, has been filled by increasing government powers and controls and new and more costly bureaucracies.

I am, therefore, proposing an amendment to whatever bill passes the Senate. This amendment would signal a healthy, new direction for the proposed Northeast Rail Corporation and the Federal National Railway Association, as proposed by the Pearson-Beall amendment, by adding a provision to the financing and labor relations sections of this bill which would explicitly mandate "to the maximum extent practicable" the use of an Employee Stock Ownership Plan for financing transfers of corporate assets and future expansions of the reorganized system. Enclosed is a copy of this amendment, together with a comparison of ESOP financing with conventional debt financing and a one-page summary of how this amendment would benefit taxpayers, workers, railroad users, and the public generally if applied to the future system under projections of the Department of Transportation.

The Employee Stock Ownership Plan is, in my opinion, the most important innovation in investment finance developed in recent years. The ESOP would spread stock ownership systematically among all employees, at no personal risk to themselves and without reducing their take-home pay or other benefits. And by building a vested and growing property stake and rising dividend incomes into each member of the corporate team, anyone -- management, union officials, and blue collar workers alike -- would share a unity of interest in the growth and profitability of the Northeast Rail Corporation, if this is the approach adopted by the Congress. Technological improvements, now viewed as a threat to workers, become a growing source of each worker's retirement and pre-retirement income under an ESOP. Thus, by offering significant equity opportunities to its work force, the new rail corporation would not only begin on a more viable footing, but, through its ESOP, can offer taxpayers some hope for an efficient, unsubsidized and relatively strike-immune rail system in the Northeast corridor.

From a taxpayer's standpoint, this amendment would add no Federal costs to the present railroad proposals now being considered. In fact, the ESOP is, I feel, our only hope for converting what is today a significant tax loser into a future, tax-paying member of the corporate community. The ESOP's advantages for meeting this crisis and other kinds of economic problems have received extensive treatment in many business and scholarly journals and in several important books on the future of the American economy. A growing number of labor leaders have recognized the ESOP as offering new horizons for democratic unionism. And from a moral and political standpoint, we have nothing to lose and everything to gain by adding an ESOP provision to the Northeast Rail bill.

I sincerely hope that you will join me as a co-sponsor of this amendment to provide all employees of the proposed Northeast Rail Corporation an equal and fair opportunity to share in its ownership. Should you wish to do so, or if you have any questions, please contact me or have a member of your staff contact Tom Imeson at x53753 by Tuesday, November 13.

Kindest regards.

Sincerely

Mark O. Hatfield
United States Senator

MOH:tib
Enclosure

REORGANIZED NORTHEASTERN RAILROAD SYSTEM BENEFITS TO BE DERIVED UNDER EMPLOYEE BUYOUT THROUGH ESOP FINANCING

The U.S. Economy in General.

•An efficient, unsubsidized, strike-immune rail system in the Northeast corridor.

•A dramatic example of how a sick industry can be revived by creating a unity of interest between management and organized labor through widespread access to corporate ownership and dividend incomes among all employees...without affecting traditional jurisdictional prerogatives of management vis-a-vis union leadership.

•A positive alternative to nationalization and current trends toward nationalization and taxpayer bail-outs of our railroads.

•Cuts government costs and reduces pressures on almost bankrupt present railway workers retirement system...yet raises the tax base.

Workers Employed After Reorganization.

•No reductions in present pay levels, present retirement contributions and other present employee benefits.

•An opportunity to buy and pay for a sizeable chunk of stock in the new company ($10,000 on the average per worker), and to own this stock in the same way as America's wealthiest families accumulated their property holdings: through access to corporate credit, with personal risk cut off by the insulation given under law to a corporation.

•No taxes paid on any worker's property acquired through the ESOP, on an appreciation in value of a worker's holdings, or dividends, as long as these assets remain "sheltered" within the ESOP.

•In addition to wages, a second income from dividends on stock held by the ESOP for each employee during his working years (an estimated supplement of almost $3,200 per year for the average employee after 5 years, based on conservative profit projections of the U.S. Department of Transportation). Dividend checks received by workers on-the-job or upon their ultimate retirement or displacement by automation are, of course, subject to personal taxes, the same as paychecks.

•An opportunity to share with his fellow workers additional company stock and diversified holdings of other companies or real estate, acquired through future financings by the ESOP, as the new corporation expands, adds new and more efficient equipment, or otherwise seeks new sources of income.

•A better answer to automation than demoralizing featherbedding, make-work, spread-work, etc.

•A personal stake in cost-cutting and higher corporate profits, thus enabling the industry to become more competitive, to grow faster, to expand into new territories, and to generate new jobs.

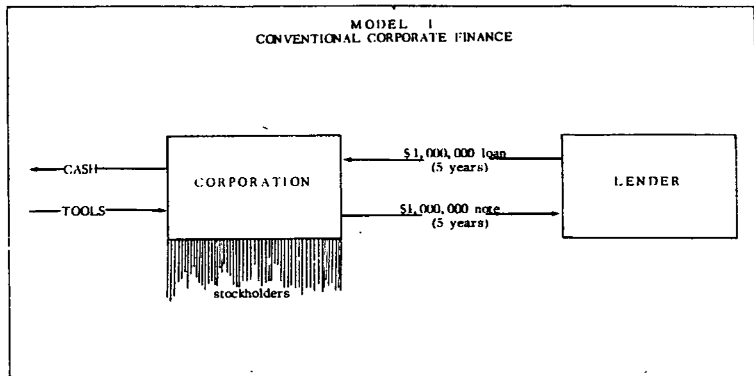
•An inflation-proof capital estate to pass on to one's heirs.

BANGERT & CO.
INCORPORATED
INVESTMENT BANKERS

111 PINE STREET
SAN FRANCISCO, CALIFORNIA 94111
(415) 788-7454

COMPARISON
OF
CONVENTIONAL DEBT FINANCING
WITH
EMPLOYEE STOCK OWNERSHIP FINANCING*

The process by which newly formed capital (improved land, new structures, and new tools) is brought into existence under conventional financing techniques can be functionally analyzed from the following example. Suppose a corporation has done its feasibility study for a contemplated expansion (self-liquidation within a reasonable period of years is the essential logic of business investment) and concludes it should spend One Million Dollars for new tools in order to increase output of goods and services for which it foresees a profitable market. The corporation goes to its bank or other lender, convinces the lender of this "feasibility," and borrows the necessary funds--let's say repayable in installments over five years. The picture looks something like this:



The important aspects of this technique of finance are:

--When the loan is paid off incremental productive power equivalent to One Million Dollars of tools has been built into a stationary stockholder base. An individual may sell stock which he owns in the corporation, and another individual with capital may buy the stock, but no net new capital owners are created in the process.

--Since, as a matter of fact, virtually the entire personal ownership of productive capital in the U.S. economy lies in the top 5% of wealthholders*, it is clear that a principal contributor to this concentration of ownership of productive power (productive input being the business basis for personal outtake or income) under the double-entry bookeeping logic of a market economy lies in a technique of finance that builds all incremental productive power into a tiny stock ownership base that already owns functionally excessive productive power, having in mind that the ultimate economic purpose of production is consumption. Those who must constitute the great majority of ultimate customers for business--the people with present and potential unsatisfied consumer needs and wants--do not acquire incremental productive power through this process. Those who are in fact already excessively productive (in relation to their present or potential consumer needs or wants) acquire all incremental productive power.

--The other principal methods of financing new capital formation, those using internal cash flow such as retained earnings, investment credits, depletion, accelerated depreciation, etc., all have precisely the same concentrating effect. In the aggregate, all of the conventional techniques of finance above mentioned accounted for nearly 98% of new capital formation during the past decade.

--The sole remaining financing method, the sale of new equities for cash, has the same concentrating effect: the new stock is sold to people with capital who can pay cash for it.

In short, the logic used by business in making investment--the logic of investing in things that will pay for themselves--is not available to the 95% of Americans born without family capital ownership. As the non-human factor increases in quantity and in relative productive power, its ownership remains concentrated in a stationary fraction of the population. With rare exceptions, employees, including executive employees, do not own functionally significant amounts of productive capital.

Business finance, because of our incomplete national economic policy (a failure to interpret the Employment Act of 1946 as requiring a broadening of the ownership of capital in order to achieve "maximum purchasing power" in the hands of those who need it) and our attempt to solve the income-distribution problem entirely through employment, has failed to recognize the importance of creating new owners of capital without diminishing the take-home pay of labor. Business operates in such a way as to deprive even the employees, both sub-managerial and managerial, of the great corporations (1,000 of which produce nearly 80% of the goods and services of the private sector) of effective means of legitimately acquiring the ownership of viable holdings of capital.

The end result, to which businessmen naturally object, is that it falls to Government to close the purchasing power gap which occurs when 5% of families (who own all the capital) acquire ownership of all incremental per capita productive power, and the majority, with most of the unsatisfied product needs and wants and rising expectations stimulated by all the modern techniques, acquire ownership of none of the incremental productive power. The techniques government must use to close the purchasing power gap, and the effects of its actions, are too well known to dwell on here:

--Welfare redistribution of every imaginable kind.

--Redistributive taxation of every conceivable kind.

--Subsidization of employment, both within and outside government, of millions of people who would not be employed except for the subsidies, the cost of which subsidies are a social burden upon the present and future of the economy directly affecting the quality of the life of the people, although the conventional wisdom overlooks them in evaluating the performance of the economy.

--The adoption of myriads of pieces of legislation encouraging employees to demand and receive more pay for less work, even to the point of demanding increasing pay for no work input whatsoever. All such costs go into the prices of products, thus creating inflation, artificial scarcities and a decline in the economic quality of life, where plentitude and growth in the affluent quality of life should prevail because it is consistent both with the objectives of business, with its technical capabilities and with the desires of the people.

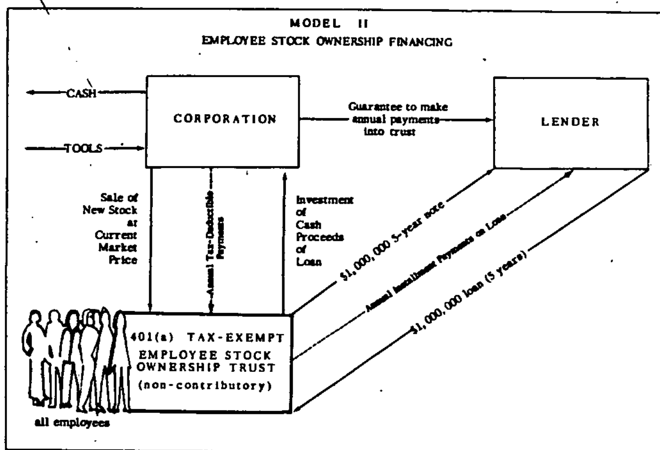
--A rising sense of strife between management and labor, and between the rich and the poor--a natural result of governmental redistribution.

--A growing sense of economic alienation and helplessness, the natural result of not owning capital in a world where most of the wealth is produced by capital.

--The fiscal integrity of government is being destroyed at every level, as a result of our defective corporate strategy and incomplete economic policy that attempts to solve the income distribution problem through employment alone rather than jointly through employment and broader ownership of capital, the other factor of production. From the municipality, the county, and the state, to the Federal government and the United Nations, staggering but still growing debt (the not-so-secret source of our precarious present prosperity) is being piled upon unwilling taxpayers and the taxpayers of the future, while the underproductive and non-productive masses demand more welfare, more subsidies, more redistribution.

The solution is to facilitate financing a significant portion of new capital formation, and normal business changes in the ownership of existing assets, by techniques that legitimately build the ownership of viable capital holdings into corporate employees without taking anything from their take-home pay or their universally inadequate (or non-existent) savings, and to do this by making the self-liquidation investment logic, traditionally used by the corporation itself, available to the corporate employee to whom capital ownership is traditionally only a frustrated dream--the frustrated American Economic Dream.

The basic building block for bringing about such change in the pattern of ownership of capital in the U.S. economy is ESOP financing (the possible variations are numerous). Using the assumptions referred to in connection with the discussion of traditional financing, Model I (See page 16 above), it may be described as follows:



The most important aspects of the ESOP financing techniques are:

--The loan is made not directly to the corporation, but to a a specially-designed ESOT that qualifies as a tax-exempt employee stock bonus trust, or money-purchase pension trust designed to be invested in employer stock, under Section 401(a) of the Internal Revenue Code. Such trusts normally cover all employees of the corporation; their relative interests are proportional to their relative annual compensation (however defined) over the period of years that the financing is being paid off. The trusts are normally under the control of a committee appointed by management and its membership may include labor representatives.

--The committee invests the proceeds of the loan in the corporation by purchasing newly issued stock at its current market value.

--The trust gives its note to the lender, which note may or may not be secured by a pledge of the stock. If it is so secured, the pledge is designed for release of proportionate amounts of the stock each year as installment payments are made on the trust's note to the lender and the released stock is allocated to participant's accounts.

--The corporation issues its guarantee to the lender assuring that it will make annual payments into the trust in amounts sufficient to enable the trust to amortize its debt to the lender. Within the limits specified by the Internal Revenue Code, such payments are deductible by the corporation as payments to a qualified employee deferred compensation trust. Thus the lender has the general credit of the corporation to support repayment of the loan, plus the added security resulting from the fact that the loan is repayable in pre-tax dollars.

--Each year as a payment is made by the corporation into the ESOT there is allocated proportionately among the accounts of the participants in the trust a number of shares of stock proportionate to the participant's allocated share of the payment. Special formulas have been designed to counteract the relatively high proportion of early amortization payments used to pay interest and the relatively high proportion of later amortization payments used to repay principal.

--As the financing is completed and the loan paid off, the beneficial ownership of the stock accrues to the employees. Most trusts are designed to permit the withdrawal of the portfolio in kind, subject to vesting provisions, either at termination of employment, or at retirement. However, it is desirable to so design the ESOT that any dividend income on shares of stock that have been paid for by the financing process and then allocated to the employees' accounts be distributed currently to the employee-participants, thus giving them a second source of income.

--Diversification of the trust can be achieved after a particular block of stock has been paid for by exchang-

ing the stock, at fair market value, for other shares of equal market value. Since the trust is a tax-exempt entity, such diversification is without tax impact.

--While there is temporary dilution of the equity of existing shareholders at the outset, due to the fact that both stock and a limited and special type of loan obligation are outstanding, each year as the corporation repays its debt in pre-tax dollars through the trust, a cash accumulation is set aside that eventually, either within the financing period or thereafter, taken in conjunction with the considerations mentioned in the following paragraph, restores the dilution because of the yield on invested net worth of the tax saving.

--When all factors are considered, including the cost and relative inadequacy of most alternative private retirement systems (for which the ESOP becomes a substitute), the probable costs and losses to the corporation resulting from (i) the inevitable demands of employees for progressively more pay in return for progressively less work input where they have no opportunity to accumulate significant capital ownership over a reasonable working lifetime; (ii) the shrinkage of markets for the corporation's products or services from the otherwise inevitable inflation of its product prices; and (iii) the added costs to the employer from alienation and demotivation of employees not enabled to acquire capital ownership in an economy where capital is a chief productive factor, etc., the cost of capital under Model II ESOT financing over the long term, i.e., beyond the financing period, is no greater, and will normally be less than the cost of capital resulting from any of the techniques discussed under Model I above.

Following is an excerpt from page 202 of the "Preliminary System Plan," Volume 1, for restructuring Railroads in the Northeast and Midwest Region pursuant to the Regional Rail Reorganization Act of 1973, dated February 26, 1975, published by the United States Railway Association.

Employee Stock Ownership Plan (ESOP).—Section 206(e) of the Act requires that the Final System Plan set forth the manner in which employee stock ownership plans may to the extent practicable, be utilized for meeting the capitalization requirements of the Corporation. USRA is giving thorough consideration to this issue and is aware of the possible advantages to be gained through employee stock plans for ConRail. However, whether ESOP or some alternative incentive system can be made applicable to ConRail is not yet known.

Any plan will need to be conceived and administered with great care in order to be a positive rather than a negative motivator of employees. The Association is attempting to determine the extent to which employee stock ownership plans provide an opportunity for lower cost financing and for more employee participation, involvement and commitment to an organization. The implementation of an ESOP must be fair and effective for all classes of stockholders and the employees themselves. Distribution of stock to employees should result in an investment which has value to them, and/or an incentive from which all parties will benefit as employees work to improve the economic performance of ConRail. USRA is studying the practicality of employee stock ownership from both of these points of view and in the light of the pro forma projections.

69-174 O - 76 - 24

RUSSELL B. LONG

United States Senate
WASHINGTON, D.C. 20510

November 29, 1973

[Senator Russell Long, a member of the Senate Commerce Committee, takes the initiative to bring about the amendment of the House-passed Rail Services Act of 1973 by the Senate Commerce Committee.]

The Honorable Warren G. Magnuson, Chairman
Senate Commerce Committee
Suite 127 Russell Senate Office Building
Washington, D.C.

Dear Warren:

Tomorrow, I will offer an amendment to Working Paper Number 1 of the Rail Services Act of 1973, which would enable all employees of Northeast and Midwest rail systems now undergoing reorganization to acquire ownership of up to 100 percent of the newly issued common stock of the new system through an employee stock ownership plan. A description of the employee stock plan and how it would affect the Northeast rail situation is attached. Also attached is a copy of my proposed amendment, which essentially follows that proposed by Senator Hatfield in his "Dear Colleague" letter of November 5, 1973.

This, in my view, is the solution to our present rail crisis. As explained in the attached materials, this amendment would hurt no one. Existing creditors would be made more secure. Since these railroads have not paid taxes in years, there would be no additional tax loss to the Treasury by adopting this amendment to the present bill now being considered by the Commerce Committee. Employees of the new rail corporation, through this highly effective financing innovation, would gain stock ownership without any cash outlay or loss of other present benefits on their part. To the relief of our taxpayers and railroad users, the ESOP is the only logical alternative to nationalizing our railroads. And to rail union officials, the ESOP opens a wholesome new era of broader bargaining potential in behalf of their members. No one stands to lose anything. Everyone will benefit by affording our railroad workers an effective opportunity to become more self-sufficient through expanded capital ownership.

I urge your support of this vital new thrust in American economic policy.

With every good wish, I am

Sincerely yours,

Congressional Record

United States of America PROCEEDINGS AND DEBATES OF THE 93d CONGRESS, FIRST SESSION

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Senate

[FLOOR STATEMENT BY SENATOR MARK HATFIELD]

S 22527-28

Employee Stock Ownership Plan

Mr. Hatfield. Mr. President, let me again express my appreciation to the members of the Commerce Committee for including within this bill my amendment for an employee stock ownership plan. I believe this will be a most significant step toward expanding the base of ownership in society. By attaching this amendment to the Northeast rail bill, we will establish the railroads as a model for demonstrating the effectiveness and viability of employee stock ownership plans. I ask unanimous consent that information explaining ESOP be printed in the RECORD at this point.

There being no objection, the information was ordered to be printed in the RECORD,

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[FLOOR STATEMENT BY SENATOR RUSSELL LONG]

Mr. Long. Mr. President, in approaching our consideration of S. 2767, a bill designed to establish a planning framework within which the reorganization and revitalization of our Midwest and Northeast rail services can be carried out, it is indispensable that we ask ourselves a basic question. Why did one of the most important railroad systems in the world, located in one of the most highly populated and highly industrialized areas of the world, possessing a labor force that was more than adequate both in numbers and in skills, fall into shameful disrepair and finally bankruptcy?

One must of necessity conclude that the causes lie within the institutional arrangements--the financial designs--of the railroads themselves, and within the institutional relationships between the railroads and governments, both Federal and State.

It is not the task of this Congress to restore the losses of stockholders of the bankrupt system. Rather, while protecting the property rights and values that still remain, it is the task of this Congress to so guide the organization and restructuring of the railroad enterprises and of their relations with government, that they will in the future run efficiently and economically, will take full advantage of our internally available fuel supplies, and will provide a model of enterprise to which we can look for answers to the industrial malaise that mars other areas of our economy.

When the railroads were built, the United States was in the midst of accomplishing the most decisive economic revolution in history up to that time: It was, through the direct intervention by Government, engaged in broadening its capital ownership base with a view to making the then most important form of capital--land--available to every citizen who sought it. Though we were struggling to become industrialized, we were still primarily an agricultural nation. We understood the importance of broad, private ownership of the means of production only in terms of ownership of land.

Accidentally, in the 30 years following the Civil War, we stumbled upon the formula for simultaneous rapid economic growth, full employment, and gentle deflation or increase in the purchasing power of money; the only time in modern history when these three much-sought after economic characteristics simultaneously concurred.

No doctrine seems better entrenched among modern economists than the notion that price stability --for example freedom from inflation--and full employment are mutually incompatible. The idea has come to be accepted that there must be a deliberate trade-off between unemployment and price stability. In spite of this widely accepted idea, however, there is an extraordinary period in American history, namely, the 30-year period following the Civil War, when we had enormous national economic growth, full employment even with high levels of immigration, and gently but constantly declining price levels. This was a unique period in economic history.

Of course, there have been times of price declines, but these have been associated with depressions, panics, or the collapse of societies. But during the period to which I allude, the nickel was an important unit of purchasing power, and every year accumulated savings became more valuable. That was the great period of railroad building. Railroad mileage in the United States increased from 35,000 miles to 160,000 miles, or 357 percent. The milling of flour increased 120 percent and the production of steel ingots increased by 23,000 percent. It was a period of growth, excitement, and industrial ferment. It witnessed the inception of the electric utility, the telephone, and the petroleum industries, plus the beginning of modern merchandising and distribution and numerous other significant developments in industrial history.

What was it that occurred in the 30 years from 1865 to 1895 in American economic history to simultaneously bring about the cherished objectives of rapid economic growth, full employment, gentle deflation, and the flowering of industrial innovation?

The answer, Mr. President, is that the 30-year

period from 1865 to 1895 was the only time in the history when a government--this Government--directly intervened to influence the pattern of capital ownership in the economy. This was the most effective period of the Homestead Acts. Congress, after a full decade of turbulent, and at times almost violent, debate, had legislated the steps to bring about the realization of the American economic dream --the accumulation, over a reasonable working lifetime, of a holding of productive capital that would provide significant income and economic security, as well as the economic underpinnings for political democracy. It was an agrarian economy in spite of its rush to bring about industrialization. Productive property was thought of primarily in terms of land ownership. It was the accessibility of land ownership to those who were born without capital that alone explains the openness of that society, its full employment, its economic growth, and the rising solidity of its currency.

But at the very moment in history when we were discovering how government could assist private enterprise by guiding the growth and the pattern of ownership and development of the country's productive system, we were laying the foundations for the most serious of errors that brought our great railroads into their present troubles. While we were trying to get the private ownership of land into the masses of our citizens, we so structured the financing of our railroad systems that by the decade of the 1970's, virtually all of our industrial capital--which now included much of our productive land--would become owned by only the top 5 percent of wealthholders.

It is today again time for Congress, taking a long view of history, to return our economy to the principles that made us great.

It is time for us to innovate in laying down the guidelines for the reorganization of our Northeast and Midwest railroad system, a new equivalent to the Homestead Acts that will broaden the private ownership of our industrial economy even more effectively than the Homestead Acts did for our agrarian economy.

Had we structured our railroad system in the first place so that, instead of becoming owned by the top five percent of our wealthy citizens, they would become owned in reasonable-sized holdings by great numbers of our citizens--particularly those employees whose labors and talents make the railroad system function, we would not be experiencing our present difficulties.

Now, as in the period following the Civil War, the pattern which we establish for the ownership of our railroads can become decisive for the health of our economy in the future. If we lay down guidelines that permit the pinnacle ownership of the reorganized Midwest and Northeast railways from this point forward, we will foredoom the American economy to disaster. In an age when the productive input of capital instruments--land, structures, machines, and intangible capital--is greater than the productive input of labor by perhaps a factor of 10, and this disparity will grow at an accelerating rate, to build incremental productive power into the rich rather than into the propertyless masses is to insure the collapse of our private property economy and the advent of inflationary and totalitarian socialism that is making such headway in other parts of the world.

We have a recent lesson in the Western Hemisphere for statesmen who frustrate the aspirations of the people not just for full employment, but for the ownership of productive capital. When the late President Allende of Chile threatened the confiscation of the trucks of the small truckowners, the lands of the small landowners, the businesses of the small businessmen, and the hopes of all the propertyless serfs who dreamed to become such owners, reaped the predictable whirlwind that leaders who fail to heed the reasonable economic aspirations of the people must suffer.

Thus, for the serious business before us at the moment, we must realize that at the very moment when we saw the importance of broad ownership of agricultural capital, we failed to generalize the underlying idea and laid the foundations for the concentrated ownership of industrial capital.

I am convinced we cannot retain our economic greatness if we do not now apply the wisdom of the Homestead Acts to economic enterprises as a whole, and to institute steps that will make it possible, within a few years, for every household and individual in America to become an owner of a viable holding of productive capital.

Fortunately, through the tools of modern finance, we can accomplish this critical objective wholly within the principles of private property and free-market economics: The foundation stones of our economic greatness and of our political freedom. We can now make "haves" of the "have-nots," without taking from the "haves."

Between now and 1980, the U.S. economy will have to put into place something on the order of $1 trillion of new capital formation if we are to continue our economic growth, restore our prosperity, protect our environment, and fulfill the economic expectations of our people. If we assure that this trillion dollars or so of newly formed capital becomes owned in reasonable-sized holdings by families and individuals from the 95 percent of our citizens who today owns no productive capital, we will have adopted what is in effect an Industrial Homestead Act: an economic policy that will apply generally and to the economy as a whole. We will restore the economic dynamics under which we can enjoy rapid economic growth, full employment and gentle deflation--the hardening of money.

The place to begin this quiet revolution, this revolution of common sense, Mr. President, is with S.2767, a bill laying down the guidelines and establishing the governmental machinery, for facilitating the restructuring and reorganization of our Midwest and Northeast region railroads.

S.2767, the Rail Services Act of 1973, squarely addresses itself to the issue of expanding the base of capital ownership for our railroads, and for the vast new capital formation which must take place within the railroads in the foreseeable future. The Senate Commerce Committee added, provisions to the bill to assure, to the extent found practicable, by the proposed Government National Railway Association, the use of a technique of finance known as Employee Stock Ownership Plan--ESOP--financing. The ESOP is a remarkable innovation in corporate finance designed to reverse the heretofore universal tendency of all widely accepted techniques of corporate finance to concentrate ad infinitum the ownership of capital. It has enormously important social, economic, and

political ramifications for strengthening our free enterprise economy.

Mr. President, I submit that the use of the ESOP financing technique to the maximum extent--ideally to the extent of 100 percent--in connection with solving the current railroad crisis, is the only logical alternative to nationalization of the railroads, for it is not just a way to efficiently finance economic growth, but also to build market power, and to motivate, in the most powerful way, the entire labor force to perform as never before in order to solve this problem.

The ESOP would enable the entire work force of the reorganized rail system to purchase, without deductions from their paychecks or savings up to 100 percent of the newly issued common stock of the proposed United Rail Corporation on credit tied to the new capital requirements of the United Rail Corporation and secured by its future profits. Shares of stock, when paid for, would be allocated to the individual accounts of each employee in a tax example deferred compensation ESOP trust, without reduction of the take home pay or other benefits of the worker. Unions and management would retain their normal bargaining prerogatives and responsibilities, but subject to a broader range of bargaining possibilities. Given these incentives, if the new system cannot be run at a profit, without subsidies, the workers will have no one to blame but themselves.

Each worker will be put in a position where his own efforts toward cost minimization and increased production will directly influence the value of the capital estate which he acquires during his working lifetime. I would anticipate that strikes and slowdowns, antiquated work rules, featherbedding, resistance to automation, and unreasonable wage demands--all seemingly unsolvable problems up to now--will eventually disappear once workers come to realize how these activities not only work against the interests of consumers as a whole, but also against their individual self-interests.

Before describing the mechanics and implications of the ESOP, I think it fitting to acknowledge the contributions of those responsible for launching ESOP as a solution to the labor and capitalization problems of the new Northeast and Midwest rail system. This concept was first proposed by our distinguished colleague from Oregon (Mr. Hatfield) in his "Dear Colleague" letter of November 5, 1973. Cosponsoring Mr. Hatfield's proposal were Mr. Curtis, Mr. Hansen, Mr. Humphrey, and Mr. Metcalf.

Description of the Basic ESOP Financing Technique

Let me briefly describe the basic logic of Employee Stock Ownership Plan financing and how it would work in the contemplated railroad reorganization. In my opinion, the ESOP financing technique is the most important innovation in investment finance developed in recent years. The ESOP addresses itself to three of the most fundamental barriers to broadening the private ownership of equity capital in connection with the financing of economic growth or the financing of changes in the ownership of business assets.

First. The logic of corporate finance is built around the idea of investing under conditions where the investment is expected to pay for itself. This can be most easily accomplished if the investor can get to the pretax--income produced by the newly acquired capital. To accomplish this objective, the ESOP involves using, in an innovative way, either or both of two traditionally recognized deferred compensation trusts designed to be qualified under section 401(a) of the Internal Revenue Code. These are the stock bonus trust and the money purchase pension trust designed to be invested, at least initially, either wholly or primarily in the stock of the sponsoring corporation.

Second. The employee must be shielded from income tax during his period of capital accumulation to the extent that his capital-derived income is used to defray the purchase price for his stock. Any "second income" or income from his newly acquired capital investment, thereafter used for consumption purposes would be subject to normal personal income taxation by Federal and State governments.

Third. The mechanism must not be capable of being abused by anyone for the purpose of building concentrated ownership rather than broad-based capital ownership. The present statutory law and regulations of the Treasury Department are admirably designed to prevent this abuse, and to assure building broad ownership into the employer.

Fourth. The financing technique must be so designed as to build significant capital ownership in the worker over a reasonable working lifetime. It often happens that where ownership of capital is insignificant in terms of its income-producing power it does not arouse the natural acquisitive instinct of the worker to protect and preserve his investment.

Fifth. Any technique suitable for building capital ownership into the workingman must be capable of doing so without making deductions from his paycheck or calling upon him for the investment of his generally nonexistent savings, or his invariably inadequate personal savings. The ESOP technique thus fully harnesses the logic of corporate investment, namely, that investment should be made upon terms where it can reasonably be expected to pay for itself within a reasonable period of years.

The ESOP is not a plan to redistribute the profits or dilute the equity of existing shareholders. It is not a stock option plan. It is not an antiunion technique, but rather is designed to broaden the outlook of both union officials and union members to comprehend both factors of production: not just the employment of labor, but the acquisition of privately owned capital by employees. And ESOP financing is not a handout or tax loophole scheme in any sense of the word.

The ESOP is merely the most logical and most economical vehicle devised to date for ownership planning and for the creation of vast amounts of new capital formation which we so desperately need within our corporate sector. The key to corporate ownership, as bankers and businessmen know so well, is having access to corporate credit. Under conventional financing techniques corporate credit is used to make the rich richer; to build capital ownership into the top 5 percent of U.S. wealthholders, who today own all the productive capital.

The ESOP makes some of that corporate credit available to employees while simultaneously financing the growth or normal operations of the corporation itself. It is a practical means for providing access to corporate credit and the normal self-liquidating logic of corporate finance to the new employee owners. It does no more than to place corporate employees in the same position that has enabled America's wealthiest families to become rich, but does so

without depriving anyone of his existing property rights. As applied to the reorganized rail system, it would spread ownership of up to 100 percent of the newly issued common stock into all employees. It should be noted here that the fact of bankruptcy itself indicates that the present common stock of the bankrupt rail corporations has been made substantially valueless. The ESOP financing technique can be used in such manner as to protect, and indeed to greatly enhance the likelihood of full recovery of their claims by existing creditors, while providing them, to the extent of their legally recognized claims, with either readjusted debt securities, or with preferred stock, or with a combination of the two. The important aspect of the ESOP financing technique in this instance is that, once the claims of creditors have been paid off through their preferential claims on the income of the reorganized corporation, the growing equity of the corporation, to the extent that the ESOP is used, will be built into employees. Thus, prior to paying off existing creditors and newly acquired creditors, the employees are motivated by the prospect of building their own capital holdings to do everything possible to run the system profitably. When and as creditors are paid off, the employees are equally motivated to build the value of their own equity holdings through diligent and cost-conscious efforts on their part.

Over 40 highly successful U.S. corporations have adopted, or are in the process of adopting ESOP's since the first application of this financing technique in 1957. Not only does the ESOP provide lost-cost capital for the employer, but it provides the most important form of job enrichment known to man: Enrichment for each employee in the form of a reasonable capital holding. It is ideally designed to generate labor-management harmony, expanded corporate profits, and to avoid the structurally inevitable inflation that arises in modern economies so long as employees are put in a position where, in order to keep up with rising living costs, rising taxes, and rising expectations, they must demand progressively more pay for progressively less work.

Financing loans, which under conventional techniques would be made directly to United Rail Corporation, would, under ESOP financing be made to a specially designed ESOP. While the details of the design of the ESOP would, under the Rail Services Act of 1973, be ultimately determined by the Government National Railway Association, it would seem that the trust in this case, as in most other ESOP financing instances, would cover all employees of the corporation, and their relative interests would be proportional to their relative annual compensation--however defined--over the period of years that they are employed. The voting power of the stock in the trust would normally be vested in a trust committee appointed by management and the membership on the committee would undoubtedly include representatives of the employees. Voting power on stock held in the trust to employees as the stock is paid for, or it may remain with the trust committee.

The trust committee invests the proceeds of loan financing and other trust income into newly issued stock of the United Rail Corporation at its current fair market value at the time of investment.

The trust gives its note to a lender, which note may or may not be secured by a pledge of the stock. If it is so secured, the pledge is designed for release of proportionate amounts of the stock to the trust each year as installment payments are made on the trust's note to the lender and the released stock is allocated to the participants' accounts.

United Rail Corporation would issue its guarantee to each credit source making a loan to the trust, insuring the lender that United Rail Corporation will make periodic payments into the trust sufficient to enable the trust to amortize its debt to the lender. Within limits specified by the Internal Revenue Code. --15 percent of covered payroll for a stock bonus trust and an additional 10 percent of covered payroll if a money purchase pension trust of ESOP design is added--and such payments are deductible by the Corporation as payments to a qualified deferred compensation trust. Thus the lender would have the general credit of United Rail Corporation to support repayment of the loan, plus the added security resulting from the fact that the loan is repayable in pretax dollars. In contrast, it should be noted under conventional financing the repayment of principal on any loans is always in after-tax dollars.

Periodically, as payment is made by the Corporation into the ESOP, there is allocated proportionately among the accounts of the participants in the trust a number of shares of stock proportionate to each participant's relative compensation from the Corporation. Special formulas have been designed to counteract the relatively high proportion of early amortization payments used to pay interest and the relatively high proportion of latter payments used to pay principal.

As each particular financing is completed and the loan paid off, the beneficial ownership of the stock representing that financing accrues to the employees and is allocated proportionately to the individual account of each in the ESOP.

Most ESOP trusts are designed to permit the withdrawal of the portfolio in kind, subject to vesting provisions, either at termination of employment or at retirement. Special provisions concerning the portability of accounts of employees in the trust should be developed for the United Rail Corporation ESOP. It is desirable to so design the ESOP that any dividend income on shares of stock that have been paid for by the financing process and are thus allocated to the employees' accounts be distributed by the ESOP trust currently to the employee-participants, thus giving such employees a second source of income--"the eye of the owner."

Diversification of the portfolio of the ESOP can, if desired, be achieved after a particular block of stock has been paid for by exchanging this stock, at fair market value, for shares in other corporations at equal market value. Some modifications of present Treasury rules and regulations with respect to this aspect of the ESOP would probably be desirable. Since the trust is a tax exempt entity, such diversification is without tax impact to the employee owning the account that is diversified.

Through the use of ESOP financing, the corporation can obtain low cost capital and save the additional expenses of conventional public stock offerings. Once installed, the ESOP becomes a permanent part of the corporation's financial machinery, combining within a single package a mechanism for comprehensive long-range planning and the resolving of basic corporate problems: Financing, employee motivation,

compensation, and retirement benefits, which in the past have been handled on a piecemeal, generally unplanned, and quite often self-defeating and mutually disruptive basis. Although there will be a temporary earnings dilution from the issuance of new stock in future financings through the ESOP, that dilution is soon restored by the inherent financing advantages of the ESOP technique: The use of pretax dollars to finance growth, the simultaneous building of property-supported retirement benefits as corporate growth is financed, the harnessing of the natural tendency of the employee under such circumstances to minimize costs and thus maximize profitability in order to benefit his own investment, and the normal savings in corporate retirement costs that occur when retirement funds are invested in the recycling of secondhand securities purchased in the market place.

Mr. President, U.S. business corporations, including railroad corporations, have always needed but heretofore have never had, a way to raise the incomes of employees, without raising corporate costs. Most approaches for liberlizing the railroad retirement systems, particularly measures calling for earlier vesting, have the same effect as wage salary increases, namely, they are inflationary. Most retirement programs are so designed that contributions become costs of doing business and enter into the costs of goods and services produced. Where retirement income payments are not made directly by business to the retirees, they are in general invested in outstanding securities--secondhand securities--purchased from speculators in the public markets. The funds thus invested do not, with rare exceptions, go into new capital formation to increase the productive power of business. Rather, the $15 to $20 billion annually contributed to private retirement systems, as recent testimony before the Financial Markets Subcommittee of the Senate Finance Committee has shown, are used to inflat the prices of outstanding stocks of "glamour corporations." Such securities are normally purchased by retirement trusts on a yield basis that is presently more than offset by the inflationary loss of purchasing power of the underlying funds. The very process that deprives the corporate sector of a major source of financing growth is thus devoted to the financing of stock market speculation and inflation. It should be remembered, that most private retirement funds contain recycled outstanding securities acquired in this irrational process.

This bill is designed to overcome these basic structural defects of present private retirement systems, while permitting earlier vesting without raising corporate costs--indeed while greatly reducing corporate costs. It is not designed, however, to adversely affect contributions to the existing Railroad Retirement System, which are mandated under present laws on a pay-as-you-go basis similar to social security. Contributions to the ESOP go directly into new capital formation, or, in certain cases can be used to acquire assets purchased on a self-liquidating basis.

Contributions to the United Rail Corporation ESOP would go directly into capital formation, using the funds to be provided under S. 2767 for that purpose. Eventually, such contributions may also be used to finance the acquisition of other operating assets. The important point to remember here, however, is that the pretax yield of productive capital is harnessed directly to the repayment of financing while building ownership into employees.

Mr. President, I know of no more efficient and effective way to build into railroad employees beneficial ownership of a private, viable capital holding, capable of supplementing their wage and salry incomes during their working lives, providing retirement security thereafter, and estates to pass on to their heirs. I know of no more practical way of enabling corporate management to raise the incomes of employees without raising corporate costs and with a long-term deflationary impact on the economy as a whole. Because the ESOP financing technique can both accelerate the growth and lower the costs of railroad transportation, it can open up the opportunity for greatly increased employment in the enormously more important railroad system of tomorrow.

Management's search for a way out of the class-conflict era of labor-management relations would take a new and brigher turn through the use of ESOP financing, be united with that of employees in revitalizing the private enterprise system generally, while building economic security into all employees. Employee stock ownership financing accomplishes the ultimate synthesis of interests defined by economist John Bates Clark almost 90 years ago as:

> Productive property owned in undivided shares by laboring men, contention over the division of products replaced by general fraternity...

Thus, Mr. President, the potential benefits of providing every worker the chance to participate in the ownership of capital are enormous.

Some of my colleagues who favor the ESOP approach have expressed concerns that over-zealous tax reformers might level unfounded charges that this bill is a "tax loophole." If it is, and I deny that it is, then it is the first such "loophole" ever provided to working Americans. To the extent that existing ESOP tax incentives are taken advantage of by United Rail Corporation under S. 2767, to that extent we will have achieved truly structural reform of the U.S. tax system. It represents a new thrust for cutting the costs of welfare, eliminating future consumer subsidies of dozens of different kinds for the purposes of "creating" jobs, and other nonproductive forms of government spending, as redundant workers among the unemployed are absorbed into a healthier and more dynamic private sector.

ESOP financing techniques are designed to build market power into the American people as they finance the growth of the American economy. I can imagine no better method for making common sense of the double-entry bookkeeping logic that is the very basis of any market economy.

This technique systematically broadens the personal income tax base for State and Federal Governments as more Americans begin drawing paychecks and dividend checks directly from enterprises that produce most of our goods and services. It is clearly a move in the direction of simplicity, fairness, and common sense, and that is what genuine tax reform is all about. Any reform that increases our dependency on government should be suspect. Conversely, the ESOP provision in S. 2767 is designed to increase the self-sufficiency and productive potential of America's railway workers and to encourage them to demonstrate the value of broadened corporate ownership as a catalyst and motivating force for up-

dating and revitalizing today's undercapitalized rail and mass transit systems.

Only when workers can become owners of new and more efficient means of production can we overcome the enormous alienation and resistance to technological advancements that have become commonplace within modern corporations, despite all the palliatives and psychological manipulations we have invented to mask the root cause of employee alienation and industrial disorder. That cause, for a certainty, lies in the inability of the worker to increase his productive power.

Without having legitimate access to the ownership of productive capital acquired on self-liquidating terms, one cannot be expected to use moral restraint against the tendency to demand progressively more pay in return for progressively less work when one must compete with the enormous productive power of modern capital. If a modern worker cannot acquire his share of the ownership of the machine, it must be a feared and hated enemy for it threatens his power to earn a living. Dignity can, however, come from acquiring legitimately, over a reasonable working lifetime, an ownership stake in the employer corporation and sharing in the "wages of capital"--the profits of the corporation in which the capital is employed.

Mr. President, there are but three political-economic roads from which we can choose.

We can take the course to the right, advocated by laissez-faire philosophers and economic anarchists, which would allow pinnacle ownership to remain and would indeed add enormously to its concentrated holdings. This would result, for example, if the existing creditors of the bankrupt railroads became the owners of the common stock of the United Rail Corporation. Under this approach, each advance in technology, and each added investment, would heighten the confrontation between the "haves" and the "have-nots", and would perpetuate economic class conflict.

We can take the road to the left, making everyone a "have-not" under the banners of "nationalization" and "equality." This would force an equal sharing of misery and scarcities, using the State or a collective to impose a new form of monopoly ownership, substituting robber-bureaucrat for robber-baron, perpetuating effective ownership by a small but different elite. This "new class" would, by such a step, be placed in a position where it could control the society not only through its stomachs, but also through the guns and nightsticks which it possesses, making corruption and tyranny even more inevitable than under pinnacle private ownership. Preventing workers from enjoying the power and distribution rights that flow from the personal ownership of productive capital, this second road invites a continuing class struggle and relentless inflation. It should be noted that the socialist-leaning critics who argue that the government-owned railway systems of nonsocialist countries would not incur losses if the "ecological benefits" from greater uses of railways were added to the Government corporation's revenues, avoid mention of the fact that each of those economies is saddled with rampaging and accelerating inflation.

Such inflation inevitably flows from putting labor in a position where it must demand progressively more pay in return for progressively less work input, whether the workers' nonownership of capital results from pinnacle private ownership, or governmental public ownership.

Or, Mr. President, we can steer a middle course, getting back to the original road that was opened by Jefferson, Adams, Madison, and other Founding Fathers, and expanded by Lincoln under the then revolutionary homestead programs. This was the essence of the American dream that sparked the hopes of the propertyless everywhere and worked so well before our land frontier closed. The third road opened by our pioneer ancestors was intended to make everyone a "have", an owner of income-producing property: it was intended to provide each person a stake to help him become independent of others for his subsistence and thus providing the economic foundation for a free and just political democracy. This road ended when our geographic frontiers ran out and our industrial frontier began.

What an irony of history that our railroads--the key to the rise of America to industrial and agricultural greatness, and now even more vital to the development of a freer, more prosperous, and more environmentally hospitable economy yet to be built--took the wrong turn over a century ago, leading the rest of American industry headlong into pinnacle ownership, the concentrated ownership of capital. Our railroads today have been the first to arrive at a deadend in that road. We, the Members of this Congress, more than a century later, are now given a second opportunity to provide a prototype design for the pattern of ownership of the American economy.

We could take the first course and further exacerbate the already intensely concentrated ownership of productive capital in the American economy.

Or we could join the rest of the world by taking the second path, that of nationalization.

Or we can take the third road, establishing policies to diffuse capital ownership broadly, so that many many individuals, particularly productive workers, can participate as owners of industrial capital.

Mr. President, the choice is ours. There is no way to avoid this decision. Non-action is a political decision in favor of continued, and indeed increased, concentrated ownership of productive capital.

Which of these three ownership alternatives makes the most common sense, the most political sense, the most social sense, the most economic sense, indeed, the most moral sense?

The eyes of the world are upon this chamber as we deliberate this fundamental question at this moment of truth of our Nation's history.

Mr. President, are we ready to begin anew where our revolutionary forebearers ended, constructing a modern extension of the third road, the road of expanded ownership of productive capital, so that everyone will have the right to own the corporations that will, regardless of our decision, propel us further into the uncertain age of automation.

The have-nots of the world, including the 95 percent of the American people who own no capital, await our answer.

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[FLOOR STATEMENT BY SENATOR VANCE HARTKE]

Mr. Hartke. Mr. President, let me say to the distinguished Senator from Louisiana, the chairman of the Finance Committee, that this is probably one of the most innovative ideas presented in this bill, which has a lot of innovation in it. His amendment deals with basic aspects of the industrial system. The Senator has given great thought to the theory of industrial democracy which in substance allows those people making their contribution to the industrial production of this Nation to share not alone as wage earners, but also as participants in the profits of their labor. Individuals that really would, under normal circumstances appear to be opposed to this kind of operation, seem to be sympathetic to it, in view of the fact that it is the chairman of the Finance Committee who is the proponent of this measure as a result of which we may be moving much more rapidly toward a democratic system. Under the private ownership plan that had heretofore been envisioned by some, people were ready to sell this system short. In other words, we are now saying that the concentration of wealth might be brought to an end by concentrating the wealth in the hands of those people who are really producing the wealth of the Nation.

I commend the Senator from Louisiana. He has a great deal of material there. Not only is it possible that this could lead the way in the railroad industry, but also this could be the beginning spot for giving consideration to other major industries in the Nation.

[FURTHER COMMENT BY SENATOR RUSSELL LONG]

Mr. Long. It might be well to find out how employees, properly motivated, can make the bankrupt corporation succeed. If this proposal works and I think it should be given a try--and I hope the Senator, as one of the conferees, will work for this--then we may very well have the answer for the future when some bankrupt corporation comes to the U.S. Government asking to be bailed out. It may be that we can say, "If you work this out so that your employees have a substantial piece of the action, our experience is that that type thing tends to work."

My big objection to our private property system is not that I do not favor it--I do favor it very much--but I object that not enough people own some of it. It would be well to see how it works when you give the employees an opportunity to own a major share of the stock, perhaps even 100 percent, if they will make the railroad a big success.

I look upon this as a great challenge for us to urge employees to be a part of the team and eliminate all those divisive labor-management practices which could be avoided when people of good will work together to make a success of an enterprise.

Congressional Record

United States of America PROCEEDINGS AND DEBATES OF THE 93^{d} CONGRESS, FIRST SESSION

Vol. 119 WASHINGTON, FRIDAY, DECEMBER 21, 1973 *No. 202*

Senate

[FLOOR STATEMENT BY SENATOR RUSSELL LONG AT TIME OF FINAL PASSAGE BY THE SENATE OF THE CONFERENCE COMMITTEE BILL]

S 23784-5

Mr. Long. Mr. President, I want to congratulate the very able Senator from Indiana for the many, many long hours and the diligent efforts he has devoted to the problems of the railroads of this country. This is the culmination of a great deal of the Senator's efforts. No Member of this body has been more diligent or more energetic in trying to solve the extremely difficult problem with which this Nation has had to grapple than has the senior Senator from Indiana, and his leadership in this area is particularly appreciated.

In addition to that, I think it should be added that Mr. Lynn Sutcliffe, who sits beside him, has burned a great deal of midnight oil in helping the Senator and the Committee to work out the compromise involved in the conference report before the Senate.

Mr. Sutcliffe has been assisted in his efforts by a number of other members of the Senate Commerce Committee staff on both sides of the aisle: Art Pancopf, Tom Allison, Paul Cunningham, Mal Sterrett, Bob Joost, John Kirtland, Dave Clanton and many other people.

There is one area in this bill in which I am greatly interested. Because I believe a plan for employee stock ownership can do much to eliminate the conflict between management and labor over various conditions of employment and to help to provide the type of cooperation that is so necessary in the joint endeavor that is needed to make any major enterprise succeed, I favor the provisions in the bill before us referring to this subject.

I have a statement to make discussing the ad-

vances made in the employee stock ownership plan, which I believe is the greatest advance Congress has made in this area. I am particularly pleased that at least part of it emerged from the conference. I thank the Senator from Indiana, as well as the Senator from Maryland, the Senator from Kentucky, and the Senator from Washington, for their assistance in seeing that this measure was at least retained to the extent that it could be, because I believe in the long run employee stock ownership will be one of the ways that will help eliminate and dissolve some of the insoluble problems that could grow between management and labor.

When people plan for failure, the odds increase that they will fail. Similarly, if we assume that the rail systems of our Northeast and Midwest corridors cannot be operated at a profit and therefore neglect to provide sufficient profit incentives for workers, they are unlikely ever to earn any profits, the "wages of technology."

Presumably, reorganization of the Penn Central and the six other presently bankrupt railroads being assisted under the Rail Services Act of 1973 is intended to wipe the slate clean, to allow these rail systems to correct mistakes that led them into financial collapse and to enable them to start anew and continue on a profitable basis.

In business, the formula for making a profit is simple: Maximize revenues and minimize costs. Being so capital-intensive and inherently efficient and low-cost energy users compared to competitive modes of transportation, railroads have historically been natural profitmakers. Only with one absurdity piled on another -- mistakes which have been well documented and need not be repeated here -- could railroads have failed. But insufficiently documented and still uncorrected is the century-old and underlying cause for today's railroad failures: Their continued concentrated ownership by a relatively self-perpetuating group of wealthy absentee capital lords, alongside their day-to-day operation by propertyless managers and workers, the latter conditioned to depend exclusively upon paychecks to meet their income needs, increasingly antagonistic to present owners and profit system generally, and now in desperation prepared to replace welfare recipients in the line for taxpayer subsidies and bailouts.

Clearly, not having the same opportunities to accumulate growing ownership stakes as the few who own most of today's railroad stock, workers have had no incentive to make the simple formula for profits work. In fact, the ownership system was wired for failure from the beginning. It was structured to lead to ever-decreasing revenues and services and ever-increasing, non-market-disciplined costs. And if our railroads fail to build substantial ownership incentives and the discipline of the profit system into its workers in the future, they will never again earn a profit. Nationalization will inevitably follow. And, since railroads have always been pacesetters in our industrial network, in the best and worst of times, we will have laid the foundation for eventual nationalization of our airlines, trucking, agriculture, mass media, telephones, energy development and production, manufacturing, and the rest of our enterprise system. Everyone will be on the Government's payroll.

In S. 2767, the Senate offered a new ownership alternative, an employee stock ownership plan or "ESOP", designed to correct defective corporate finance and concentrated ownership patterns in our railroads. Not enough of the conferees, particularly our House colleagues, had sufficient opportunity to study and fully understand this innovation and its far-reaching implications for saving our railroads. Organized labor and railroad management also need more time to acquaint themselves, the workers, and the public generally on this new thrust. The ESOP, however, still remains a key feature of this legislation and will be studied and, hopefully, fully implemented by the railroads covered by the final bill.

The ESOP, a unique tax-free financing method, would enable the entire railroad work force to purchase as individuals, without savings, newly issued common stock on credit tied to the capital requirements of the new system and secured by its future profits. Each worker would thus be placed in a position where his own efforts toward cost minimization and increased production would directly influence the size of his dividend checks and the value of the capital estate which he can acquire during his working lifetime. From the public's standpoint, we could reasonably anticipate that strikes, and slowdowns, antiquated work rules, featherbedding, resistance to automation, and unreasonable wage demands -- all seemingly unsolvable problems up to now -- would gradually disappear once workers are placed in a position to realize how these activities not only work against the interests of consumers as a whole, but also against their individual self-interests. If the railroads cannot become profitable, then the employees will have no one to blame but themselves. But they must first be placed in a position and given maximum incentives to make the system profitable.

I think it will be a grave error for the courts, the administrators of this legislation, and the proposed United Rail Corporation to hand over automatically all new common stock to existing creditors and to delay in building substantial equity ownership into the railroad work force. How fast and how much ownership we build into workers will directly determine the odds that we can avoid nationalization. There is still enough flexibility left in the conference in my opinion, to unite, through fair and widespread ownership sharing, the interests of individual workers, their labor representatives, management, and existing creditors. Only in this way can Congress demonstrate that the misguided and short-sighted notion that railroads cannot provide low-cost, quality services at a profit, will not become a self-fulfilling prophecy.

Mr. Hartke. Mr. President, I want to say to the Senator from Louisiana that this approach is not only a new approach, but it is a plan to make our democratic system work for people who work for a living, and I thank the Senator for his interest and efforts.

Mr. Long. The Senator shares with me the thought that our principal objection to the way in which free enterprise is operated is that not enough people own it. We want to spread the ownership system among those who help build up this country. I think this proposal is the greatest advance in that area that has occurred. I am hopeful that the com-

mittee's work in that regard will bear fruit. At least we have a plan in which it can go forward.

THE REGIONAL RAIL REORGANIZATION ACT OF 1973
Public Law 93-236

Sections of the Act Relating Specifically to Employee Stock Ownership Plan Financing

"Sec. 102. As used in this Act, unless the context otherwise requires --

* * * * * * * *

"(5) 'employee stock ownership plan' means a technique of corporate finance that uses a stock bonus trust or a company stock money purchase pension trust which qualifies under section 401(a) of the Internal Revenue Code of 1954 (26 U.S.C. 401(a)) in connection with the financing of corporate improvements, transfers in the ownership of corporate assets, and other capital requirements of a corporation and which is designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees."

"Sec. 206. (a) Goals. -- The final system plan shall be formulated in such a way as to effectuate the following goals:

* * * * * * * *

"(e) Corporation Features. -- The final system plan shall set forth --

* * * * * * * *

"(3) the manner in which employee stock ownership plans may, to the extent practicable, be utilized for meeting the capitalization requirements of the Corporation, taking into account (A) the relative cost savings compared to conventional methods of corporate finance; (B) the labor cost savings; (C) the potential for minimizing strikes and producing more harmonious relations between labor organizations and railway management; (D) the projected employee dividend incomes; (E) the impact on quality of service and prices to railway users; and (F) the promotion of the objectives of this Act of creating a financially self-sustaining railway system in the region which also meets the service needs of the region and the Nation."

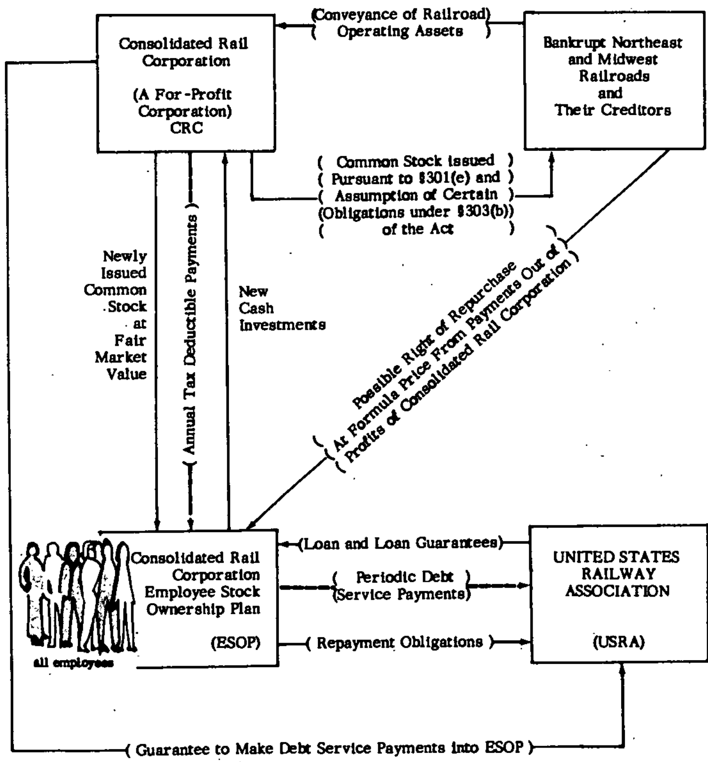
"Sec. 301. (a) Establishment. -- There shall be established within 300 days after the date of enactment of this Act, in accordance with the provisions of this section, a corporation to be known as the Consolidated Rail Corporation.

* * * * * * * *

"(e) Initial Capitalization. -- In order to carry out the final system plan the Corporation is authorized to issue stock and other securities. Common stock shall be issued initially to the estates of railroads in reorganization in the region in exchange for rail properties conveyed to the Corporation pursuant to the final system plan. Nothing in this subsection shall preclude the Corporation from repurchasing the common stock initially issued through payments out of profits in order to establish an employee stock ownership plan; and nothing in this sub-section shall preclude the recipients of common stock initially issued from establishing an employee stock ownership plan."

EXHIBIT I

GENERAL DESIGN FOR FINANCING REORGANIZATION OF NORTHEAST AND MIDWEST RAIL SYSTEMS WHILE BUILDING EQUITY OWNERSHIP INTO RAILROAD EMPLOYEES PURSUANT TO REGIONAL RAIL REORGANIZATION ACT OF 1973*



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NORTHEASTERN RAILROAD TRANSPORTATION CRISIS

HEARINGS

BEFORE THE

SURFACE TRANSPORTATION SUBCOMMITTEE

OF THE

COMMITTEE ON COMMERCE UNITED STATES SENATE

NINETY-THIRD CONGRESS

FIRST SESSION

ON

S. 1031

TO DESIGNATE A NATIONAL NETWORK OF ESSENTIAL RAIL LINES; TO REQUIRE MINIMUM STANDARDS OF MAINTENANCE ON SUCH LINES; TO CREATE A NOT-FOR-PROFIT CORPORATION TO ACQUIRE AND MAINTAIN RAIL LINES IN THE NORTHEAST; TO PROVIDE FINANCIAL ASSISTANCE FOR REHABILITATION OF RAIL LINES; AND FOR OTHER PURPOSES

FEBRUARY 28 AND MARCH 2, 1973

Serial No. 93–8

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92–668 WASHINGTON : 1973

EXHIBIT II

Senator HARTKE. The next witness is Mr. Louis O. Kelso, general counsel, Bangert & Co., San Francisco, Calif.

STATEMENT OF LOUIS O. KELSO, GENERAL COUNSEL, BANGERT & CO., SAN FRANCISCO, CALIF.

Mr. KELSO. Senator Hartke, congressmen, and gentlemen. My name is Louis O. Kelso. I am a lawyer, economists and writer. My main field of activity over the past 35 years has been corporate finance and corporate law.

I am here as general counsel for Bangert & Co., a highly specialized investment banking firm, organized 2 years ago, in part with my participation, and with others, from the financial and business community, for the purpose of putting into action some underlying concepts that I will discuss today.

It seems to me that when we have the techical or the physical capability for building, improving, and operating railroads, keeping them well equipped and instrumented and carefully controlled; when we have the manpower, and the technological know-how, and when at the same time, we have an enormous need for low-cost, efficient transportation, and we do not get it and our railroads get into trouble, we must ask where the major error is.

I sense in your questions, Senator, through the morning, as the witnesses have testified, you are also, if I may interpret you, saying that some thing. We are not addressing ourselves to the great pervasive error which has caused our railroad system to break down under those circumstances.

The same difficulties underlie the fact that we no longer have passenger vessels operating under U.S. registry. We have lost 20 percent of our steel markets and 16 percent of our automobile markets. The Japanese can buy iron ore and coke in the Western Hemisphere, haul it 10,000 to 13,000 miles across the Pacific, manufacture it into beams, automobiles, heavy machinery and what-have-you, and haul it back to the United States again and still undersell our local producers.

To me this means that we are not asking the right questions. We are not getting to the structural defect, the basic defect that underlies all of these problems. Now confronted with the difficulties of the railroads, it seems to me it is time to take a stand and examine whether or not we are doing something wrong that we could correct.

I wish to suggest to you that the problem lies in the underlying economic concepts upon which our corporate institutions, our banking institutions, our investment banking institutions, our labor unions and also our governmental regulations operate.

That concept, that erroneous concept reflected in our national economic policy, the Employment Act of 1946, or at least in its interpretation is that we can solve the income distribution problem solely through employment. Mr. Dumaine said this morning that the railroads, if merged and consolidated with a lot of excessive management

and a lot of excessive labor cut out, might work very effectively.

We cannot, however, escape double entry bookkeeping. What about the thousands of people who are made unemployed by these transactions? In other words, if our thinking is so narrow that we create 10 problems in the process of solving 1, we have not really done anything in the big sphere.

While a particular president of a particular railroad can take that limited view, the Congress of the United States, to which the people of the United States looks for guidance and governance, can hardly do so.

The structural defect to which I refer—and it seems to me that this committee in connection with the investigation of the railroads could now raise this point and could authorize a study of it, debate it and get to the root of it—is simply this: The underlying logic of a market economy is double entry bookkeeping. What each man puts into the economy is supposed to be the basis for what he takes out.

And there are two ways of making that input. One is through the performance of a job. I do not care what kind of job we are talking about—anything performed by a human being falls in the category of labor in this definition. Labor includes management as well as workers. White or blue collar—it does not make any difference.

The other input factor we label capital—land, structures and machines. Technological change shifts the input mix. That is its sole function. Technology is a process by which man harnasses the laws of nature and makes nature work for hm—not through human beings but through capital instruments, through improved land, through structures, through machines, through railroads, if you will.

If we are going to enable the masses of people to participate in the production of wealth as a means of enabling them to get an income and live, and still produce all of the necessary services that we want. and all of the luxuries we want for that matter, then as technology makes the performance of labor less and less adequate as a basis for income, our institutions must make it possible for more and more men and women legitimately to acquire the ownership of captal and to broaden their participation in production through that ownership.

In my humble opinion, there is no better place to begin than with the railroads. Conventional finance is carried on in such a way that even though we bring into existance $100 billion of newly formed capital every year, it becomes automatically owned by the same people who owned it all yesterday.

All of the studies of the concentration of the ownership of wealth—the qualitative studies rather than the quantitative ones—show that the economy's productive capital is owned, really, by the top 5 percent of consumer units.

Yes, the New York Stock Exchange will tell us there are 32 million shareholders in the United States. But what it does not tell us is that 26 or 27 million of those shareholders own only enough shares that, if they collect the dividends for several years, they could buy a pair of shoes.

In other words, their ownership is qualitatively inconsequential. What does this situation do for labor? It forces labor into doing exact-

ly that which has been a primary factor in wrecking the railroads, wrecking the shipping industry, and gradually wrecking the entire U.S. economy.

It forces labor into the position of demanding progressively more pay for progressively less work. When that happens, the pay increases go into costs. It is a form of concealed welfare. Pay is pay for production. But you do not get pay for production, you do not even know what the worth of pay for production is, unless labor is evaluated under competitive market conditions.

Let me say that American labor is now beginning to be just as concerned with this problem as American business. Every time there is a wage increase, which is based on no increased physical labor productive input, the cost of living goes up. The unions are aware, or at least certain of the more advanced labor leaders are aware, that as they achieve what their members expect them to achieve in this way, they also cancel out the gain.

And this is a major area of inflation from which we suffer. Our proposal is submitted in writing before the committee and I would ask permission of the chairman to insert that into the record——

Senator HARTKE. Your entire statement will be made a part of the record. The publications will be included by references.

Mr. KELSO. Thank you, sir. And certain of the exhibits that are not published may those be included in the record as well?

Senator HARTKE. They will be included.

Mr. KELSO. Thank you, sir. Our proposal is that a Comsat-type corporation—we have not had time to do the careful design work, the details of execution—but, nevertheless, a Comsat-type corporation be authorized to acquire the railroads. We think this should probably take place in the reorganization process. Through a device which we are using in the financing of corporations today—and we are doing it under existing law, although the law could be improved, as my testimony on May 16 before the House Ways and Means Committee shows—the corporation would be so financed that, over the course of paying off its debt, which I assume would either be governmental or governmentally guaranteed, the ownership of the equity of the railroads would gradually be built into the employees of the railroads.

The object of this device is, I think, quite self-evident. First, it would enable a man, over a reasonable working lifetime, to accumulate ownership of enough private-equity capital to provide for his retirement, and even to give him a supplemental second source of income during his working years.

Second, its objective is to put each railroad employee in a position where, if he demands more pay for less work, he will be impairing the value of his own investment. In other words, he will be committing a form of financial suicide, and most people are not suicide-prone.

Third, it will enable us to plateau off and perhaps, over a period of time, reduce wages as capital income rise. I think it will not be necesary to legislate this change, or to impose it by regulation; I think it will come about automatically, because of the vision of union leadership and the self interest of workers.

Today our financing techniques build the whole growth of newly formed capital into people with no unsatisfied needs and wants, into the top 5 percent of consumer units. We fail to build that capital ownership into those who do have unsatisfied needs and wants—people who are in a postion where they otherwise must demand progressively more pay for progressively less work.

Our national economic policy, represented by the Employment Act of 1946, is inadequate and incomplete. It urges the solution of our income-distribution problem solely through full employement; it should urge the solution of the income-distribution problem through as much full employment as we technically need, together with broadened, expanded ownership of the nonhuman factor of production to make up that deficiency and, indeed, to provide the participants in production with higher incomes.

If all men participate in the production of wealth, all men can enjoy the consumption of wealth. The way to fight poverty is not to give handouts to the poor, but to make men more productive.

How do you make workers more productive? In the past, we assumed we could do that by simply paying them more, but that has turned out to be inflataionary and inadequated; in fact, illusory. We make them more productive by enabling them to buy capital, pay for it out of what the capital produces, and then own it and husband it. and receive its income.

The logic of corporation finance is the logic of investing in things that will pay for themselves. Historically, that opportunity has never been open to individuals. Yet, under the employee stock-ownership trust that we have designed, and which we have used in some 25 corporations so far, and which we hope will use in somewhere between 50 and 100 additional ones this year, is a financial and legal design which puts the individual in the same position that the corporation has historically enjoyed: namely, where he has access to nonrecourse credit, which he can use to buy newly issued stock in the corporation that he works for, and get a commitment from the corporation to the lender that it will, in effect, make a high payout of the wages of capital, the per share net earnings of the capital to the trust in which he is the beneficial owner so as to enable him to pay for his stock out of what the underlying real capital produces.

It is the redesign, Mr. Chairman, of the invisible structure of the railroads that is called for. If we retreat today from solving the railroad problem, and retreat tomorrow from solving the airline problem—because the difficulty they are up against is the same—and the next day from solving the steel problems, and the next day the shoe manufacturers' problems, we are retreating from private enterprise, we are being plowed under, not by our incompetence, not by our laziness, not by our lack of resources, but by our out-of-date, outmoded, unrealistic economic concepts.

Those can be changed. It is up to Congress to set policies. It is up to Congress to analyze the world and tell us if we are doing the wrong thing. I think that the destiny of man is controlled by the people who ask the questions. not by the ones who answer them, and not even by whether the answers are right or wrong, because wrong answers can be corrected.

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But wrong questions can keep a nation on the wrong course until, like the British Empire, it dwindles from a great power to insignificance. I hope that we will not do that.

Senator HARTKE. Mr. Kelso, I hear you. You have got a long way to go.

Mr. Kelso. Yes, sir; we all do.

Senator HARTKE. Well, I am going to tell you why I think you have a long way to go. It is very simple. I do not think many people are going to hear you down here. I do not ask you to comment on that. You say you have been in front of the Ways and Means Committee. I think you have put your finger on at least a philosophical concept which I do not find at all contrary to many of my own views.

Mr. KELSO. Senator, some——

Senator HARTKE. Look, I am not disagreeing with you. I just do not think you can sell it to Congress.

Mr. KELSO. Senator, I do think that the winds are changing. I think that, given an opportunity—if this committee, for example, will make a study of the subject—we have all of the tools for analyzing the underlying problems. I think it can be shown that, if we redesign the financial structure of the railroads, we can protect the existing shareholders and bondholders, at least with whatever value is left in those securities——

Senator HARTKE. And probably very better service.

Mr. KELSO. And I think we can vastly improve service. And I think we can get the unions, by the way, to cooperate. Joseph Curran, of the National Maritime Union, came before a Senate subcommittee about a year ago that was considering legislation to authorize sale of some American ships to foreign owners. Mr. Curran said if those ships could be acquired by a new corporation financed in such a way that the employees, over a reasonable working lifetime, would acquire a reasonable piece of capital ownership, the union would cut wage costs by 50 percent.

And there is nothing sacred about the figure 50 percent; maybe it should be 75 percent. In other words, they would have eliminated featherbedding. They are realists. They would have cut out featherbedding; they would have tapered off their pay. But unless there is some other economic hope, other than becoming charges of welfare, they are not going to do that.

Senator HARTKE. Maybe the proper approach is the one used by the Chicago & North Western Railroad where the employees did acquire the railroad. Do you think that is a step in the right direction?

Mr. KELSO. Senator Hartke, one of the exhibits attached to my testimony—and I would hope this would go in the record—is a letter to Larry Provo of the Chicago & North Western Railroad. In my humble opinion, which the C. & N.W. did in fact use is a spurious imitation of the right method.

The ownership of that railroad, the equity ownership, is in less than 10 percent of the employees. There is no way in the world that the employees as a whole are going to surrender their power to demand more and more pay for less and less work in order to fatten up 10 percent of the employees.

By the way, the top 1 percent of those employees own about 90 percent of what the 10 percent owns including Mr. Provo himself, with $100,000 of the leverage stock. That is not the right answer.

The techniques we use, that the banks and companies use, build over a period of time ownership, proportionate to relative incomes, into the entire labor force.

It does not ask sacrifices of the labor force without giving them something that is better. The Chicago & North Western, in my opinion, is a disaster in the sense that it is not going to work. And when it does not work, people are going to say that this is proof that private ownership by employees is bad. It is a bad application of an idea rather than

a bad idea.

Senator HARTKE. I follow you. All right. I hear you, and I think at least this is innovation, and I see so little of it that I appreciate it when it comes.

Mr. KELSO. Mr. Chairman, I hope that this committee will not back away from the responsibility of addressing itself to this question. We must not abdicate our society, our economy, as the British have.

Senator HARTKE. Do you not think you ought to address that to the President, maybe?

Mr. KELSO. I have done that, too, Senator Hartke. We are all in the boat together.

Senator HARTKE. All right. Fine. We will stand in recess until 2.

EXHIBIT 3
to Testimony of Louis O. Kelso

Joint Economic Committee
Hearings on Employee Stock
Ownership Plan (ESOP) Financing

December 11 and 12, 1975

INCOME MAINTENANCE

through

TWO-FACTOR THEORY

and

The Second Income Plan

by

Louis O. Kelso

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.

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* Copyright 1969 by Louis O. Kelso.

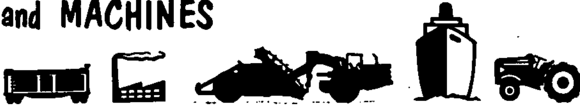
Here is the essence of the case:

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**



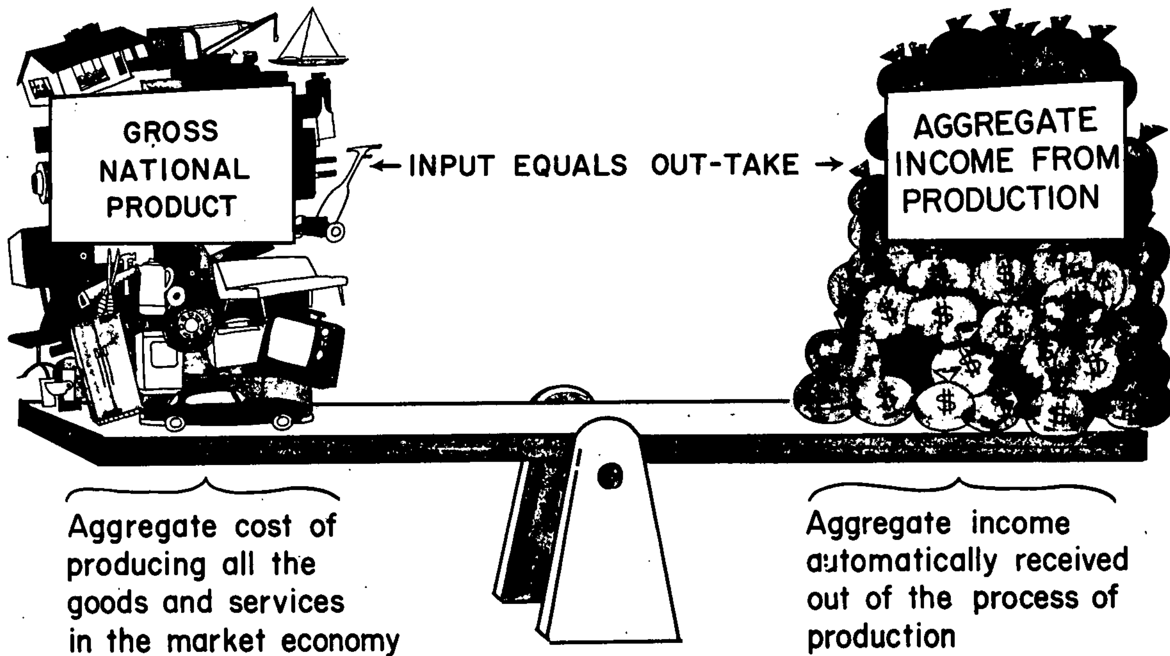
and *NOT to money.*

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



"SYSTEM" means LOGIC...

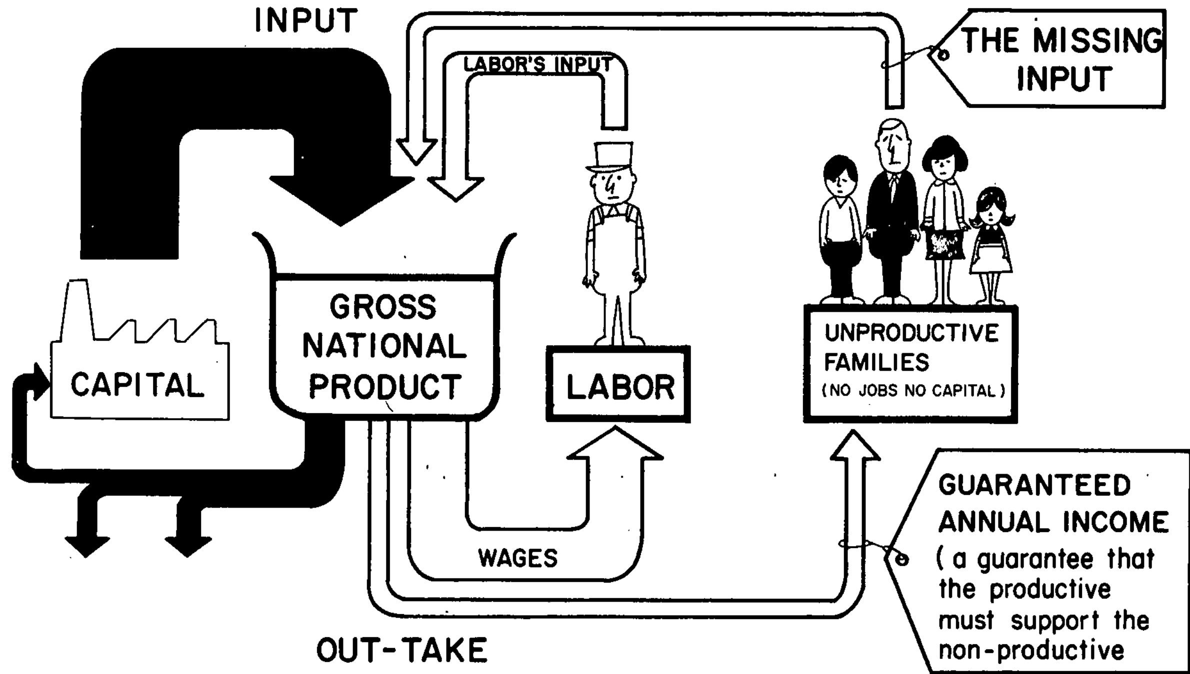
IF THERE IS NO LOGIC TO AN ECONOMY, OR IF ITS LOGIC CANNOT BE IDENTIFIED, THEN THE ECONOMY CANNOT BE CALLED A *SYSTEM.*

THE LOGIC OF A MARKET ECONOMY IS

DOUBLE-ENTRY BOOKKEEPING

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

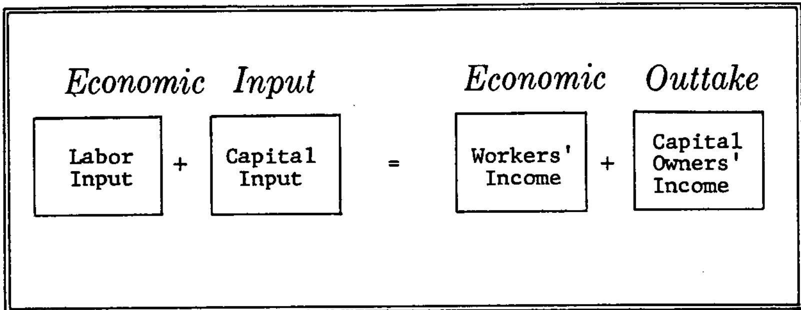
Out-take without input violates the logic of double-entry bookkeeping



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:



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 book-keeping.

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 machismo.

> 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 *merely* 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.

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.

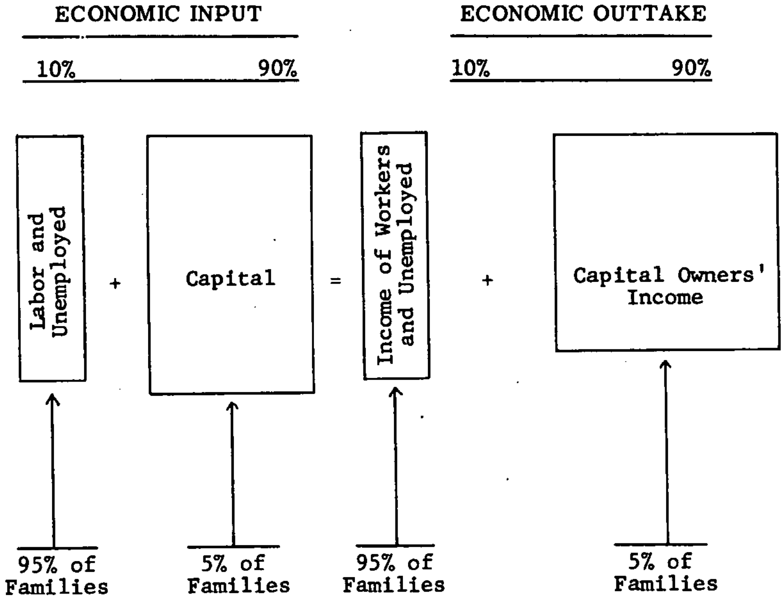
WHAT DOES THE SHIFTING OF PRODUCTIVE INPUT FROM CAPITAL INSTRUMENTS TO LABOR DO TO INCOME DISTRIBUTION?

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

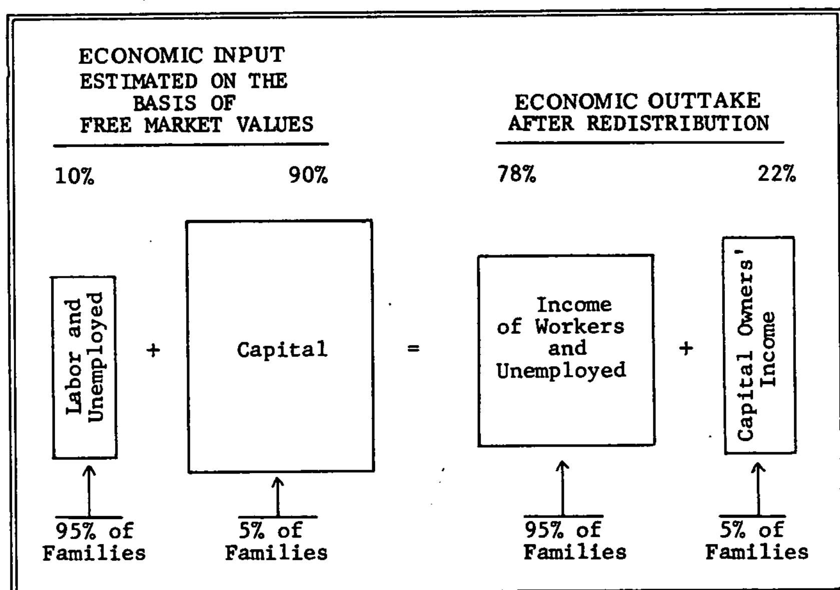


Obviously, if labor were to be suddenly evaluated at its free market value, the condition could continue only momentarily. Starvation of the masses, and the collapse of consumption, as well as production, would be instant.

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:



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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:

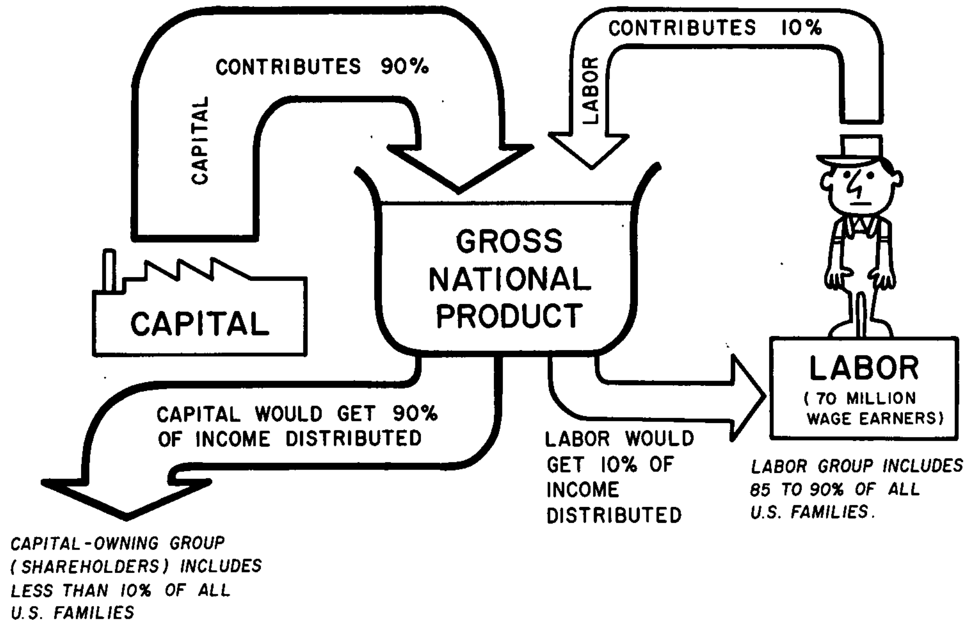
> Since functionally private property in capital instruments exists only where the owner receives all that his capital produces, it would totally destroy private property in the non-human factor of production.
>
> Since capital owners are discouraged by being deprived of the fruits of their capital, 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.

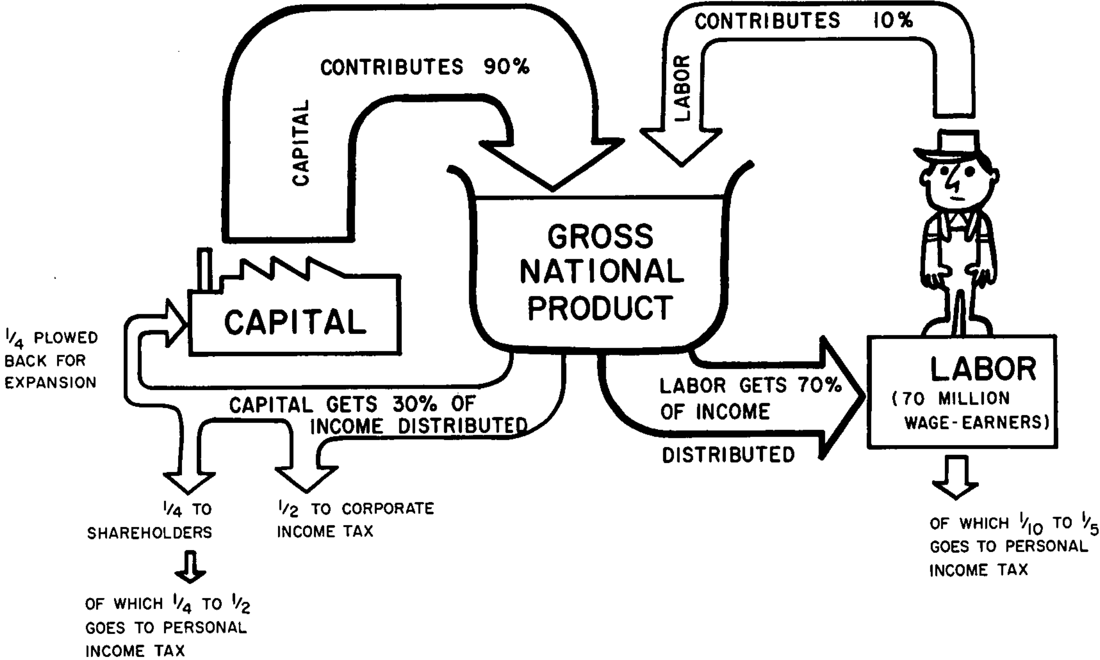
Route II

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:



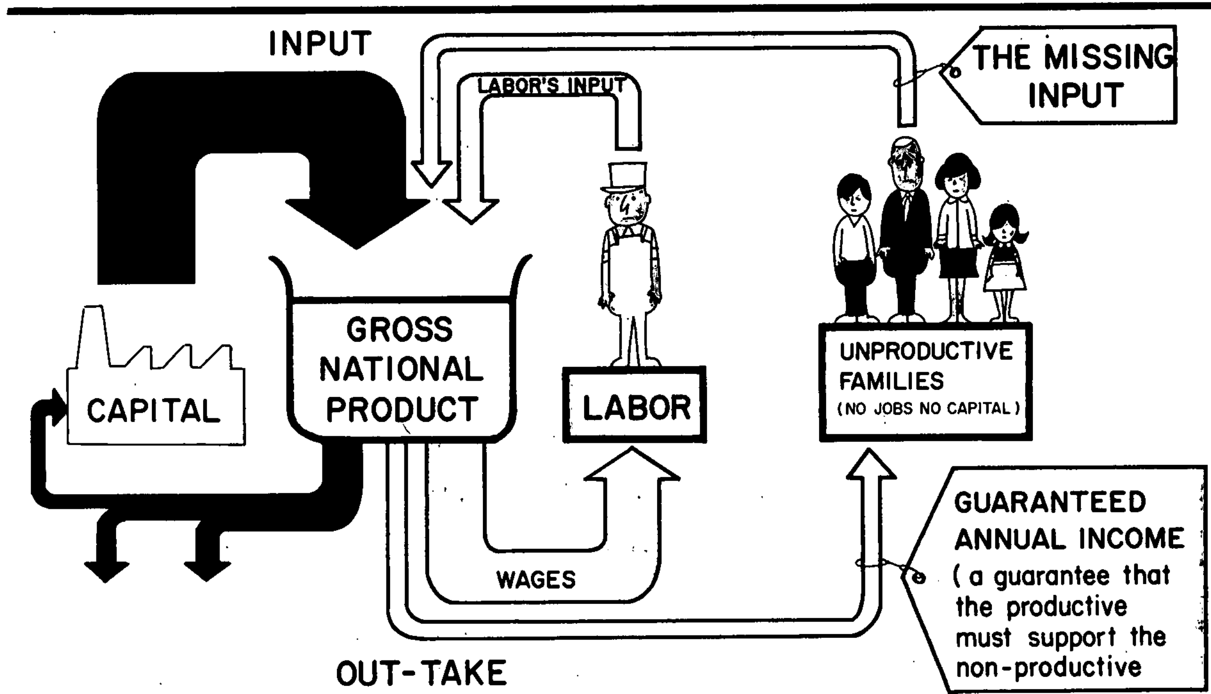
Wealth doesn't go proportionally to those who produce it. Here's what really happens:



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.

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



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 _produce_ general affluence.

To make a greater _productive input_ 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.

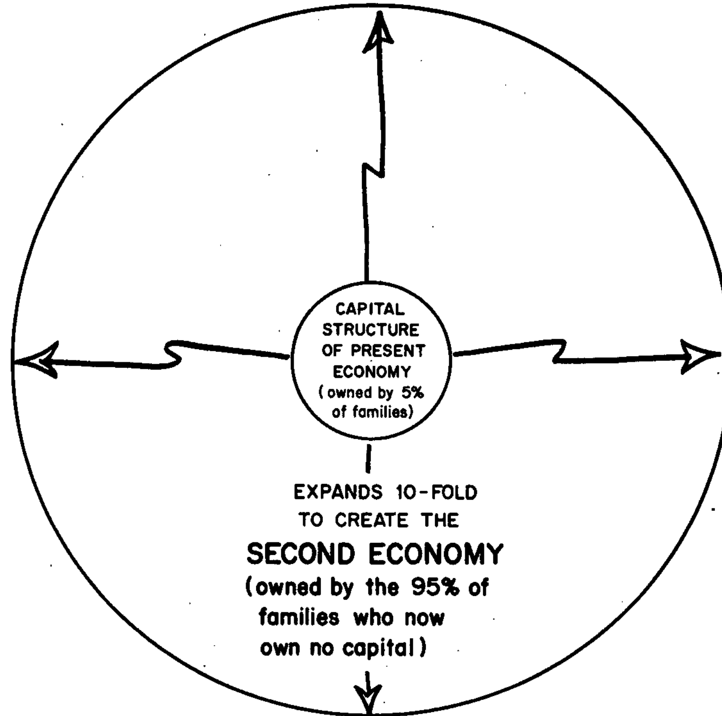
To buy, pay for, and own viable holdings of productive capital.

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. _This is the corrective method of the Second Income Plan._

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.

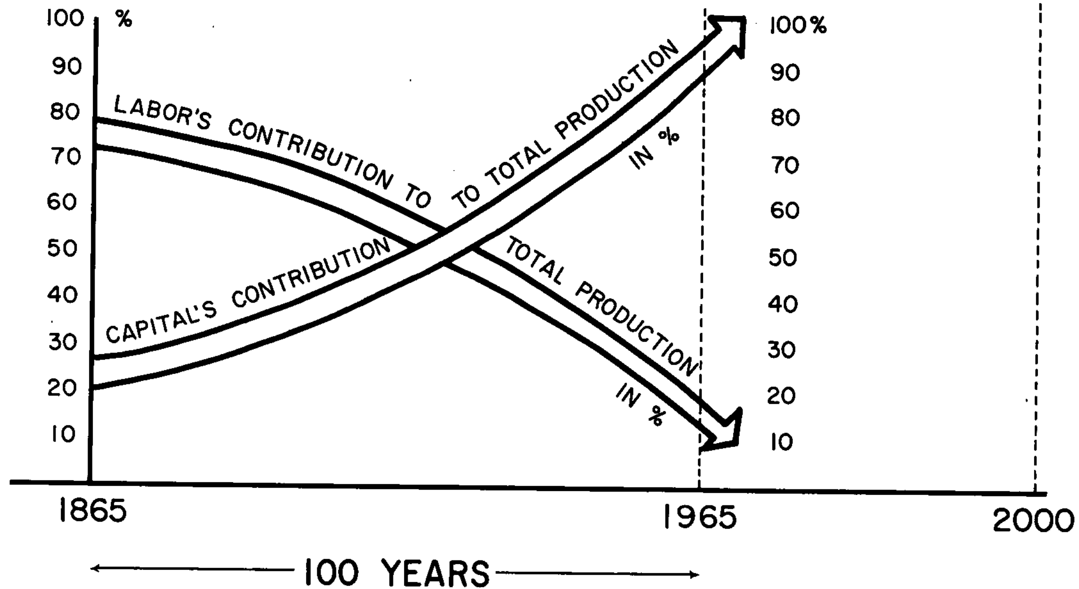
Income Maintenance
AND THE BUSINESS CORPORATION STRATEGY:

America's economic problem is simple:

Almost nobody owns any
productive capital anymore.

Meanwhile, capital is producing at least
90% of our total wealth.

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



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

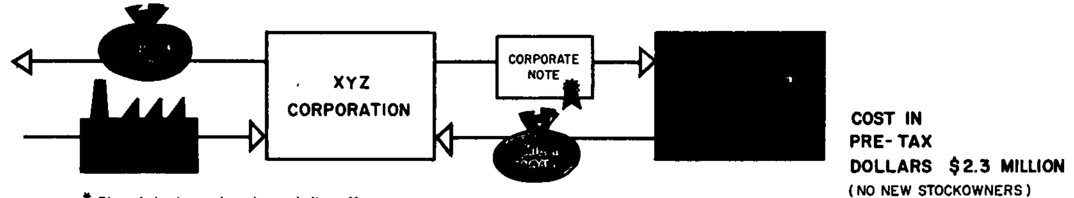
> This automatically means, under double-entry bookkeeping, that 80% of the purchasing power generated by the private economy (outside agriculture) arises in corporations.

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.

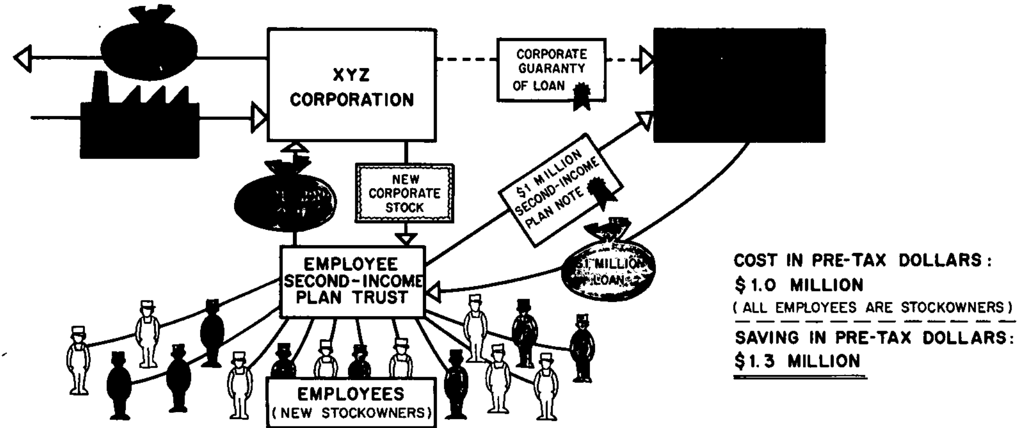
2 ways to finance corporate productive capital (new plant)

1. CONVENTIONAL DEBT FINANCING:*



* Plowed-back earnings have similar effect

2. EMPLOYEE SECOND-INCOME-PLAN FINANCING:



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.

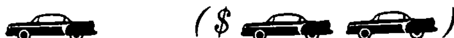
etc. *etc.*

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:

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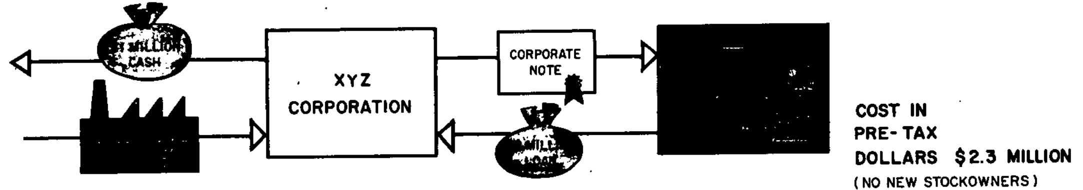
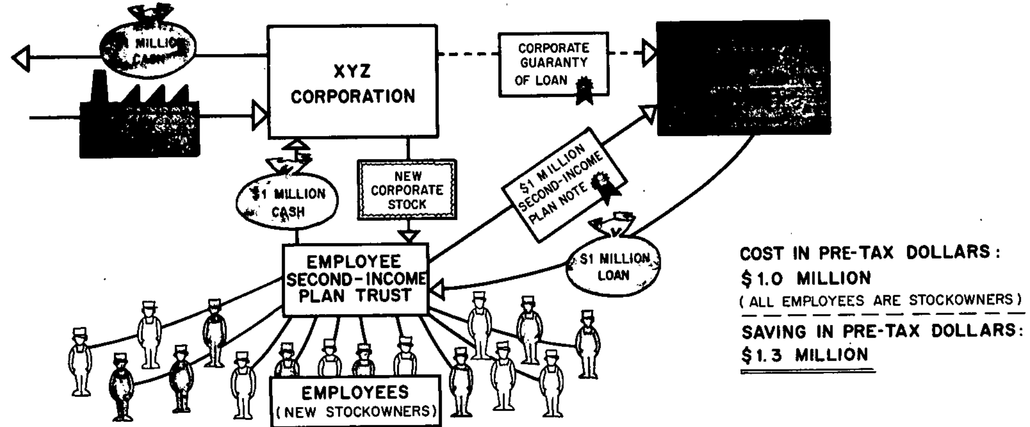
2 ways to finance corporate productive capital (new plant)

1. CONVENTIONAL DEBT FINANCING:*



* Plowed-back earnings have similar effect

2. EMPLOYEE SECOND-INCOME-PLAN FINANCING:



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 _through the trust_, 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:

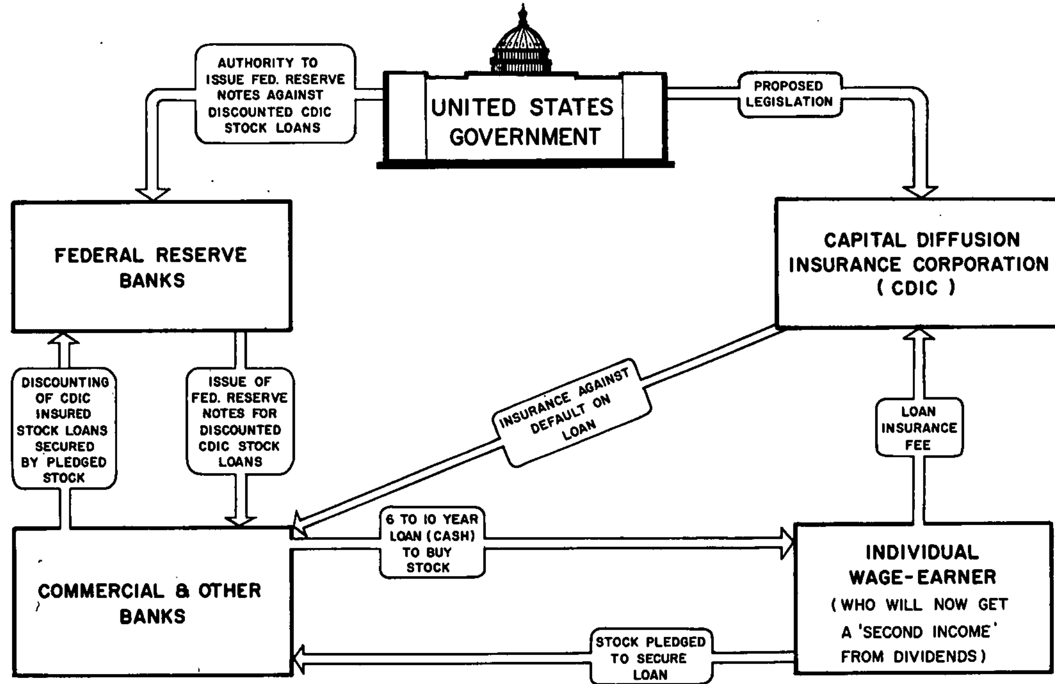
- Repeal the "Employment Act of 1946" (with its narrow focus on LABOR alone.)

- 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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EXHIBIT 4
to Testimony of Louis O. Kelso

Joint Economic Committee
Hearings on Employee Stock
Ownership Plan (ESOP) Financing

December 11 and 12, 1975

SHOULD CONGRESS PROHIBIT ESOP FINANCING?

or

SHOULD IT MAKE IT MORE EFFECTIVE?

MEMORANDA

by

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June 13, 1974

MEMORANDUM CONCERNING ADMINISTRATION'S ENDORSEMENT AS TRANSMITTED BY THE DEPARTMENT OF THE TREASURY AND THE DEPARTMENT OF LABOR OF A PROPOSAL TO THE HOUSE AND SENATE CONFEREES ON H.R. 2, PENSION REFOREM BILL, TO TERMINATE THE LEGAL FEASIBILITY OF USE BY CORPORATIONS OF EMPLOYEE STOCK OWNERSHIP PLAN FINANCING.

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MEMORANDUM CONCERNING ADMINISTRATION'S ENDORSEMENT AS TRANSMITTED BY THE DEPARTMENT OF THE TREASURY AND THE DEPARTMENT OF LABOR OF A PROPOSAL TO THE HOUSE AND SENATE CONFEREES ON H.R. 2, PENSION REFORM BILL, TO TERMINATE THE LEGAL FEASIBILITY OF USE BY CORPORATIONS OF EMPLOYEE STOCK OWNERSHIP PLAN FINANCING. [1]

ADMINISTRATION RECOMMENDATIONS TO ABOLISH EMPLOYEE STOCK OWNERSHIP FINANCING.

By "strongly recommending" the substitution of the provisions of the Senate bill (Secs. 511 and 522), which is exquisitely designed to make the entire technique of employee stock ownership plan ("ESOP")financing and certain related transactions unusable, for the provisions of the House Bill H.R. 2 (Sec. 111), which would authorize sale of stock by a "party in interest" to an ESOP trust and party in interest guarantees of financing relating thereto if such transfer is in return for no less than adequate consideration, the Administration is employing logic equivalent to the Congressional abolition of the automobile to spare the damage done every year to a few hundred good solid, God-fearing, tax-paying American citizens.

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[1] The Departmental endorsements, signed by Secretary of Treasury, George P. Schultz and Secretary of Labor, Peter J. Brennan and the text of recommended changes in H.R. 2, are set forth in the "Daily Report for Executives", No. 95, Special Supplement dated May 15, 1974, published by the Bureau of National Affairs, Inc. The only provisions covered by this memorandum are to be found on pages 13-14, title "IV FIDUCIARY STANDARDS", subtitle "Prohibited transactions".

This memorandum is intended to reflect the extent of potential damage to the U.S. economy, its growth, its stability, and even its survival that is threatened by this rash, unwarranted, and politically misguided proposal.

Presumably, the defective thinking lying behind the Administration's position is that of Frederick W. Hickman, Assistant Secretary of the Treasury for Tax Policy, as reflected in Mr. Hickman's letter of April 30, 1974 to the Hon. Russell B. Long, Chairman of the Committee on Finance of the United States Senate. Mr. Hickman's letter deals with the provisions of S. 1370, a bill proposing added tax incentives to accelerate the use of ESOP financing. While it does not comment on H.R. 2. the Pension Reform bill, Mr. Hickman's letter (the "Hickman letter") [2] reflects its author's misconceptions of the nature of ESOP financing, a distorted grasp of the significance of the only proven technique for broadening the ownership of productive capital in the U.S. economy and its importance to the fiscal health of the Federal and State governments.

The purpose of this memorandum is not to discuss our reasons for supporting the provisions of S.1370, which the

[2] For completeness, a memorandum specifically analyzing the errors of the Hickman letter, together with a copy of S.1370, is attached hereto as Exhibit I.

Hickman letter opposes -- we deal with that in Exhibit I hereto -- but rather to discuss the relative merits of the Prohibited Transactions Provisions of the Senate bill (secs. 511 and 522), as set forth in the Administration recommendations to the House and Senate Conferees on H.R. 2, Pension Reform Bill. Mr. Hickman's letter, however, suggests that there is an effort on the part of certain individuals within the Treasury Department to destroy the use of the ESOP concept for financing corporate growth and building broad capital ownership into employees in the U.S. economy.

The Hickman theory of ESOP financing is that it endangers the retirement security of employees by encouraging "...speculative leveraged investments, as opposed to a more conservative investment policy...". This position ignores the following fundamentals of the ESOP vehicle.

THE PURPOSE OF ESOP FINANCING

1. A stock bonus plan under Code Section 401(a) is not primarily a "retirement plan". In the Revenue Act of 1921, Congress first provided tax exemption to profit sharing and stock bonus trusts. It was not until the Revenue Act of 1926 that exemption was

extended to pension trusts. Clearly, the tax incentives granted for stock bonus plans were for the primary purpose of providing ownership interests for corporate employees. As recently as Revenue Ruling 69-65, the Internal Revenue Service stated its position that "the purpose of a stock bonus plan is to give employee-participants an interest in the ownership and growth of the employer's business."

2. Notwithstanding its primary statutory purpose, an Employee Stock Ownership Plan may and frequently does provide significantly greater retirement benefits to employees than conventional retirement plans. Conventional pension and profit sharing plans generally invest trust funds in accordance with the so-called "prudent investor rule" or "prudent man rule." The experience of the last five years has clearly demonstrated that investment in the public stock markets has seriously endangered the retirement security of employees by subjecting the value of trust funds to the irrational fluctuations of a marketplace dominated not by investors but by speculators. ESOP financing extends to employees the credit (non-recourse as to the employees) of the employer-corporation for investing in a stock whose value they may

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themselves enhance through the motivation generated by ownership. In addition, conventional retirement plans generally are designed to minimize costs and contributions by the employer. Under an ESOP, the employer's incentive is to maximize its contributions so as to provide larger amounts of capital for financing its own corporate growth. The typical corporate pension plan requires contributions of less than 8% of covered payroll, while an ESOP generally is funded to the extent of 15% of payroll, thereby maximizing both corporate financing and employee benefits.

3. ESOP financing is the most effective vehicle for financing corporate growth, while providing for broadening of capital ownership. The U.S. economy faces capital requirements of $4.5 trillion over the next decade. [3] Conventional methods of corporate finance simply are not adequate to meet this need. Even if they were, without the broadened use of ESOP financing, all newly-formed capital will become owned by the same 5% of the population that currently owns 95% of existing productive capital. ESOP builds capital

[3] U.S. NEWS AND WORLD REPORT, May 27, 1974, pp. 22-23, 38.

ownership into workers who currently are solely dependent upon their labor income. Economic self-sufficiency and expanded consumer purchasing power can be provided, without inflation, only by means which broaden the ownership of capital through ESOP type financing techniques.

ESOP FINANCING SEEKS TO CORRECT A DEFECT IN OUR BUSINESS STRATEGY AND IN OUR NATIONAL ECONOMIC POLICY.

The economic policy of the United States, as represented by the Employment Act of 1946 and supplemental legislation, contains a fatal deficiency in that it seeks to solve all our income distribution problems solely through employment and welfare, whereas only a rapid broadening of the ownership of the capital base of the U.S. economy, present and future, carried out consistently with the logic of private property and of corporate finance, can really solve our income distribution problems and reverse the deepening economic crisis into which we are plunging.

In a series of books including _The Capitalist Manifesto_ and _The New Capitalists_ (Kelso and Adler, Random House, 1958 and 1961), and _Two-Factor Theory: The Economics of Reality_ (Kelso and Hetter, Vintage Press, 1967) and in testimony before executive panels and committees and before Congressional commit-

tees,[4] Louis O. Kelso, general counsel for Bangert & Co. and Norman G. Kurland, Washington counsel for Bangert & Co. have shown:

1. That the productive capital of the United States economy is owned entirely by the top 5% of wealth-holders and that conventional corporate finance assures that this condition will continue and indeed grow more severe in the future.[5]
2. ESOP financing, which employs stock bonus trusts and/or money purchase pension trusts designed to

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[4] (a) "Eliminating the Purchasing Power Gap through Two-Factor Theory and the Second Income Plan" by Louis O. Kelso and Patricia Hetter, INCOME MAINTENANCE PROGRAMS, Hearings ... Joint Economic Committee, 90th Congress, 2d Session, Volume II, pp. 633-652; (b) "Income Maintenance Policy Needed to Increase Employment and Buying Power for the Poor Without Inflation through New Techniques for Financing a Broader Ownership Base for American Industry" by Louis O. Kelso and Norman G. Kurland, Social Security and Welfare Proposals, Hearings ... Committee on Ways and Means, House of Representatives, 91st Congress, 1st Session, Volume IV, p. 1357; (c) "Proposals to Amend the INternal Revenue Code to Encourage and Facilitate the Use of Employee Stock Ownership Financing" by Louis O. Kelso, Tax Proposals Affecting Private Pension Plans, Hearings ... Committee on Ways and Means, House of Representatives, 92nd Congress, 2nd Session, May 16, 1972, Volume III, pp. 647-720; (d) Appendix II to "Employee Stock Ownership Plan Financing to Get U.S. Railroads Back on the Track and in the Black" by Bangert & Co., Road Transportation Crisis, Hearings...Surface Transportation Subcommittee, Committee on Commerce, U.S. Senate, 93rd Congress, 1st Session, February 28, 1973, pp. 89-149: (e) Statement of Louis O. Kelso and Norman G. Kurland for Bangert & Co., March 9, 1973, General Tax Reform, Hearings...Committee on Ways and Means, House of Representatives, 93rd Congress, 1st Session, pp. 793-828; (f) Statement of Louis O. Kelso and Norman G. Kurland for Bangert & Co., September 24, 1973, Financial Markets, Hearings...Subcommittee on Financial Markets, Committee on Finance, U.S. Senate, 93rd Congress, 1st Session, Part II, pp. 13-18, 37-42, 48-98.

[5] While the quantitative studies indicate some 30 million shareholders in the U.S., the qualitative studies show virtually all the stock in the top 5%. As to indirect ownership, through financial intermediaries such as insurance companies and mutual funds, such investments are almost never acquired on a self-liquidating basis, so they do not make a net increase in the buyer's standard of living. They substitute income from capital for income from labor, but they rarely raise the economic productiveness of the individual. Such investments evidence a reduced present standard of living and the "storing" of purchasing power, subject to the effects of inflation, for future use. In our advanced industrial economy, it is rare indeed for one to acquire through personal savings, a capital holding that would yield a viable income. On the degree of concentration of ownership of productive capital, see Robert J. Lampman, National Bureau of Economic Research, The Share of Top Wealth-Holders in National Wealth, 1922-1956, (Princeton: Princeton University Press, 1962) pp. 23, 108, 195; (Wharton School Stock Ownership Study, Proceedings of the American Statistical Association, Business and Economic Statistics Section, 1963), pp. 146-168; McClaughry Associates Inc. Expanded Ownership, the Sabre Foundation, Fond du Lac, Wisconsin, 1971. At pages 101-198 is a comprehensive survey of the studies on The Distribution of Weatlh in the Twentieth Century, by Professor James D. Smith of the Pennsylvania State University. All of the studies surveyed confirmed the general accuracy of the Lampman analysis.

qualify under Section 401(a) of the Internal Revenue Code, the details of which are more fully explained in the letter of Bangert & Co. of September 28, 1973 to John M. Martin, Jr., Chief Counsel of the Committee on Ways and Means in connection with H.R. 4200, [6] is the only technique so far developed that is capable of enabling U.S. enterprise both to meet the staggering new capital formation requirements facing it during the coming years and to so effectively broaden the capital ownership base (and build up the corporate and individual tax base) that the U.S. economy will once again begin to function automatically without radical wealth redistribution, destructively high interest rates, spiraling inflation, debauchery of our currency, and uncontrollably rising federal debt.

THE POLITICAL SIGNIFICANCE OF THE ADMINISTRATION RECOMMENDATIONS ON PROHIBITING ESOP TRANSACTIONS.

The evidence taken by four committees of Congress preceding the drafting of the bill now before the conference Committees demonstrated clearly that conventional pension and profit sharing plans, with very rare exceptions, do not solve the current

[6] See Exhibit II hereto.

income inadequacy of the American consumer, and furthermore do not solve his retirement income problem. Those hearings further demonstrated that to so accelerate funding and vesting of pensions (upon which the great majority of private retirement system members depend) sufficiently to enable them to provide adequate retirement income while still investing in the wares of the Wall Street casinos -- the outstanding second-hand securities -- will bankrupt much of American industry. We cannot presume that those who urge the abolition of ESOP financing through the Senate version (Sec. 522) of the new Pension bill are unaware of the reality of this judgment. Consequently, we must presume that they wittingly or unwittingly are pushing the United States towards the elimination of private retirement plans altogether and the substitution of an income policy based upon redistribution of income through an expanded super-social security. America, if they prevail, will become the greatest socialist state on earth.

EVIDENCE THAT EXPEDITING NEW CAPITAL FORMATION IS CRITICAL

That the stock ownership base of the U.S. economy should be broadened with all possible haste and should be given every conceivable Congressional encouragement is evidenced not only by the fact that our economy will be called upon to put in

place some $4.5 trillion of new capital formation by 1984, [7] but that already enterprises large and small are rushing to the government for financial aid because they cannot survive under the defectively structed pattern of narrow concentrated capital ownership. Among those seeking government assistance are our largest railroads, our largest manufacturers, our largest utilities, several of our largest banks and several of our largest airlines, along with spectacular increases in the bankruptcies of smaller businesses and of individuals. The human alienation of workers, of the young who want to be employed, of the elderly who cannot cope with inflation, of the many who turn to economically-oriented crime is evidence of the tide of disaster calling for a change in economic policy and in corporate strategy to broaden the ownership of the economy's _other_ productive factor -- _capital_.

Nor is the evidence of urgency confined to the crescendo of crises within the U.S. economy. Every economy on earth is affected by the health of the U.S. economy and the health of the U.S. monetary system. Every non-socialist economy on earth looks to the United States to innovate solutions to its economic problems, so that its example may be imitated.

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[7] U.S. NEWS AND WORLD REPORT, May 27, 1974, pp. 22-23, 38.

THE ECONOMIC CRISES CAN ONLY BE EXPLAINED THROUGH TWO-FACTOR ECONOMIC THEORY.

The two factor explanation of the economic, fiscal, monetary, and social crisis is simple, stark, and irrefutable:

--- In market economies, what each individual receives in income is expected to be based on his economic input into the process of production.

--- Our morality is built upon this principal, which we call the Puritan Ethic (not a work ethic, but a production ethic, because there are two factors of production, not just one).

--- The logic of the economy, double-entry bookkeeping also reflects this market economy rationale.

--- If we divide the input factors into people (labor power or the human factor) and capital (the physical non-human factor) for the reason that the ownership of one (capital) can be concentrated and the ownership of the other (labor) is totally diffused and non-concentratable, we find the main thrust of technological change is shifting the productive burden off the human factor and onto the capital or non-human factor. With this shift goes a change in income distribution, because the principal of distribution in a private property market economy

is "from each according to his economic input, to each according to his economic input."

--- To complete the prevailing design for the collapse of the free market, private property society, which is the American economic ideal, conventional corporate finance assures that all future new capital formation become owned by the tiny minority who have previously owned it all. [8]

--- To make the situation more explosive under this economic policy and its concomitant corporate strategy that causes capital to increase its productive share and labor to decrease its productive share, while the ownership of capital becomes more concentrated in an ever smaller class, the production of almost all kinds of goods and services is becoming more capital intensive at an accelerating rate.

THE ONE WAY OUT OF THIS IMPENDING DISASTER.

ESOP financing, as pioneered and designed by Bangert & Co. and its general counsel, Louis O. Kelso, is the theoretically sound and practically proven method for reversing our rush to economic and social collapse from these cataclysmic forces under which vast incremental power is being built into

[8] See testimony of Kelso and Kurland of September 24, 1973, to the Financial Markets Subcommittee, Senate Finance Committee; Kelso and Hetter, Two-Factor Theory: The Economics of Reality.

the tiny class of capital holders who have no present or potential unsatisfied consumer needs and wants, [9] and is being denied to the 95% of American consumers whose unsatisfied consumer needs and wants are virtually unlimited.

But, ESOP financing for the purpose of efficiently building capital ownership into American workers without taking money from their pockets or paychecks depends upon the availability of Section 401(a) stock bonus and money purchase pension trusts using ESOP financing techniques to give the propertyless workers (including that most strangely propertyless class of all -- U.S. management) rational access to the speedy, effective, acquisition of the ownership of capital and a second source of income.

--- No other technique does this.

--- Fifty years of conventional pension and profit sharing have not only failed to broaden the capital ownership base, but indeed have seen it shrink, as the effects of the Homestead Acts of the period 1865-1900 wore off.

THE RATIONAL "PROHIBITED TRANSACTIONS" PROVISIONS OF THE HOUSE BILL, H.R. 2, SHOULD BE RETAINED AND THE PROVISIONS OF THE SENATE BILL (SECS. 511 AND 522) WHICH WOULD DESTROY ESOP FINANCING SHOULD BE REJECTED.

On the effective and continued availability of ESOP finan-

[9] As Aristotle wisely noted, the purpose of all economic production is human consumption. Financing techniques that defeat enjoyment of a good standard of living by every consumer in the economy are clearly defective.

cing, which the Administration recommendations on fiduciary standards would destroy, depends the reversal of our economic rush to disaster.

--- Our reversing spiralling inflation.

--- Our creating legitimate full employment;

--- Our regaining competitive supremacy in world economic markets;

--- Our meeting the requirements of financing $4.5 trillion of new capital formation within this decade (See U.S. NEWS AND WORLD REPORT, May 27, 1974, Page 22, et. seq.)

--- Our assuring the American family and the American consumer of economic self-sufficiency and ending the welfare mess;

--- Our regaining our national fiscal health by restructuring the private economy so that it supports all families and consumers and gets the welfare burden out of federal and state budgets and off the taxpayers backs.

--- Our providing an example to the free world as to how a modern economy, by casting out the cancerous theoretical errors which threaten its destruction (the idea that income distribution can be solved solely by employment and welfare) can enable us to contribute to restoration of the other economies of the world to health, sanity and prosperity.

DETAILED EXPLANATION OF HOW THE SENATE VERSION OF H.R. 2 (Secs. 511 AND 522) WOULD TOTALLY DESTROY ESOP FINANCING FOR U.S. EMPLOYEES AND U.S. ENTERPRISE.

The Senate version of H.R. 2 (originally H.R. 4200), contains fiduciary standards provisions which would, in effect, abolish the use of ESOP financing. Specifically, the following activities by a qualified ESOP would become "prohibited transactions":

1. An ESOP trust would be prohibited from buying for employees, with accumulated contributions or with borrowed funds, newly-issued stock at its fair market value from the employer-corporation (a "party in interest").

2. An ESOP trust would be prohibited from buying for employees, with accumulated contributions or with borrowed funds, outstanding stock of the employer-corporation from a close-holding stockholder (a "party in interest").

3. An employer-corporation would be prohibited from loaning funds to an ESOP trust to enable it to buy for employees the corportion's stock, either newly-issued or outstanding in the hands of close-holding stockholders.

4. An employer-corporation would be prohibited from guaranteeing repayment of a loan by a bank or insurance company or other lender to an ESOP trust to enable it to purchase for employees the corporation's stock, either newly-issued or outstanding in the hands of close-holding shareholders.

5. A close-holding stockholder, such as a holding corporation with an operating subsidiary, would be prohibited from guaranteeing repayment of a loan by a bank or insurance company to an ESOP trust to enable it to purchase for employees the operating corporation's stock, either newly-issued or outstanding and owned by the close-holding parent (for example, a divestiture to employees).

6. A corporation, or a close-holding stockholder would be prohibited from selling stock to an ESOP trust for employees under an installment payment contract, pursuant to which the trust would make payments from the corporation's annual contributions into the trust. This method now enables employees to acquire stock at a fixed price and to pay for it over a period of years, even where financing from a bank or other loan source is not available either because interest rates are excessive, or because of tight money, or because the lender balks at 100% financing.

7. When the installment contract method referred to in Paragraph 6 above is used to buy stock for employees from a close-holding stockholder, the corporation would be prohibited from guaranteeing to the close-holding stockholder that the annual payments will be made by the corporation into the trust. Thus the credit of the corporation would not be available to the seller, although it is invariably necessary to make employee acquisition feasible. In fact, in virtually every case of ESOP financing, it is exclusively the credit of the cor-

poration that the lender relies upon.

In the House version of H.R. 2, the requirement for transactions which involve "self-dealing" is that the standard of "adequate consideration" be applicable. The only possible abuse in ESOP financing that may be accurately described as "improper self-dealing" is the sale of stock to the Trust by the employer corporation or by an existing shareholder, at a price in excess of its fair value. This potential abuse, in practice is unquestionably rare, either because the market value is known from trading in active markets, or because competent and careful appraisals have been obtained to avoid the dire consequences under present law of fraud, disqualification of the trust, denial of corporate tax deductions, etc. Nevertheless, if the Conferees doubt that the present deterrents to this possible abuse are inadequate, it can easily be absolutely and totally eliminated by a "no-action" procedure whereby the Internal Revenue Service would issue an advance determination as to the fair market value for the stock proposed to be sold to the Trust.

THOSE WHO RECOMMEND THAT THE PROVISIONS OF THE SENATE BILL (SECS. 511 AND 522) ABSOLUTELY PROHIBITING THE PURCHASE AND FINANCING OF THE PURCHASE OF EMPLOYER STOCK BY AN ESOP TRUST SUPPORT THEIR POSITION ONLY BY THE ASSERTION THAT THE TREASURY DEPARTMENT "WOULD HAVE THE DIFFICULT BURDEN OF PROVIDING THAT THE FIDUCIARY'S DETERMINATION OF ADEQUATE CONSIDERATION WAS NOT MADE IN GOOD FAITH." [See B.N.A. Special Supplement #95, dated May 15, 1974, on H.R. 2, p. 13.]

We have shown above that without the simple ESOP reform of business financing techniques in order to build broad capital ownership and second sources of income into the American working population, the U.S. economy may well not extricate itself from its deepening economic crisis. The Administration, without so much as being aware either of that problem or the ease of its solution under ESOP financing techniques, would restore the "Prohibited Transactions Sections" of the Senate bill (Sections 511 and 522) that would effectively make impossible the broadening of capital ownership in the U.S. economy, and indeed will insure that such ownership will continue to narrow at an accelerating rate.

It is important to understand at the outset that the administration does not take the absurd and self-defeating position that the ownership of an employer, or an equity interest in an employer by an employee, is an inherently bad thing. It can hardly be disputed that the American economic dream is, always has been, and presumably always will be the opportunity, over a reasonable working lifetime, to acquire a large enough capital holding to provide economic security and a vicarious means of producing income, irrespective of ability or opportunity to work. Thus, the only possible abuse in ESOP financing techniques relates to the question of "adequate consideration", that is, whether stock purchased by an employee stock bonus trust or money purchase

pension trust, either from the public (if financed), from the employer, or from an affiliated corporation, or from another "party in interest" has been unfairly overpriced. The reality of the difficulty here alleged deserves careful analysis.

In the first place, if on an audit or otherwise, the Treasury determines, for whatever reason, that the price paid for the employer securities was in excess of "adequate consideration", and so asserts, <u>the burden, as a matter of procedural tax law, is on the fiduciary to prove otherwise, not on the government</u>. Thus the intimation that the Government has "a difficult burden of proving that the fiduciary's determination of adequate consideration was not made in good faith" is grossly and unfairly misleading, for in fact the burden lies on the employer, or the selling stockholder, or other fiduciary, rather than on the Government.

Furthermore, it should be noted that most ESOP Trusts cover all employees -- everyone from the chairman of the board to the maintenance employees. Thus, the management of the company, who presumably have both the knowledge and the confidence to prevent <u>their</u> trust from being overcharged for company stock, are in a perfect position to so assert. Thus, the likelihood of an overpricing is minimal. In fact, in our own experience in installing some fifty Employee Stock

Ownership Plans, we have noticed a strong desire on the part of companies in selling newly-issued stock to an employee trust, and on the part of close-holding stockholders who sell their stock to an ESOP Trust, to minimize the price, that is, to use the lowest justifiable price out of sheer interest in developing maximum employee good will and motivation.

A SIMPLE MODIFICATION OF THE HOUSE BILL WOULD SEAL OFF FOREVER ANY POSSIBILITY OF OVERPRICING EMPLOYER STOCK PURCHASED ON CREDIT OR OTHERWISE BY AN ESOP TRUST.

Socrates once remarked that the unexamined life is not worth living. To paraphrase Socrates, we might also note that the unexamined tax law can become a source of immeasurable irritation and a serious barrier to carrying on life and business in an orderly society.

As the law involving plans designed to be qualified under Section 401(a) I.R.C. stands today, and for our purposes here, particularly plans designed to be invested wholly or primarily in the stock of the employer, setting the price to be paid by an employee trust for any asset, whether stock of the employer or otherwise, involves serious risks, except in those many cases where the stock is widely and publicly traded. It so happens that the Internal Revenue Service accepts prices of publicly traded stocks as realistic, although thousands of experts and corporate executives today believe otherwise.
It should be noted, parenthetically, that in its zeal to prevent broadening of the ownership of American enterprise by

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American workers, the Senate version (Secs. 511 and 522) urges modifications which would prohibit the purchase of employer stock by an employee trust from an interested person at the market price, even where the stock is widely and publicly held, and widely traded!

The risk of error in fixing the price of a closely-held stock to an employee trust include fraud charges by the Internal Revenue Service, loss of corporate tax deductions, possible disqualification of the trust, expenses of audits and litigation, additional appraisals, and what not. In other words, it is a step taken by all concerned with trepidation and care.

But we wish to attack the matter somewhat more deeply here. There are literally thousands of companies in the U.S. economy whose top managements and boards of directors are deadly serious in saying that the public stock markets radically underprice the value of their stocks. The Senate Financial Markets Subcommittee Chairman, Senator Lloyd Bentsen, has issued a series of press releases based on staff studies showing that such in fact is the situation. These studies further show that the inadequacies of the public stock markets cause, through the "herd instinct" of securities analysts, certain major corporations ("the nifty-fifty") to be radically overpriced because of the concentration of the intitutional investors trading in those securities. Thus the truth of

the matter is that the active "auction market", once believed by all, is still believed by the Internal Revenue Service to be the paragon of ultimate precision in determining "real" and "objective" value of securities. But this belief is being very widely questioned by industry, by knowledgeable people in government, and by a great many security analysts themselves.

So far as deferred compensation trusts are concerned, the Internal Revenue Service will not issue advance rulings or determination letters relating to the value of securities. Thus, take the case of an elderly family that has built a very valuable business and owns all or most of its stock. The family wishes to sell that stock to the employees, who, for their part, dearly want to acquire the business and to continue their operation of it. While virtually every other method for accomplishing this is hopelessly unusable, the effectiveness and efficiency of ESOP financing techniques make it an easy transaction to accomplish in many, many cases, even without taking money out of the pockets or paychecks of the workers. This is possible simply because valuable business assets tend to pay for themselves in cycles again and again. ESOP financing simply provides the legal and financial design that extends non-recourse credit to employees so that when the capital involved pays for itself the next time, the employees are its beneficial owners.

RATHER THAN MAKING IMPOSSIBLE A WHOLESOME TRANSACTION THAT IS SOCIALLY AND ECONOMICALLY DESIRABLE, THE LAW SHOULD FACILITATE AND TAKE THE UNNECESSARY RISK OUT OF IT.

What is needed, in order to assure that a satisfactory price is used when a "party in interest" sells stock to an ESOP Trust, is a "no-action" procedure, whereby the entire facts and proposed price can be submitted to a specially established division of the Internal Revenue Service and an approval or disapproval obtained in advance. Under such a procedure, if the Service concluded that the price was high, negotiations to achieve a mutually acceptable price would ensue. Similar no-action procedures have been used by the Federal Trade Commission and the Securities and Exchange Commission for decades, and have saved both citizens, corporations, and the Government millions of dollars in litigation and frustration.

Perversely, however, the Internal Revenue Service insists on putting taxpayers who want to build capital ownership into their employees without risk or cost to the employees in a position of jeopardy if the seller and buyer pick a different price than the I.R.S. personnel involved, with the priceless benefit of hindsight, think to be the correct one. This is the glorious and amusing game of ambushing --and possibly bankrupting the taxpayer.

Why is it that a taxpayer cannot go to the Internal Revenue Service and outline a proposed sale procedure and price and get an opinion from the Service on which all parties can rely

on closing such a transaction? That such a method would be infinitely better for everyone concerned, including the United States economy and the Internal Revenue Service than the acquisition of the business by a conglomerate, or "taking the business public" by selling it to the faceless speculators in the stock market, is beyond question.

RATIONALE OF THE INTERNAL REVENUE SERVICE IN NOT GIVING AN OPINION ON VALUE OF STOCK SOLD TO AN ESOP TRUST.

Why does the Service refuse to issue an opinion after the taking of adequate evidence in such cases? Here is its official explanation:

> "SEC. 4 AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED.*** 1. Any matter where the determination requested is primarily one of fact, e.g., market value of property." (REV. PROC. 72-9: I.R.B. 1972-1, 28).

Very little reflection is required for anyone to quickly convince himself that the "market value of property", whether it is employer's stock, an old rocking chair, an old painting, or whatever, IS NEVER A FACT OR A QUESTION OF FACT. Actually, market value is almost the perfect example of something that can never be a fact. It is an anti-fact. It is only an opinion.

Three opinions are important in ESOP financing: (1) the Seller's opinion that the price is high enough, (2) the Buyer's opinion that the price is low enough, and (3) the opinion

of the Internal Revenue Service. When the first two mentioned opinions concur, a sale can take place. When the third opinion concurs, if given in advance, a tranquil, safe and efficient sale can take place.

Of course, once a sale is made and buyer and seller, being under no compulsion on the one hand to buy or on the other hand to sell, have concluded a sale, you have found not a fact, but a case of concurrent opinions. This makes the sale possible. The same buyer and a different seller might well reach a different result. Different buyers and sellers would most likely reach various different results.

The absurdity of treating market value as a fact rather than as purely a matter of opinion, leads to the administration of the tax laws in such way as to ambush taxpayers. That is, taxpayers are forced to conclude transactions -- often transactions involving large sums of money or large values of property, only to have the values questioned by the Treasury, and to be saddled with the incredibly expensive procedure, anguish and heartache of having to carry the burden of proving that their opinion was the right opinion, when in fact there is no such thing as an ultimately right opinion about value at all. Adam Smith's discovery that value is determined by the forces of supply and demand was not a discovery about how a fact is ascertained, but rather about how opinions interact in the market place. Nothing more.

From the taxpayer's standpoint, there is only one opinion about market value that needs to be known with certainty in order that orderly life and business transactions can be carried out. That is the opinion of the Internal Revenue Service -- the Service that dodges on giving such opinions on the grounds that they are matters of "fact" in order to push the burden of reaching an opinion on some judge or jury, or series of judges and a jury, all of whom will almost certainly be the rankest of amateurs in such matters.

It would be infinitely more sensible and infintely less expensive to the taxpayers and to the Government, to require the Treasury to establish a department of experts who, upon proper presentation of information, taking of evidence and/or testimony, and upon proper examination, will issue an official opinion of fair value upon the request of interested parties. The individuals staffing such a division of the Treasury would become expert in their fields, which is a great deal more than can be said for most tax court judges or Federal judges, or any jurors who are ultimately forced to do in the hardest and most grotesque way possible what the Internal Revenue Service could easily and inexpensively do in the first place.

PROPOSED MODIFICATION OF H.R.2 TO ELIMINATE ALL DOUBT ABOUT THE ADEQUACY OF CONSIDERATION IN THE SALE OF EMPLOYER STOCK TO A QUALIFIED PLAN DESIGNED TO BE INVESTED SOLELY OR PRIMARILY IN THE EMPLOYER STOCK.

To make life greatly simpler and less vexing for the taxpayer, and to put on the Treasury one of the burdens that is inherent in the collection of taxes from the people for the conduct of Government, and to eliminate the Administration's objection to the present provisions of the House bill (Section 111) relating to purchase of employer securities by such a qualified trust, we suggest the following amendment to H.R. 2:

Add at the end of Paragraph (3) of SEC. 111(b) the following:

"The Secretary of the Treasury or his delegate shall establish and implement a procedure for issuing, upon the request of a fiduciary or an employer or other interested person a determination of fair value on the basis of which any proposed acquisition of securities described in subparagraph (B) of this paragraph will not violate the requirement of subparagraph (E) of paragraph (2) of this subsection."

This simple provision should dispose of the Administration objections to the prohibited transactions provision of the House Bill, and should make life vastly easier and more livable for both the Treasury Department and the citizens of the United States in the future.

CONGRESS HAS ALREADY BEGUN TO RELY UPON ESOP FINANCING TO SOLVE THE ECONOMIC CRISIS IN CERTAIN MAJOR SITUATIONS.

In December, 1973 Congress passed, and on January 2, 1974

the President signed the Regional Rail Reorganization Act of 1973 (Public Law 93-236). This Act mandates that ESOP financing shall be used to build a portion or possibly all of the ownership of the reorganized Penn Central and related railroads into the employees, provided that the United States Rail Association, and ultimately Congress itself, concludes that such financing meets certain criteria. The purpose of including this provision in the very important railroad reorganization bill was, as the letters and floor statements by Senators Long, Hartke, and Hatfield demonstrated, to avoid repetition of the same railroad crisis in the future if the the employees of this major U.S. railway system are left in a position where they must, of necessity, demand progressively more pay for progressively less work because of their lack of access to effective acquisition of the ownership of the other factor of production -- capital.

1. Section 102(5) of the Regional Rail Reorganization Act of 1973 adopts a definition of an "employee stock ownership plan" that conforms to the objectives of the ESOP financing trusts designed by Bangert & Co. The definition reads:

> (5) "employee stock ownership plan" means a technique of corporate finance that uses a stock bonus trust or a company stock money purchase pension trust which qualifies under section 401(a) of the Internal Revenue Code of 1954 (26 U.S.C.401[a]) in connection with the financing of corporate improvements, transfers in the ownership of corporate assets, and other capital requirements of a

corporation and which is designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees.

2. Section 206(e)(3) of the Act requires that the final system plan for the Consolidated Rail Corporation set forth, among other things:

> (3) the manner in which employee stock ownership plans may, to the extent practicable, be utilized for meeting the capitalization requirements of the Corporation, taking into account (A) the relative cost savings compared to conventional methods of corporate finance; (B) the labor cost savings; (C) the potential for minimizing strikes and producing more harmonious relations between labor organizations and railway management; (D) the projected employee dividend incomes; (E) the impact on quality of service and prices to railway users; and (F) the promotion of the objectives of this Act of creating a financially self-sustaining railway system in the region which also meets the service needs of the region and the Nation.

In his floor statement of December 11, 1973, Senator Long characterized ESOP financing as:

> "...a remarkable innovation in corporate finance designed to reverse the heretofore universal tendency of all widely accepted techniques of corporation finance to concentrate ad infinitum the ownership of capital. It has enormously important social, economic and political ramification for strengthening our free enterprise economy."

> "...the only logical alternative to nationalization of the railroads, for it is not just a way to efficiently finance economic growth, but also build market power, and to motivate, in the most powerful way, the entire labor force to perform as never before in order to solve this problem."

"...a new ownership alternative....designed to correct defective corporate finance and concentrated ownership patterns in our railroads....a key feature of this legislation...(which) will be studied and, hopefully, fully implemented by the railroads covered by the final bill."

THE MOST PERFECT OF PENSION LAWS MAY NOT SOLVE THE RETIREMENT INCOME PROBLEMS FOR MOST AMERICANS. FOR THIS REASON, THE PROTECTION AND ENHANCEMENT OF LAWS MAKING IT POSSIBLE TO BROADEN THE OWNERSHIP OF PRODUCTIVE CAPITAL BY PEOPLE WHO ARE LIVING AND WORKING IS OF THE UTMOST SOCIAL, POLITICAL, AND ECONOMIC IMPORTANCE, SINCE FAMILIES AND INDIVIDUALS WITH SIGNIFICANT CAPITAL ESTATES ALREADY HAVE A MAJOR PRE-REQUISITE TO SOLVING THEIR RETIREMENT INCOME PROBLEMS.

Four of the most diligent and highly qualified Committees of Congress, and both Houses of Congress, have labored long and hard over pension reform for the past four years and more. They have had at their disposal volumes of testimony showing that, up to this point, the private retirement systems in the U.S. economy simply don't work. A typical retiree or retiree family from private industry adds together his or its social security income and his or its private retirement system payments and drops to a poverty level of consumer income during the very years when he or they have the leisure to enjoy life -- if they could afford to.

The power of the U.S. economy to produce goods and services is very great indeed, and its potential power to do so is still greater by a large but unknown factor. Nevertheless, most people are poor. Indeed, if we define being "rich" as owning sufficient productive capital to provide the family

or individual with income sufficient to support a reasonable standard of living, whether or not that individual or members of that family are able to work or can find work, then well under 5% of consumers (families and individuals) in the U.S. economy can be said to be rich.

THE HAUNTING UNKNOWN HANGING OVER THE PROPOSED NEW PENSION LEGISLATION.

Irrespective of what detailed provisions may ultimately be agreed upon by the Conference Committees with respect to traditional pension and profit sharing plans which now cover virtually all workers and families covered by private retirement systems, since ESOP trusts are still not widely known, one big haunting question will remain:

> IT IS ANYTHING BUT CERTAIN THAT -- IN TERMS OF RETIREMENT INCOME -- THE RETIREE UNDER A PRIVATE PENSION OR PROFIT-SHARING PLAN OF THE FUTURE WILL HAVE A BETTER STANDARD OF LIVING AFTER ENACTMENT OF THE NEW LAW THAN BEFORE!

Some of the reasons are:

-- Pension and profit-sharing plans will continue to invest, and indeed under improved vesting and funding requirements of a new law, will increase investment -- in second-hand, outstanding securities, contributing virtually nothing to the growth of

newly-formed capital. They will continue to be pure cost to business, contributing indefinitely to inflation. Inflation, so far as we can tell, will go merrily on its way.

-- The new law will add substantially to the corporate costs of maintaining retirement systems, and this, too, will go into the cost of goods and services.

ESOP FINANCING PROVIDES A CRITICAL ALTERNATIVE TO CONVENTIONAL RETIREMENT SYSTEMS THAT IS DEFLATIONARY, CONTRIBUTES DIRECTLY TO FINANCING THE GROWTH OF THE ECONOMY, ENCOURAGES CORPORATIONS TO PROVIDE MORE ADEQUATELY FOR EMPLOYEE RETIREMENT, AND HARNESSES TO THE GROWTH OF OUR ECONOMY AND THE PURCHASING POWER OF OUR CONSUMERS THE GREATEST SOURCE OF MOTIVATIONAL POWER KNOWN TO HUMAN HISTORY: THE ACQUISITIVE INSTINCT, OR DESIRE TO OWN THE MEANS OF PRODUCTION.

We respectfully urge the Conferees to retain the House version of the prohibited transactions legislation (Sec.III), and to enact, as part of the new H.R.2 our suggested provision requiring the Treasury to establish a "no action" procedure for reaching a government approved opinion on fair value for stock sold to ESOP's before the transaction takes place.

Respectfully submitted

LOUIS O. KELSO, INC.

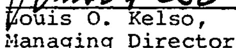
By 
Louis O. Kelso,
Managing Director

EXHIBIT I

Analysis of Letter dated April 30, 1974 from Frederick W. Hickman, Assistant Secretary of the Treasury, to The Honorable Russell B. Long, setting forth "the views of the Treasury Department" on S.1370, a bill to amend the Internal Revenue Code of 1954 to facilitate ESOP financing.

According to Mr. Hickman's letter, a copy of which is attached hereto, the Treasury Department opposes the enactment of S.1370, a bill intended to facilitate ESOP financing by increasing the tax incentives to corporations to build stock ownership into their employees.

Unfortunately, Mr. Hickman's letter is based upon almost total misconception as to the legal structure of employee stock ownership plan ("ESOP") financing and reflects lack of awareness of the growing chasm within the U.S. economy that ESOP financing alone promises to bridge within a time span capable of reversing what many informed people believe to be an impending economic crisis.

Presumably, if the drastic errors in his understanding of the nature of ESOP financing were corrected, and his breadth of vision as to its significance broadened, the Treasury view of S.1370, as expressed to the Chairman of the Senate Finance Committee, may be altered.

THE ERRORS REFLECTED IN MR. HICKMAN'S LETTER AS TO HOW ESOP FINANCING WORKS.

Error Number One. "The effect of the arrangement is very much the same as if conventional financing had been utilized and a contribution of employer stock equal in market value to the amount of the loan had been made to a stock bonus trust. The principal differences are that, under ESOP financing, the trust is liable to repay the loan if the employer defaults, and the trust's investment in employer stock is in effect leveraged."

This statement is totally erroneous. The arrangement is radically different, as Mr. Hickman himself notes on the next page, than making a conventional loan and then making a contribution of stock to the employee trust, for the very simple reason that an installment loan payable over a period of years permits employees to buy stock at a price which does not fluctuate, and the price remains fixed over the financing period. The guaranty of the corporation to make annual payments into the trust to enable the trust to amortize its loan obligations, is, in economic theory, merely a commitment to make a high payout of the "wages of capital" or net earnings allocable to the stock purchased by the trust, in pre-tax dollars, so as to enable the employees, thus having access to the basic

logic of business finance, to buy stock on terms where it, in effect, pays for itself.

The trust is not liable to repay the loan if the employer defaults except to the extent of stock which may be pledged to secure the loan and which has not yet been paid for by corporate contributions. In other words, as the loan is paid down, any pledged stock (very often the loans are made without the pledge of any stock) thus paid for is realeased from the pledge and returned to the trust where it is allocated, irrevocably (subject only to the vesting schedule) to the employees' accounts. Thus, every cent of contribution made to the employee trust irrevocably redounds to the benefit of the employee participants. The word "leveraged" is a false, inappropriate, and misleading term where every share of stock paid for by contribution is released from the risk of any non-payment of the remainder of the debt.

Thus, the investment by employees in the stock is not "in effect leveraged." It is a straight financing transaction under which employees are given access to non-recourse credit, to buy company stock, with a commitment on the part of the company to make a high payout of the earnings underlying the stock (in the form of a contribution to the trust that meets the limits prescribed by Section 404(a) of the Internal Revenue Code) so that the stock will pay for itself.

We have participated in excess of 50 ESOP financing transactions and in no case--in not one single case--has the credit of the trust ever been relied upon in the slightest; only the general credit of the corporation itself. Most loan agreements between banks or insurance companies and ESOP trusts in fact recite the non-liability of the trust assets to secure the loan. It is the credit of the corporation that is used for the exclusive benefit of the employees while at the same time the proceeds of the financing are used to finance the company which the employees have thus invested in. Thus a rational use of both the trust and the financing is made, as contra-distinguished from the typical "safe" trust which Mr. Hickman refers to, in which the assets are invested in second-hand, outstanding, reshuffled securities in the emotion-controlled gambling casinos of the stock markets.

> Error Number Two. "However, it (the ESOP) has the disadvantage of decreasing employee's retirement security. Since the stock bonus trust is buying employer stock with borrowed funds (i.e., on margin), a reduction in value of employer stock would result in a significant reduction in the funds available for retirement."

This is simply self-evident nonsense. It amounts to an assertion that an employee has less security where ESOP financing

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is used to simultaneously finance the growth of the corporation, build economic security and retirement security into the employee, and to create the motivational, legal, and psychological relationship of owner between the employee and the employer. Mr. Hickman's assertion that pension trusts and profit sharing trusts invested at random in the second-hand securities market are "safer" retirement security than ownership of the company for which the employee works simply does not conform to the facts of life or the facts of history. Mr. Hickman, of course, is alluding to the so-called "prudent man rule" under which it is generally held that diversification of investments is a basic aspect of protecting the principal of a capital estate and assuring a reasonable yield.

Mr. Hickman overlooks the fact that the "prudent man rule" is a rule that was laid down, and only makes rational sense, when applied to rich men -- that is, people with substantial capital estates. The working employees of America are not -- with the rarest of exceptions -- "rich men." Virtually every significant fortune in the United States, and indeed in industrial history, has been built upon investment in the company with which the employee is associated over his working lifetime. Andrew Carnegie laid down the principle very clearly in his biography, when he said "if you want to be rich, put all your eggs in one basket and watch the basket very closely." The precise rule which enables the rich man

to stay rich ("the prudent rich man's rule") also has enabled, when applied to poor men, to keep them poor. It is inconceivable that anyone, using the prudent man rule, could build a significant capital estate which would give him economic independence, and therefore retirement security. Such gross oversight on the part of Mr. Hickman is the kind of backward thinking that causes the richest nation on earth to turn out such great numbers of propertyless, impecunious, retired employees, totally lacking in capital estates which could provide them with economic security and retirement income. It is the same kind of thinking that has raised pension costs of U.S. corporations to crushing levels, while contributing virtually nothing to the financing of new capital formation in the U.S. economy.

ESOP financing not only builds formidable capital estates into employees, but finances growth and motivates growth for the companies that use it.

It would appear that Mr. Hickman does not understand the meaning of the word "margin" in the securities business. A margin loan is one which, if the value of the stock fluctuates below the specified margin, requires the borrower either to put up more security, or to pay down the loan, or permits the lender to sell out the security interest and apply the proceeds to the loan. To use that slanderous term, which comes from the gambling world of stock speculation, on an ESOP,

where there can be no possibility of foreclosure of a loan because of fluctuation in the value of the stock, is simply to attempt to mislead the Chairman of the Senate Finance Committee.

Error Number Three. Mr. Hickman advances as criticism the fact that if the stock purchased by the ESOP increases in value, the employee will be better off and that if it decreases in value the employee will be worse off. This can hardly come as a revelation to the Chairman of the Senate Finance Committee. However, if Mr. Hickman has discovered a way to invest in productive capital through non-recourse financing so that the investor wins both on increasing values and on decreasing values, we will be pleased to incorporate his wisdom into the design of ESOP trusts.

Error Number Four. Mr. Hickman states "a basic question posed by ESOP financing is whether employee trusts should be encouraged to enter into such more speculative leveraged investments, as opposed to a more conservative investment policy designed to maximize the security of the employees' provision for retirement."

We submit that this statement is not only groundless and misleading, but that it is senseless. Thousands of pension plans and profit sharing plans today are suffering from the fact that their total portfolios have values of only a fraction of the original amounts contributed for the covered employees. Thousands of companies in the U.S. economy are suffering from the fact that their retirement costs are "pure costs" because the funds are invested in recycled, regurgitated, outstanding second-hand securities, rather than financing the growth of new capital formation in the U.S. economy itself. Thousands of companies are suffering from lack of motivation of their employees because there is no property relationship between the employer and the employee capable of giving the employee "the eye of the owner." Conventional profit sharing and pension plans contribute enormously to inflation in the U.S. economy, particularly the wildest and most erratic inflation of all -- the irrational and emotion-controlled fluctuations in the securities markets for second-hand stocks. Mr. Hickman would do well to focus first on understanding what employee stock ownership plan financing is, and secondly on what the needs of the U.S. economy and the U.S. government's fiscal structure are. If he did so, he would not make irresponsible and misleading statements such as the preceeding one.

Most of the literature on ESOP financing urges that it be used in the largest and solidest enterprises in the economy;

that it be used to connect the economically weakest people with the economically strongest corporations. Mr. Hickman's gratuitous advice about such "speculative leveraged investments" seems entirely ludicrous in view of this.

> Error Number Five. The "Treasury is opposed to the use of the charitable deduction as an incentive to make contributions to qualified trusts. Among other things, the deduction for a contribution to a charitable organization is justified on the basis that it encourages the financing of organizations which achieve social objectives which would benefit the public in general. The direct benefits of ESOP will be limited to corporate employees."

Again, Mr. Hickman is deficient in his comprehension of the facts of economic life, the facts of history, and of philosophy. No charity is greater than making American workers self-sufficient, so that they need not be wards of charity. This is a "social objective which would benefit the public in general." In fact, I challenge Mr. Hickman to name a greater and more socially desirable one. The ancient Jewish philosopher, Maimonides, in his description of the "eight degrees of charity" described the eighth and highest degree of charity as that kind of charity which enables men to become self-sufficient and never again be wards of charity. Rather than

channel the great and grotesquely concentrated fortunes that defective one-factor finance has created in the United States into foundations where bureaucrats can administer them in accordance with their whims as to what the "public need" is, a wise society would break up those great capital holdings in reasonable sized holdings and would connect them to citizens who otherwise will never own significant productive capital, for the purpose of raising their economic productiveness, for the purpose of giving them individual economic power, for the purpose of motivating them to do their jobs well because their acquisition of such holdings would depend upon performing their jobs well over a reasonable working lifetime, and providing them with capital holdings that would keep them from being wards of charity, claimants for higher social security payments, or engaging in other forms of parasitical activity to which many such "charities" administer.

Again, Mr. Hickman's comprehension of what life should look like in a private property free enterprise society is too dwarfed to be used as the basis for Treasury policy and certainly not for legislative policy.

It is perfectly true that ESOP financing cannot be used to instantly eliminate all need for charity overnight and to build viable capital estates in the entire population overnight. But if used heavily and encouraged by Governmental leadership and tax policy for U.S. corporations, it can make

enormous steps within as short a period as five years, and can totally change the character of our economy into one of universally broadly held capital ownership within twenty years. Every day that we fail to correct the defect of concentrated capital ownership in our economy sets that great day of economic salvation back one day further.

> Error Number Six. Mr. Hickman criticized the provisions of S.1370 for permitting a deduction for dividends paid by a corporation on its stock held by an ESOP on the grounds that the entire "second tax" should be eliminated from the system at once.

This is a matter of opinion, but it occurs to us that we could well experiment with its use in connection with ESOP financing and that to do so would help communicate to employees the significance, importance, and motivational import of growing capital ownership, since it would encourage corporations to pay dividends which would pass through the trusts into the employees' pockets after their stock has been paid for.

> Error Number Seven. Mr. Hickman criticizes sections 3 and 4 of S.1370, which would give added tax incentive to corporations to use ESOP financing.

Whether such added tax incentives are desirable or not is something for Congress to evaluate on the basis of its views as to the gravity of the economic crisis of the United States and the degree of speed needed to expand the proprietary base of ownership of U.S. productive capital in order to stem the clearly impending disaster ahead. If the higher limits proposed by Sections 3 and 4 seem too high, then lesser limits should be fixed. Conversely, if Congress believes that we have waited too many years to begin to make capital owners rather than propertyless working serfs out of the masses of Americans, perhaps the levels of deductibility proposed by S.1370 should be increased rather than decreased.

Point Number Eight. The impact of S.1370 is not limited to ESOP financing.

As S.1370 was originally submitted, this is proper criticism. We would be content to see the provisions of the bill limited to ESOP financing because of our confidence that as the rational soundness of ESOP financing becomes evident throughout industry, and the irrationality of conventional profit sharing and pension plans investing in the reshuffling of second-hand securities also becomes evident, the future financing of growth of our economy as well as the financing of retirement security and second sources of income for employees will take place primarily if not exclusively, through ESOP trusts.

<u>Error Number Nine</u>. Mr. Hickman admits the difficulty of estimating the revenue effect of S.1370.

The difficulty is greater than he imagines, since we do not know the productive power of men and women once they realize that they have been put in a position where they can acquire a viable capital holding over a reasonable working lifetime. Looking back in history, we do know that the dream of such accumulation of modest wealth drove men and women to incredible economic performance in the past and that the latent and unused incentive of the acquisitive instinct is very great indeed.

As for revenue losses, we think that at best, however heavily ESOP financing may be used in the U.S. economy, they would be temporary and within four or five years at most, would be replaced by the diminishing burden on government to subsidize phony jobs in order to keep the economy functioning satisfactorily, the diminishing demands for future welfare, the growth of the tax base, the elimination of the need to use high interest rates to control the structural defects in the economy flowing from the concentration of ownership of capital, and that the cumulative result of these would be to put the United States government on the road to fiscal health, diminished taxes, gentle but beneign deflation, and to restore the strength of its productive power and competitive power in world markets.

All of these aspects seem to lie above the reach of M. Hickman's insight into the problem.

We trust that neither Senator Long nor other conferees on H.R.2, nor the members of the Senate or House of Representatives in general will be swayed by the superficial and shortsighted criticisms of ESOP financing levelled by Mr. Hickman.

Dated: June 14, 1974

LOUIS O. KELSO, INC.

By ____________________
Louis O. Kelso
Managing Director

LOK:bh

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

APR 30 1974

Dear Mr. Chairman:

You have asked the views of the Treasury Department on S. 1370, a bill to amend the Internal Revenue Code of 1954 to facilitate acquisition of ownership of private enterprises by the employees of such enterprises.

The Treasury Department opposes the enactment of S. 1370.

We understand that the general intent of S. 1370 is to provide additional tax incentives for the adoption of Employee Stock Ownership Plan (ESOP) financing, as advocated by Louis O. Kelso on behalf of Bangert & Co. Incorporated before the House Committee on Ways and Means on March 9, 1973. ESOP financing and the provisions of the bill are described below.

ESOP Financing

ESOP financing is intended as an alternative to conventional bank loan financing by corporations. Under ESOP financing, the needed funds are obtained indirectly through a trust established under a profit-sharing or stock bonus plan. The trust borrows the money and uses it to buy employer stock from the employer. The employer agrees to contribute to the trust sufficient funds to pay interest and principal on the loan. The effect of the arrangement is very much the same as if conventional financing had been utilized and a contribution of employer stock equal in market value to the amount of the loan had been made to a stock bonus trust. The principal differences are that, under ESOP financing, the trust is liable to repay the loan if the employer defaults, and the trust's investment in employer stock is in effect leveraged.

ESOP financing has the advantages of encouraging the growth of the private retirement system, encouraging stock ownership, and (hopefully) improving employee productivity. However, it has the disadvantage of decreasing employees' retirement security. Since the stock bonus trust is buying employer stock with borrowed funds (i.e., on margin), a reduction in value of employer stock would result in a significant reduction in the funds available for retirement. In a low market, employer contributions would have to be used to repay loans rather than to buy investments at bargain prices.

An example will illustrate the effect of ESOP. Suppose that $100,000 in stock would have been contributed each year for five years to an employee stock bonus plan. The number of shares contributed each year would have varied inversely with variations in the market price of the stock. Suppose further that the employer adopts an ESOP financing plan in lieu of the stock contribution plan. Under the plan, the trust borrows $500,000 and purchases $500,000 worth of stock from the employer. The employer contributes each year $100,000, plus the amount necessary to pay interest on the loan. The effect of ESOP financing is to fix, as of the time of the loan and stock purchase, the price at which the annual employer contributions will be converted into stock. This magnifies the advantages to the employees of an upward trend in the price of the employer's stock and multiplies the disadvantages of a downward trend. Because it is buying stock on margin, the trust's gains and losses are leveraged. Thus, if a share of stock is worth $10 in the first year, and it appreciates 10 percent per year, the trust will own 50,000 shares worth $805,000 in the sixth year ($16.10 per share). If it depreciates 10 percent per year, the trust will own 50,000 shares worth $295,000 in the sixth year ($5.90 per share). By contrast, if the trust had purchased $100,000 worth of stock each year, the risk would have been less. If the stock appreciated 10 percent per year, the trust would have owned 37,908 shares worth $610,319; if the stock depreciated 10 percent per year, the trust would have owned 69,367 shares worth $409,265.

A basic question posed by ESOP financing is whether employee trusts should be encouraged to enter into such more speculative leveraged investments, as opposed to a more conservative investment policy designed to maximize the security of the employees' provision for retirement.

Provisions of S. 1370

Section 1 of the bill would allow income, gift and estate tax deductions for contributions to trusts maintained under qualified pension, profit-sharing or stock bonus plans. The trusts would be treated as public charities eligible for income tax deductions up to 50 percent of an individual's contribution base. Contributions to trusts created by the donor, or by a corporation which controls or is controlled by or under common control with the donor taxpayer would not qualify for this special treatment.

The Treasury is opposed to the use of the charitable deduction as an incentive to make contributions to qualified trusts. Among other things, the deduction for a contribution to a charitable organization is

justified on the basis that it encourages the financing of organizations which achieve social objectives which would benefit the public in general. The direct benefits of ESOP will be limited to corporate employees. The deduction would be available for contributions to qualified plans under section 401. While a plan must be nondiscriminatory, i.e., it cannot favor the highly compensated employee, officer or shareholder, often the plan will include only a fraction of the employees in the business Thus, the benefits of ESOP are very limited and would not justify treating a contribution as a charitable deduction.

Section 2 of the bill would allow a corporation a deduction for "qualified dividends." A qualified dividend would be defined as a distribution to a qualified profit-sharing or stock bonus trust with respect to stock held by such trust, if the distribution is currently passed through to employees covered by the plan.

Under present law dividend distributions may not be deducted by the distributing corporation, and corporate earnings thus are subject to a double tax, first at the corporate level and again at the shareholder level. Alterations in this system, if they are to be made, should be general and not confined to such limited situations as those covered by section 3. For example, we see no justification for according more favorable treatment to dividends on stock held by a profit-sharing or stock bonus trust than to dividends on stock owned directly by employees or by the general public.

Section 3 of the bill would increase the limitation on deductible contributions to profit-sharing and stock bonus trusts from 15 percent of compensation to 30 percent and would increase the limitation on deductible contributions to a combination of pension and either profit-sharing or stock bonus trusts from 25 percent of compensation to 50 percent.

Increasing the amount and limits on contributions to profit-sharing and stock bonus trusts for all employees is contrary to the purposes of the pension legislation presently being considered by Congress. The pension bill passed by the Senate and the Ways and Means bill, H. R. 12855, contain limits on the maximum retirement benefits which could receive tax shelter treatment. To the extent that S. 1370 would allow additional contributions to qualified plans for the highly compensated executives it would defeat the intention of these limits.

Section 4 of the bill would allow a special deduction whenever contributions paid by an employer to a stock bonus or profit-sharing trust are used by the recipient trust for reducing "stock acquisition indebtedness," defined as indebtedness incurred by the trust to make certain purchases of employer stock. The special deduction would be equal to 50 percent of the amount of employer contributions to the

trust used by the trust to reduce stock acquisition indebtedness during the taxable year. The special deduction would be in addition to the regular deduction for employer contributions, and the combined deductions might equal as much as 150 percent of employer contributions.

This section of the bill would create a tremendous premium on deferred compensation, i.e., a 150 percent deduction for deferred compensation vs. a 100 percent deduction for current compensation. We believe that such a bias in favor of deferred compensation is unwise and runs counter to the recent trend in tax legislation, which has attempted to achieve neutrality as between deferred compensation and current compensation or to favor current compensation. For example, the maximum tax on earned income under section 1348 of the Internal Revenue Code, which was enacted in 1969, was intended in part to encourage highly compensated employees to take income currently rather than to defer the receipt of such income.

Finally, it should be noted that the impact of the bill is not limited to ESOP financing. The charitable contribution provisions would apply to all qualified trusts. The deduction for qualified dividends would apply to all profit-sharing or stock bonus plans. The increase in deduction limits would apply to all qualified plans. The special deduction related to stock acquisition indebtedness would apply to all stock acquisition indebtedness of profit-sharing or stock bonus trusts.

Revenue Effect

The revenue effect of S. 1370 is very difficult to estimate because it requires a guess of how people would react to the new tax incentives. The revenue effect of sections 1 and 2 would probably not be great. The increases in percentage limitations on contributions by employers to qualified trusts might result in a substantial revenue loss, but it is difficult to predict how many corporations would make additional contributions in excess of the present limitations.

Presumably, many employers would take advantage of the special deduction for reduction of stock acquisition indebtedness since a $1.50 deduction would be available for every $1.00 of expense. Employers would have a very strong incentive to persuade pension trusts to enter into ESOP financing arrangements, even if it meant increased contributions to the trust. Thus, although the revenue effect is very difficult to estimate, we believe there would be very significant revenue losses -- perhaps as much as, or more than, $1 billion per year. For instance, the corporate deduction for contributions under qualified plans was $11.1 billion in 1969 and $12.2 billion in 1970. Assuming roughly $16.0 billion

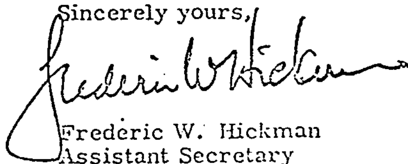
is currently deducted, if 25 percent of those deductions related to profit-sharing or stock bonus plans, if the profit-sharing or stock bonus contributions would be increased by 25 percent because of the tax incentives offered by this bill, and if all of the profit-sharing or stock bonus contributions were used to pay off stock acquisition indebtedness, the resulting revenue loss might be in the neighborhood of $1.5 billion per year.

The Treasury Department is strongly opposed to the enactment of S. 1370. While in particular cases ESOP financing may prove advantageous to employees, on the whole it decreases the security of funds held by employee trusts. Where a stock bonus or profit-sharing trust is a major ingredient in the employees' retirement plan, it is questionable whether the trust should commit any substantial portion of its funds to ESOP financing. Moreover, the extent to which profit-sharing plans should invest in stock of the employer is itself a much debated question among plan administrators, many of whom believe such plans should hold a diversified investment portfolio. For instance, H. R. 4200, the pension bill passed by the Senate on September 9, 1973, contains limits on the amount of assets which may be invested in the securities of any corporation. Accordingly, the tax laws should at least be neutral with respect to ESOP financing rather than according a massive tax incentive, as under section 4 of S. 1370, to induce employers and plan administrators to adopt ESOP financing.

In any event, we do not believe that any advantages that may result from ESOP financing are sufficient to justify the significant revenue loss that would be incurred under S. 1370.

The Office of Management and Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,



Frederic W. Hickman
Assistant Secretary

The Honorable
Russell B. Long, Chairman
Committee on Finance
United States Senate
Washington, D. C. 20510

DEPARTMENT
OF THE TREASURY

Date: 5/28/74

To: Mr. Kelso

M. Gill

Frederic W. Hickman
Assistant Secretary
for Tax Policy
Room 4308, Ext. 5561
3430

69-174 O - 76 - 31

Exhibit A

Congressional Record

United States of America

PROCEEDINGS AND DEBATES OF THE 93d CONGRESS, FIRST SESSION

Vol. 119 WASHINGTON, TUESDAY, MARCH 27, 1973 *No. 47*

S 5757 SENATE

STATEMENTS ON INTRODUCED BILLS AND JOINT RESOLUTIONS

By Mr. FANNIN (for himself, Mr. HANSEN, and Mr. DOMINICK):

S. 1370. A bill to amend the Internal Revenue Code of 1954 to facilitate acquisition of ownership of private enterprises by the employees of such enterprises. Referred to the Committee on Finance.

Mr. FANNIN. Mr. President, on behalf of myself, Mr. HANSEN, and Mr. DOMINICK, I introduce a bill to amend the Internal Revenue Code and ask that it be appropriately referred.

This legislation is designed to facilitate the expanding of the capital ownership base of the U.S. economy, beginning with the employees of U.S. corporations which account for over 80 percent of the goods and services produced by the private sector.

Today there is vital need for revitalization of the free enterprise system. We need to create incentives that will rekindle the work ethic in America.

You may be familiar with some of the unhappy statistics:

The fact that more people draw money from the Government for not working today than during the depression;

The fact that General Motors estimates that absenteeism costs the company more than $50 million annually in fringe benefits alone;

The fact that some workers purposely sabotage the assembly lines they work on;

The fact that too many workers have no pride in the product they are turning out.

We obviously have a problem that threatens our national well-being and our ability to remain competitive in world trade.

We have been told that the alienation of youth and the general frustration of many Americans today is the inevitable result of the capitalist or free enterprise system. In the past, the solution to every problem is to create more bureaucracy, to provide more government control, to dilute the capitalist system.

This attitude has prevailed in the Congress now for the better part of four decades; and as a result we have found that we have inflation, unemployment, and an apparent lack of national determination or purpose.

Mr. President, the amendments to the Internal Revenue Code contained in this bill would allow for the expansion and development of corporate financing techniques called employee stock ownership plan—ESOP—which are successfuly being employed by a growing number of corporations.

One of the major problems in the current economic scheme is the manner in which corporations obtain new financing. In most cases a corporation will borrow money to buy new productive machinery. When the loan is paid off, it means usually that the book value of the outstanding stock has increased. This indirectly benefits the old stockholders, or the established capitalists, but does not in itself add any new stockholders.

Today when corporations issue new stock to finance their expansion, this stock is usually purchased by the already established capitalists. Lower and middle class Americans simply do not have the excess income to make large investments in stock.

Under this bill, corporations would have new incentives to obtain their new financing through employee trusts.

The existing ESOP plans incorporate the use of a deferred compensation trust—technically a stock bonus trust—into the financing process itself. Under one ESOP technique, the trust borrows funds to invest in the employer corporation. This instantly makes the employees beneficial owners of the corporation's stock, subject only to the trust's paying off the loan. 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 employees than it otherwise could, and the cost of financing its growth is about the same as if it conventionally borrowed and repaid—as to principal—in after-tax dollars After the employer's 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 the trust

In order to facilitate the use of ESOP financing methods by business by linking the day-to-day performance of work by employees and the day-to-day growth and operation of business, the bill modifies the Internal Revenue Code as follows:

First. Provides that a qualified employee benefit trust shall have the tax characteristics of a charitable organization for purposes of income, estate, and gift taxes.

Second. Provides a tax deduction to corporations for the amount of dividends which they pay on stock held by qualified profit-sharing or stock bonus plan trusts, provided that the dividends are promptly paid over to the employees covered by the plan.

Third. Provides for an increase from 15 percent to 30 percent in the percentage limitation on the maximum annual tax-deductible contribution that can be made to a qualified employee benefit trust

Fourth. Provides an additional tax deduction for a corporation making a contribution to a qualified profit-sharing or stock bonus trust where the trust pays off indebtedness incurred to purchase stock of the corporation. The amount of the special deduction would be 50 percent of the principal amount of the indebtedness paid by the trust during the taxable year of the corporation.

Mr. President, the most important aspects of the ESOP financing technique are:

The loan is made not directly to the corporation, but to a specially designed ESOP that qualifies as a tax-exempt employee stock bonus trust under section 401(a) of the Internal Revenue Code. Such trusts normally cover all employees of the corporation and their relative interests are proportional to their relative annual compensation—however defined—over the period of years that the financing is being paid off. The trusts are normally under the control of a committee appointed by management and its membership may include labor representatives.

The committee invests the proceeds of the loan in the corporation by purchasing newly issued stock at its current market value.

The trust gives its note to the lender, which note may or may not be secured by a pledge of the stock. If it is so secured, the pledge is designed for release of proportionate amounts of the stock each year as installment payments are made on the trust's note to the lender and the released stock is allocated to

participants' accounts.

The corporation issues its guarantee to the lender assuring that it will make annual payments into the trust in amounts sufficient to enable the trust to amortize its debt to the lender. Within the limits specified by the Internal Revenue Code, such payments are deductible by the corporation as payments to a qualified employee deferred compensation trust. Thus the lender has the general credit of the corporation to support repayment of the loan, plus the added security resulting from the fact that the loan is repayable in pretax dollars.

Each year as a payment is made by the corporation into the ESOP, there is allocated proportionately among the accounts of the participants in the trust a number of shares of stock proportionate to the participant's allocated share of the payment. Special formulas have been designed to counteract the relatively high proportion of early amortization payments used to pay interest and the relatively high proportion of later amortization payments used to repay principal.

As the financing is completed and the loan paid off, the beneficial ownership of the stock accrues to the employees. Most trusts are designed to permit the withdrawal of the portfolio in kind, subject to vesting provisions, either at termination of employment, or at retirement. However, it is desirable to so design the ESOP that any dividend income on shares of stock that have been paid for by the financing process and are then allocated to the employees' accounts, be distributed currently to the employee-participants, thus giving them a second source of income.

Diversification of the trust can be achieved after a particular block of stock has been paid for by exchanging the stock, at fair market value, for other shares of equal market value. Since the trust is a tax exempt entity, such diversification is without tax impact.

The ESOP financing technique properly uses the qualified deferred compensation trust to give the employee a means of legitimately buying and paying for capital as a function of enabling the corporation to finance its growth and the acquisition of assets, and motivating its employees, it can properly be said that what the employee receives is not compensation in the sense of pay for labor at all. He is being provided with a means of buying stock through the device of a deferred compensation trust, coupled with a commitment by the corporation—usually to a third person—to pay what amounts, in economic theory, to a pretax preferential dividend to employee buyers who are being so financed. The justification from the standpoint of the corporation, for making such an economic preferential dividend is that it wishes to take advantage of the acquisitive instinct of employees in order to motivate them, not only to work harder, but to insist upon their fellow workers also working harder and to use every effort to achieve cost savings. The employee, in short, is by the ESOP financing technique, put in a position where what he does, and what his fellow workers do, affects the value of his capital holding. No better motivational device can be conceived.

The concern about the problems of worker alienation that abound in our society today turn primarily on the fact that most work in America does not make a man rich. To be rich means to own income producing capital. A man who merely has high wages or a high salary, dissipated by the high cost of living and high taxes, an income that will terminate the instant he stops performing personal productive toil, is not rich, no matter what income he receives. The most important type of job enrichment is simply enrichment.

Through the use of ESOP financing, the corporation can obtain low cost capital, not on a short term basis, but on a long term basis, after the tax savings, and the yield of that savings retained in the corporation, has restored the temporary earnings dilution. Corporations need, but heretofore have never had, a way to raise the incomes of employees without raising their costs. Whether the yield of the capital represented by the stock acquired by the ESOP trust is accumulated in part in the corporation, or accumulated in the trust, or passed through the trust into the employees' pockets, such income is for the exclusive benefit of the employee participants in the trust. The employees either gain current income, or current capital appreciation, or capital accumulation, or any two or all three of these from the moment they acquire beneficial ownership of the stock. Absent this unique arrangement, so long as we have rising costs of living, rising taxes—which need no documentation—and reasonably rising expectations, employees have no possibility, if we are realistic, of avoiding frustration except to demand progressively more pay for the same, or very often for less work input.

By planning in advance to build a reasonable share of the ownership of the corporation's growth into the labor force, management puts the employees in a position where their economic security and future income growth can occur without their demanding more and more pay for the same, or for less work. Thus every reason that management has historically used to avoid the class conflict approach to labor relations justifies ESOP financing from the corporation's standpoint. ESOP financing attacks the causes of inflation by enabling the employee to build his economic security without demanding progressively more pay for progressively less work, the force that has powered the engine of inflation for 40 years or more.

Thus, Mr. President, the benefits of providing every worker a chance to participate in the ownership of capital are enormous:

It spreads the base of capitalism.

It motivates productivity.

It increases income and purchasing power.

It could minimize unemployment and welfare.

It raises the tax base.

It eliminates causes of inflation.

And it provides adequate retirement income.

Mr. President, I ask unanimous consent that the full text of the bill be placed in the RECORD at the conclusion of my remarks.

There being no objection, the bill was ordered to be printed in the RECORD, as follows:

S. 1370

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 170(b)(1)(A) of the Internal Revenue Code of 1954 (relating to percentage limitations on the deduction for charitable contributions by individuals) is amended—

(1) by striking out "or" at the end of clause (vii),

(2) by inserting "or" at the end of clause (viii), and

(3) by inserting after clause (viii) the following new clause:

"(ix) a trust described in section 401(a),".

(b) Section 170(c) of such Code (relating to definition of charitable contribution) is amended by inserting after paragraph (5) the following new paragraph:

"(6) A trust described in section 401(a) (other than a trust created by the taxpayer or by a corporation which, directly or indirectly, controls or is controlled by the taxpayer or the person or persons who control the taxpayer) if, pursuant to the terms of the trust or a condition of the contribution, no part of the contribution may be allocated to or held for the benefit of the taxpayer, or if the taxpayer is an individual, the taxpayer's spouse, children (including legally adopted children), grandchildren, or parents, or any person who owns 50 percent or more in value of the stock of the corporation that created the trust, or, if the taxpayer is a corporation, any shareholder who owns, directly or indirectly, 50 percent or more in value of the stock of the corporation, or, in the case of a partnership, estate, or trust, any partner or beneficiary thereof."

(c) Section 2055(a) of such Code (relating to the reduction for transfers for public, charitable, and religious uses in computing the taxable estate) is amended—

(1) by striking out "or" at the end of paragraph (3),

(2) by striking out the period at the end of paragraph (4) and inserting in lieu thereof "; or", and

(3) by inserting after paragraph (4) the following new paragraph:

"(5) to a trust described in section 401(a) if, pursuant to the terms of the trust or a condition of the contribution, no part of the contribution may be allocated to or held for the benefit of the decedent's spouse, children (including legally adopted children), grandchildren, or parents, or any person who owns, directly or indirectly, 50 percent or more in value of the stock of the corporation that created the trust."

(d) Section 2522(a) of such Code (relating to the deduction for charitable and similar gifts in computing taxable gifts) is amended—

(1) by striking out the period at the end of paragraph (4) and inserting in lieu thereof "; or", and

(2) by inserting after paragraph (4) the following new paragraph:

"(5) a trust described in section 401(a) if, pursuant to the terms of the trust or a condition of the contribution, no part of the contribution may be allocated to or held for the benefit of the donor, his spouse, children (including legally adopted children), grandchildren, or parents, or any person who owns, directly or indirectly, 50 percent or more in value of the stock of the corporation that created the trust."

(e) The amendments made by subsections (a), (b), and (d) shall apply only with respect to contributions or gifts made after the date of the enactment of this Act. The amendment made by subsection (c) shall

*Omission of the underlined words from S. 1370 is suggested by Bangert & Co., Incorporated, San Francisco.

apply only with respect to estates of decedents dying after such date.

SEC. 2. (a) Part VIII of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to special deductions for corporations) is amended by adding at the end thereof the following new section:

"SEC. 251. DIVIDENDS PAID ON STOCK HELD BY CERTAIN QUALIFIED EMPLOYEE TRUSTS.

"(a) GENERAL RULE.—In the case of a corporation, there shall be allowed as a deduction the amount of any qualified dividend paid during the taxable year by the corporation on its stock.

"(b) QUALIFIED DIVIDEND DEFINED.—For purposes of subsection (a), a dividend paid by a corporation shall be a qualified dividend if—

"(1) the stock with respect to which the dividend was paid was held on the record date for such dividend by a trust which forms part of a profit-sharing or stock bonus plan described in section 401(a), and

"(2) the dividend is paid by the trust to the employees who are covered by such plan during the year in which it is received by the trust in the proportion in which such dividend is to be allocated to the employees under the plan."

(b) The table of sections for such part is amended by adding at the end thereof the following new item:

"SEC. 251. Dividends paid on stock held by certain qualified employee trusts."

(c) The amendments made by this section shall apply only with respect to dividends paid after the date of the enactment of this Act.

SEC. 3. (a) Section 404(a)(3)(A) of the Internal Revenue Code of 1954 (relating to the limitation on the deduction for contributions to profit-sharing and stock bonus trusts) is amended by striking out "15 percent" each place it appears and inserting in lieu thereof "30 percent".

(b) Section 404(a)(7) of such Code (relating to the limitation on the deduction for contributions to more than one trust) is amended by striking out "25 percent" and inserting in lieu thereof "50 percent", and by striking out "30 percent" and inserting in lieu thereof "50 percent".

(c) The amendment made by this section shall apply only to taxable years beginning after the date of the enactment of this Act.

SEC. 4. (a) Section 404 of the Internal Revenue Code of 1954 (relating to deduction for contributions of an employer to an employees' trust) is amended by adding at the end thereof the following new subsection:

"(g) Additional Deduction for Certain Contributions—

"(1) General rule.—If contributions are paid by an employer under a plan described in subsection (a)(3) under which such contributions are to be used for the purpose of paying stock acquisition indebtedness of the trust, there shall be allowed, in addition to the deduction allowed under subsection (a), a deduction equal to 50 percent of the amount of the stock acquisition indebtedness paid by the trust during the taxable year.

"(2) Stock acquisition indebtedness defined.—For purposes of paragraph (1), the term 'stock acquisition indebtedness' means the principal amount of any indebtedness of the trust incurred in connection with—

"(A) a qualified stock purchase by the trust of stock of the employer, and

"(B) any purchase from the employer by the trust of any stock (including treasury stock) of the employer.

"(3) Qualified stock purchase defined.—For purposes of paragraph (2)(A), the term 'qualified stock purchase' means the purchase by a trust of issued and outstanding stock of the employer if immediately after such purchase the trust is in control of the corporation. For purposes of the preceding sentence, the term 'control' means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation."

(b) The amendment made by subsection (a) shall apply only to taxable years beginning after the date of the enactment of this Act.

EXHIBIT II

BANGERT & CO.
INCORPORATED
INVESTMENT BANKERS

111 PINE STREET
SAN FRANCISCO, CALIFORNIA 94111
(415) 788-7454

September 28, 1973

John M. Martin, Jr., Chief Counsel
Committee on Ways and Means
Room 1102, Longworth House Office Building
Washington, D.C. 20515

Re: House Bill H.R. 4200 (H.R. 10470)

Dear Mr. Martin:

Proposed Amendment to H.R. 4200 (H.R. 10470)

Senate Bill S.1179, recently reported out by the Senate Finance Committee and added as an amendment to House Bill H.R. 4200 (H.R. 10470), on the whole responds carefully to many of the problems raised in the various hearings, but it does contain at least one serious flaw. Unlike Senate Bill S.1179, as originally proposed and reported to the Senate on August 21, 1973, the prohibited transaction sections of H.R. 4200 contain no exemptions for the purchase of employer securities by a stock bonus plan from the employer or from a ten percent (10%) or more stockholder, or for the guarantee by the employer or other party in interest of loans to a stock bonus plan. This change, we believe inequitably defeats the efficient acquisition of ownership of company stock by employees covered by such plans. From the standpoint of U.S. employees, such plans are far more generous than other types of retirement plans.

It seems inconceivable that Congress, in its attempt to expand and protect employee benefits, would knowingly eliminate this exemption. It also seems inconceivable that Congress would, on the one hand, require greater protection of employee benefits by requiring expanded coverage, earlier vesting, earlier funding, portability of benefits, etc., but would, on the other hand, eliminate the one benefit that is most directly meaningful to employees, the ability to acquire a substantial ownership interest in the companies for which they work.

In order to correct this technical flaw in H.R. 4200, we recommend that the exemptions which were contained in proposed Internal Revenue Code §4973(d)(2)(C) and §4973(d)(2)(H)(ii) of S.1179, as originally proposed, be reworded and reinserted in H.R. 4200 as new subparagraph (K) under §4974(d)(2) as follows:

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"(K) STOCK BONUS PLAN - The acquisition from a party in interest of a security issued by an employer or a member of an employer group by a stock bonus plan described in section 401(a) is not a prohibited transaction if the trust pays therefor an amount which is not in excess of the fair market value of the security at the time of acquisition and if the loan or other extension of credit incurred in connection with such acquisition is on terms at least as favorable to the trust as an arm's-length transaction with an unrelated party would be."

We also recommend that a corresponding exemption be made under proposed §15(c) of the Disclosure Act by adding the following new paragraph (7):

"(7) the acquisition from a party in interest of a security issued by an employer or a member of an employer group by a stock bonus plan described in section 401(a) if the trust pays therefor an amount which is not in excess of the fair market value of the security at the time of acquisition and if the loan or other extension of credit incurred in connection with such acquisition is on terms at least as favorable to the trust as an arm's-length transaction with an unrelated party would be."

THE LIMITED EFFECT OF THE PROPOSED AMENDMENTS

The amendments herein proposed create a very limited and narrow exception to the prohibited transaction provisions. The exceptions created would only apply to stock bonus plans. The purpose of the exceptions would be to enable a stock bonus plan to purchase or otherwise acquire shares of the stock of the employer company either from the company or from any shareholder, and to enable the employer company or a shareholder of the employer company to lend money or extend credit to a stock bonus plan for the limited purpose of enabling the stock bonus plan to acquire stock of the employer company.

It is most important to the operation of the stock bonus plan that the trust thereunder be permitted to purchase or otherwise acquire stock of the employer company. Indeed, one of the elements of the definition of a stock bonus plan is that benefits thereunder are distributable in stock of the employer company. See Income Tax Regulation §1.401-1(a)(2)(iii). As is stated in the Senate Finance Committee report on S. 1179 (Section IV.G. entitled "Acquisition of Securities of the Employer"), ". . . such limitations in these cases would be inconsistent with the nature of these plans."

Again, the exemption would apply only to stock bonus plans and only to the lending of money or other extension of credit to the trust and only if the purpose of the loan or extension of credit is to enable the stock bonus plan to achieve its principal purpose, which is to acquire stock of the employer company.

Accordingly, the proposed amendment creates a much more limited exception than the exceptions which were originally included in S. 1179 in §§4973(d)(2)(C), (H)(ii) and (H)(iii).

A DESCRIPTION OF EMPLOYEE STOCK OWNERSHIP PLAN FINANCING

In an ordinary stock bonus trust the annual employer contributions to the trust may be made in cash or in company stocks. If in cash, the funds contributed are used to purchase employer securities for the accounts of employees either from the company or from holders of outstanding shares. When the employee retires or terminates his employment with the company the shares are distributed from the employee's account in the trust. An Employee Stock Ownership Plan is a stock bonus plan in which the employer securities are acquired at the outset with borrowed funds and the loan is paid off out of annual employer contributions. The essential aspects of Employee Stock Ownership Plan financing are as follows:

An employee stock bonus trust is established under §401(a) of the Internal Revenue Code. Such trusts normally cover all employees of the corporation and their relative interests are proportional to their relative annual compensation over the period of years that the financing is being paid off.

The trust obtains a loan from a bank or other lending organization, gives its note to the lender, and uses the proceeds of the loan to purchase either newly issued stock of the corporation or outstanding stock of the corporation at its current fair market value.

Since no bank or lending institution would be willing to loan the trust sufficient money to make such an investment, the corporation issues its guarantee to the lender, thereby assuring the lender that it will make annual payments to the trust in amounts sufficient to enable the trust to amortize its debt to the lender.

Each year as the payment is made by the corporation into the stock bonus trust, there is allocated proportionately among the accounts of the participants in the trust a number of shares of stock proportionate to the participants' allocated shares of the payment.

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As the financing is completed and the loan paid off, the beneficial ownership of the stock accrues to the employees.

Although the foregoing is the most typical example of Employee Stock Ownership Plan financing, two other variations are used:

1. The trust may borrow funds from a bank or other lending institution and, instead of using the proceeds of the loan to purchase newly issued stock, the trust may use the proceeds to purchase stock from existing shareholders at no more than its current fair market value.

2. If the shareholders are willing, the trust may, instead of borrowing from a bank or other lending institution, purchase stock from the company's shareholders at its current fair market value and give the shareholders its note for the purchase price.

In each of these transactions, the entire benefit of the transaction accrues to the employees covered by the stock bonus plan in that they acquire the beneficial ownership of a block of shares at present fair market values and in a block larger than could be purchased with a single year's contribution.

The advantages of an Employee Stock Ownership Plan to the covered employees are threefold:

1. The employees obtain beneficial ownership of the securities at present fair market values. In an ordinary stock bonus plan, each year's annual employer contribution must be used to purchase employer stock at its then present fair market value. Hence, during periods of inflation and during periods of increased corporate stock values, each year's annual contribution purchases fewer and fewer shares for the benefit of covered employees. In an Employee Stock Ownership Plan, on the other hand, the trust obtains ownership of the shares at the fair market value of the employer's stock on the date of purchase.

2. In an Employee Stock Ownership Plan, the trust is normally thus able to obtain a larger block of securities than could be purchased with a single year's contribution.

3. In an Employee Stock Ownership Plan, since the securities are acquired at the outset rather than gradually over a period of years, there is a larger potential benefit to employees in that there is a larger investment that is subject to

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Page Five

appreciation; the appreciation occurs over a longer period of time, and, in the case of dividend paying securities, there is a larger investment which accrues income which accumulates over a longer period of time.

EFFECT OF THE PRESENT PROVISIONS
OF §4974(d)(1)(A) and (B) OF H.R. 4200

Subparagraph (A) of §4974(d)(1) prohibits the sale or exchange of any property between the trust and a party in interest. Subparagraph (B) of §4974(d)(1) prohibits the lending of money or other extension of credit between the trust and a party in interest.

Under subsection (e) a party in interest is defined to include an employer, a controlling shareholder, an officer, director, or ten percent or more shareholder.

The effect of subparagraph (A) would be to prohibit an Employee Stock Ownership Plan from purchasing either newly issued stock from the corporation or outstanding stock from the corporations's shareholders.

The effect of subparagraph (B) would be to prohibit an Employee Stock Ownership Plan from financing the purchase of either newly issued stock from the corporation or existing stock from the corporation's shareholders. That is, if the Employee Stock Ownership Plan desired to purchase newly issued stock, it would not be allowed to give a note to the corporation. Similarly, if the trust desired to purchase stock from the corporation's shareholders, the trust would not be able to acquire the stock by giving a note to the shareholder. Nor could it purchase in either case under an installment-purchase contract.

Subparagraph (B) also has the effect of prohibiting an Employee Stock Ownership Plan from borrowing money from a bank or other third party lending source. Since an Employee Stock Ownership Plan has no assets other than the assets beneficially owned by employees because allocated to their accounts and securities that are purchased but not paid for, an Employee Stock Ownership Trust is able to borrow funds from a third party lender only if the loan is guaranteed by the corporation. Subparagraph (B) prohibits the lending of money or "other extension of credit" by a party in interest. Accordingly, subparagraph (B) would also prohibit the corporate guarantee of a third party loan to the Employee Stock Ownership Plan, and also would prohibit the company itself to make loans to the trust for such purposes as purchasing stock from retired employees wishing to convert their holdings into cash.

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Subparagraphs (A) and (B) were surely not intended to have these effects. Subparagraphs (A) and (B) were intended to accomplish a wholly different purpose, relating to pensions, and it was apparently not realized that these subparagraphs would virtually stalemate the use of Employee Stock Ownership Plans and Trusts.

An Employee Stock Ownership Plan, however, does not involve any borrowing of money from the trust by the company or by any party in interest. Moreover, an Employee Stock Ownership does not involve a situation wherein the borrowing of funds by the trust has either the purpose or effect of furnishing capital or property for use in the employer's business at a time when the employer's financial condition is such that is is unable to borrow money from usual financial sources. Clearly the Employee Stock Ownership Trust would be unable to borrow the money and finance the purchase of the company stock unless the company's guarantee were the real security behind the financing. In the case of all Employee Stock Ownership Plan financings which we have ever seen, it has been the credit worthiness of the company and its guarantee of the trust debt that the lender has relied upon in extending the financing.

EFFECT OF PROPOSED AMENDMENT TO §4974(d)(2)

The effect of the amendment herein proposed to H.R. 4200 would be to create an exemption from subparagraphs (A) and (B) in order to enable a stock bonus plan to purchase securities from the employer corporation or from an existing shareholder of the employer corporation, as they have been permitted to do under present law, and in order to enable the employer corporation or a shareholder of the employer corporation to loan money or otherwise extend credit to a stock bonus plan for the limited purpose of enabling the plan to purchase employer securities.

We believe that this exemption, which would apply only in the case of a stock bonus plan and not to a pension plan or profit-sharing plan, creates a very limited exception, which would be beneficial to the employees covered by a stock bonus plan, and would in no way involve any potential for misuse or diversion of trust fund assets.

ARGUMENTS IN SUPPORT OF
THE PROPOSED AMENDMENT

We would like to emphasize that we strongly support the various provisions of H.R. 4200 which provide for earlier vesting, earlier funding, and for greater assurances that trust assets will be administered and distributed in a manner which is in the best interest of the employees.

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We recognize that the principal purpose of a pension plan is to provide fixed retirement benefits to employees and that the incentive element should be down-played in the case of a pension plan.

Unlike a pension plan or a profit sharing plan, a stock bonus plan is specifically designed to invest its assets in employer securities. In a stock bonus plan, the emphasis is on employee incentive and, accordingly, the Internal Revenue Code has long permitted employers to use a stock bonus plan to create employee ownership in securities.

Since a stock bonus plan is necessarily a plan which invests in employer securities, no purpose would be served by prohibiting a stock bonus plan from purchasing employer securities. Such a restriction would be a major impediment to the continued operation of many stock bonus plans in the United States whereby employees, in many cases, have been able to acquire a major portion, and in some cases total ownership of the company for which they work. To prohibit a stock bonus plan from purchasing employer securities would be wholly inconsistent with these objectives.

Further arguments in favor of the adoption of the proposed amendment are as follows:

1. Firstly, a larger number of shares can be purchased due to the purchase at a fixed price. Secondly, employee incentive is greatly enhanced due to the fact that the employees have not merely an unspecified committment from the company to make future contributions, but, in effect, have a "funded" trust and an identifiable interest in specifically segregated trust assets which can be "earned-out" by them over a period of years. Accordingly, an Employee Stock Ownership Trust is of more benefit to the employees than an ordinary stock bonus plan.

2. The whole purpose of the Private Pension Security Bills of 1973, the whole tenor of the hearings, and of the testimony that has been presented before Congress, and the principal emphasis and all of the various bills, has been to provide greater protection to employees, to allow greater benefits to employees and to insure and guarantee that benefits promised to employees actually accrue to employees upon termination of service or retirement. Accordingly, all of the Bills have provided for expanded participation, for earlier vesting, for earlier funding, for higher fiduciary standards, etc. As shown above, a stock bonus plan which purchases employer

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securities at the outset does commit the corporation in advance to funding and assures employees that they will acquire the maximum number of shares which the employer contributions can possibly provide. Hence, an Employee Stock Ownership Plan provides greater assurances that the benefits promised by the plan will actually be provided to the employees than any other type of plan. Accordingly, it would be wholly anomalous for any Private Pension Security Bill to eliminate the option of employers voluntarily to use Employee Stock Ownership Plans.

3. H.R. 4200, in the section relating to fiduciary standards (§15(b)(2)(A)) of the Disclosure Act, provides that the investment of trust assets in employer securities by the trustee of a stock bonus plan, a profit sharing plan, a thrift plan or similar plan, shall not be deemed to be a breach of fiduciary obligations. Again, it would be wholly anomalous to provide, on the one hand, that a trustee of a stock bonus plan may invest trust fund assets in employer securities on a year-by-year basis, but may not, on the other hand, provide even greater employee benefits by purchasing employer securities at a fixed price at the outset, using borrowed funds or installment purchase contracts.

For the foregoing reasons, we urge you to approve the proposed amendment for insertion into H.R. 4200. If you have any questions concerning the amendment, or if you desire us to comment further on any matters regarding these amendments, please call Louis O. Kelso or John D. Menke at (415) 788-7200.

Very truly yours,

BANGERT AND COMPANY, INC.

By____________________
Louis O. Kelso,
General Counsel

NOVEMBER 1974 / VOLUME 54 NUMBER 11

EXHIBIT 5
to Testimony of Louis O. Kelso

Joint Economic Committee
Hearings on Employee Stock
Ownership Plan (ESOP) Financing

December 11 and 12, 1975

SURVEY OF CURRENT BUSINESS

UNITED STATES DEPARTMENT OF COMMERCE / SOCIAL AND ECONOMIC STATISTICS ADMINISTRATION/BUREAU OF ECONOMIC ANALYSIS

By MARSHALL E. BLUME, JEAN CROCKETT, AND IRWIN FRIEND

Stockownership in the United States: Characteristics and Trends

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Part 1: Introduction and Summary

RELATIVELY little is known about the patterns of stockownership or changes in these patterns over time, although stockholdings are a highly important component of total wealth, especially for individuals at upper income levels. Even the available historical series on the total market value of stock owned by U.S. individuals (and by individuals and nonindividuals combined) are subject to a substantial margin of error. More deficient still is the information on the value and characteristics of individual issues and stock portfolios held by various income and other sociodemographic groups and on the investment experience of these groups. Such information is valuable for analyses of a wide range of economic issues, including problems associated with the inequality in the distribution of income and wealth, the magnitude and timing of asset effects on consumption and saving, and the riskiness and performance of stock investments held by different groups.

NOTE.—The authors are Professors of Finance and members of the Rodney L. White Center for Financial Research at the Wharton School of the University of Pennsylvania. The research on which this article is based was financed by a grant from the National Science Foundation and was greatly assisted by the cooperation of the Bureau of Economic Analysis (BEA).

The purpose of this article is to fill in some of these deficiencies, mainly on the basis of data on individual dividend receipts and the income, occupation, location, and broad age grouping of the recipients, as reported in two large stratified random samples of individual income tax returns (forms 1040) for 1960 and 1971. Although the information from the 1960 special sample was analyzed in earlier papers, this article represents the first use of the 1971 data.[1]

The 1971 results are based on a special random sample of 17,056 returns, stratified so as to oversample greatly the upper income groups. The actual returns were sampled by the Internal Revenue Service (IRS). For each return in the sample, the data on the amount of individual dividend receipts, the names of the payer corporations, and the income and other sociodemographic characteristics of the taxpayers (but not their names) were transmitted to the Census Bureau. The authors provided to Census the information on the dividend yield, market rates of return, industry, size, and risk characteristics for each of the payer corporations listed in the sample returns; Census then prepared tapes matching the corporate information with the

1. J. Crockett and I. Friend, "Characteristics of Stock Ownership," *Proceedings of the Business and Economic Statistics Section of the American Statistical Association*, 1963, and I. Friend and J. de Cani, "Stock Market Experience of Different Investor Groups," *Proceedings of the Business and Economic Statistics Section of the American Statistical Association*, 1966.

data on the individual returns. These tapes, which were designed to preserve the anonymity of individual returns, were used by BEA to carry out the tabulations necessary for this study. Only IRS had access to the actual returns.

The 1960 and 1971 special samples are unique in that, by permitting the matching of characteristics of individual stockholders with those of the stock-issuing corporations, they make it possible to estimate the market value of stock owned by different sociodemographic groups. Although IRS publishes annually the distribution of dividends by income class of recipient, it is not possible to estimate satisfactorily the distribution of market value directly from these data, since price-dividend ratios may vary substantially by income class. Using dividend receipts from individual payer corporations and applicable price-dividend ratios, the 1960 and 1971 special samples provide the basis for estimating average price-dividend ratios for stock held by different groups of individuals. While the market value of stock held by these groups can be estimated directly from the sample data, somewhat more reliable estimates of the distribution of market value by income class are obtained by applying the estimated price-dividend ratio for each income class to the aggregate IRS figure for dividend receipts by that class. The distributions of market value by other sociodemographic characteristics estimated from the sample data are made to conform to the distribution by income class obtained in this way. (A detailed description of the procedures followed, including the adjustments made for nondividend-paying stock, is provided in the appendix to part 5.)

From the 1960 and 1971 data, it is possible not only to obtain fairly reliable estimates of the distribution among sociodemographic groups of the market value of all stock held by individuals but also to determine other characteristics of the stock held by these groups. The data can further be used to analyze portfolio performance and risk characteristics and to improve the accuracy of estimates of the total market value of outstanding stock in the United States.

Some information—specifically, estimates of the distribution of dividend income and market value of all stock by income class—will be presented for 1958, 1964, 1969, and 1970, as well as for 1960 and 1971. However, the market value estimates for the first 4 years are not as reliable as for the last 2.

Summary of main result

The main results and implications of the analysis are:

1. The concentration of dividend income and market value of stock among upper income groups continued to decline from 1958 to 1969, but not from 1969 to 1971. The share in stockownership of the wealthiest 1 percent of the population changed very little over the entire period, in contrast to an appreciable decline from 1958 to 1969 in the share of the other upper income groups. Other data suggest that the 1958–71 period was characterized by stability, or a slight decline, in the concentration of total family income and net worth, although these estimates—especially those for net worth—are subject to substantial error.

2. Although data on the distribution of income and net worth after 1971 are not available, the sharp drop in stock prices since then, relative to prices of other assets, implies a significant decline in the concentration of net worth, inasmuch as stock constitutes a major part of the assets of the upper, but not of the lower, income groups. However, no similar effect on the distribution of total income between the two groups would be expected, since dividends, unlike stock prices, have not been depressed.

3. Although the distributions of both total income and dividend income became considerably less concentrated from the 1920's to the end of World War II, only the latter continued to show a significant trend toward less concentration in the following years, and even that trend seems to have abated substantially in recent years.

4. Despite the fairly substantial movement in the postwar period, and probably earlier, toward a more egalitarian distribution of stockownership, the 1971 distribution among different income classes remained quite concentrated. Thus, the 1 percent of U.S. families (including single individuals) with the largest personal income accounted for 47 percent of dividend income received and 51 percent of the market value of stock owned by all families, while the 10 percent of families with the largest income accounted for 71 percent of dividend income and 74 percent of market value. (Foreign as well as domestic stock and beneficial ownership of stock held by fiduciaries and agents are reflected in these figures.) The 1 percent and 10 percent groups in 1960 owned 50 percent and 79 percent, respectively, of the market value of families' shareholdings. The 1971 and 1960 figures, each of which is based on a single year's income, probably understate the concentration of stockownership that would be indicated for upper income groups if families were classified by their normal lifetime income or their average income over a period of years.

5. As of mid-1971, U.S. individuals owned an estimated $780 billion in stock. (This is moderately higher than the corresponding Securities and Exchange Commission (SEC) and Federal Reserve Board (FRB) estimates and may be compared with $335 billion for mid-1960.) Of the $780 billion, $460 billion was held in domestic New York Stock Exchange (NYSE) and other listed issues, $50 billion in mutual fund stock, $35 billion in unlisted bank and insurance company stock, and $190 billion in direct holdings of other traded and privately held unlisted stock.

6. The two employment status groups with the largest stockownership in 1971 were the managerial and the retired. The relative share of stock owned by families headed by retired persons was appreciably higher than in 1960.

7. In 1971, a surprisingly high proportion of the portfolios held by individuals was dominated by a very small number of issues; thus, the portfolios were not well diversified. This

finding applies to all income groups. Since there is ample evidence that investors are risk-averse, the lack of effective diversification strongly suggests that two of the basic assumptions typically made in capital asset pricing theory cannot both be valid: namely, that investors measure risk by the volatility of the rate of return on the entire portfolio, and that investors hold homogeneous expectations about rates of return and risk. The lack of effective diversification also has important social implications since, in a major downturn in the stock market, a high proportion of investors will do very much worse than the market. Thus, since early last year, when the market value of NYSE stock as a whole dropped nearly 40 percent from its high point, millions of investors—including many with moderate means—must have experienced catastrophic losses.

8. The lower income groups tended to hold somewhat less risky stock than did the upper income groups. Although the latter owned substantially more stock on the average, as high a proportion of their portfolios were as poorly diversified as those of the lower income groups. Mutual funds were a much more, and NYSE stock a somewhat more, important part of lower income portfolios. Among the NYSE stock, the lower income groups were relatively more likely to hold telephone and electric and gas utility stock than the upper income groups, but the differences for telephone stock were smaller in 1971 than they had been in 1960. Electric and gas utility stock constituted a much smaller proportion of holdings of all income groups in 1971 than in 1960.

9. Among employment status groups, managers tended to hold the riskier stock and retired and other not gainfully employed persons the less risky stock.

10. Investors in the upper income groups tended to hold stock with higher price-dividend ratios than other investors did. This tendency is consistent with the greater tax advantages to high-income individuals of stock with low dividend payout, that is, a high earnings retention ratio. The same tendency was observed in 1960, but became more pronounced by 1971.

11. The rates of return realized on average in 1970–72 on stock held by the lower income groups in 1971 were not significantly different from those realized by the middle and upper income groups in these periods. This result is quite similar to that found for the years immediately preceding and following 1960.

12. There were no noteworthy differences in 1971 investment performance among occupational or regional groups holding a substantial amount of stock. This article provides the first comprehensive data on this subject.

13. While the total market value of stock owned by U.S. families and the number of individuals owning stock increased greatly from the late 1950's to 1971 (and still remained much higher than in the earlier period), the percentage of stock owned by individual investors declined appreciably. This decline reflects both the rapid rise in assets of financial institutions and the increased proportion of these assets channeled into stock investment. Many individual holdings of all sizes have been replaced by a much smaller number of large institutional holdings, and a large number of new and generally rather small stockholders have acquired shares through the reduction in holdings of more substantial individual investors. As a result, since institutions have not played an active role in corporate affairs, and small individual investors have tended to be less active than large investors, managerial control of U.S. corporations may have been enhanced over this period.

Part 2: Earlier Studies of Trends in Stockownership

Earlier studies have provided historical insights into a number of different facets of stockownership, though much of the information provided by these studies was based on fairly tenuous data. There are reasonably useful, but rough, long-term estimates of the: (1) total market value of stock outstanding in the United States, (2) aggregate amounts owned by the two major groups of investors—financial institutions and families or households, (3) number of individuals owning stock, and (4) amounts of dividends and of total income received by groups of families classified by total income.[2]

Historically, the market value of stock has increased considerably more than that of total net worth either of the economy as a whole or of the household sector.[3] For many years, stock has been by far the largest of the financial assets held by families and has constituted one of the two major components of household net worth.

Importance of institutions

Excluding personal trusts, most of which are administered by commercial banks, stockholdings and stock trading by financial institutions became important only after World War II. In 1940, such holdings accounted for less than 5 percent of the market value of all outstanding stock in the United States; even by 1950 this percentage was less than 8, in contrast with over 24 percent currently. Stock held in personal trust funds experienced little change in relative importance over the past half-century, accounting for about 10 percent of all outstanding stock owned by noncorporate entities. A relatively small number of institutions now hold close to 35 percent of all outstanding stock; the remainder is owned by somewhat under 32 million individual stockholders.[4]

2. There are no long-term series available on the number of families owning stock.

3. R. W. Goldsmith, R. E. Lipsey, and M. Mendelson, *Studies in the National Balance Sheet of the United States*, National Bureau of Economic Research, 1963, provides historical estimates of the value and composition of assets and liabilities of households and financial institutions. More recent, though less comprehensive, estimates can be found in the Securities and Exchange Commission (SEC) *Statistical Bulletins* and the Federal Reserve Board (FRB) *Flow of Funds* publications.

4. New York Stock Exchange (NYSE) *1973 Fact Book*. The NYSE shareownership series started in 1959.

Despite the marked decline in the share of the market value of all stock owned by individuals, the number of such stockholders has increased greatly since the turn of the century. Earlier studies have indicated that the number of individual stockholders in the first three decades of this century may have risen from about 1 million to 10 million.[5] In the next two decades, the number actually declined, but the decline was reversed in the 1950's. By the end of the decade, the number had increased to about 12.5 million, and by early 1972 a peak of 32.5 million was recorded.

Information on the number of stockholders, or the ratio of that number to the total population, obviously provides a completely inadequate picture of the diffusion of ownership among different sectors of the population. It does not even provide an altogether satisfactory picture of the growth in the number of basic consumer units (families or households) owning stock, since several members of the same basic unit may hold stock in their own names and the number doing so may vary over time as a result of changes in tax laws.

The two major sources of information on historical trends in the distribution of stockownership among different groups are the dividends reported by income class on income tax returns (forms 1040) and the asset data on estate tax returns.[6] Of the two, the estate tax data are less useful information sources because they cover a considerably smaller range of incomes, and, more importantly, because they require a number of questionable assumptions to estimate the assets of wealthy survivors from those reported for wealthy decedents (see part 4).

Importance of upper income groups

The analyses of trends in the distribution of dividend income based on income tax data point to a substantial decrease in the proportion of dividend income received by the highest income classes over the 1919–57 period. On the other hand, over this period, estimates derived from estate tax data point to a moderate increase in the concentration of the market value of stockholdings in the top wealth group. The discrepancy seems too large to be explained wholly by differences that may exist between the concentration of dividend income by income class and the concentration of value of stock by wealth group as a result either of differential movements in price-dividend ratios of stock held by upper and lower income families or of differential movements in the relation of income to wealth for these two groups. As noted previously, the findings from the income tax data seem more reliable and appear to suggest some decrease in the proportion of stock held by the upper income and probably also the upper wealth families. Those findings also seem more plausible in light of the fairly broad range of evidence that the concentration of total income in the upper income groups diminished during most of this period.[7]

Data on the distribution of dividend income, based on income tax returns, and on the distribution of the market value of stock, based on estate tax returns, are available for a number of years after the late 1950's. These will be discussed in part 4 of this article in conjunction with the data for 1971.

Probably the most comprehensive and reliable data previously available on the distribution of stockownership by income class and by other socio-demographic characteristics are contained in the 1960 study, which is the precursor of the present analysis.[8] The 1960 and 1971 studies make possible the first reliable estimates of the market value and of the ownership trends of stock held by different groups of families over this period. In addition to giving information on the distribution of stockownership, the two studies also make possible improved estimates of the market value of outstanding stock in the United States and provide new information in the risk, rate of return, and other characteristics of the stock held by different groups.[9]

Part 3: Distribution of Dividends and Stockholdings Among Broad Groups

A basic input in estimating the aggregate value and distribution by income class of the shareholdings of individuals is the information on dividends reported on Individual Income Tax Forms 1040. Such information, based on a very large sample of returns, is developed each year by the Internal Revenue Service (IRS) and published in *Statistics of Income: Individual Income Tax Returns*. However, the Statistics of Income (SOI) data omit two components of dividends allocable to individuals: (1) dividends retained by estates and trusts on individuals' behalf as beneficiaries, and (2) dividends received by individuals, but not reported on individual tax returns, either because recipients were not legally required to report them or because recipients illegally underreported them.

The dividend gap

The aggregate magnitudes of the two omitted components were estimated by the following procedure. The first aggregate was derived from total dividend receipts of estates and trusts as reported on fiduciary income tax returns, after allowance for distribu-

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5. See E. B. Cox, *Trends in the Distribution of Stock Ownership*, University of Pennsylvania Press, 1960, for a summary of these studies.

6. The income tax data have been analyzed in S. Kuznets, *Shares of the Upper Income Groups in Income and Savings*, National Bureau of Economic Research, 1953, and Cox, *Trends*. The estate tax data have been analyzed in R. Lampman, *The Share of Top Wealth-holders in National Wealth*, National Bureau of Economic Research, 1962.

7. Kuznets, *Shares*, and D. B. Radner and J. C. Hinrichs, "Size Distribution of Income in 1964, 1970, and 1971," SURVEY OF CURRENT BUSINESS, October 1974.

8. The earlier results are presented in Crockett and Friend, "Characteristics," and Friend and de Cani, "Stock Market Experience."

9. The 1960 figure on the market value of outstanding stock was used as a new benchmark by the SEC.

tions of fiduciary income to individuals and other categories of beneficiaries. The income tax data, which are available for 1970, were updated by using the market value of stock held by bank-administered trusts and estates in 1971 (see appendix to part 3). The second aggregate was derived by comparing domestic corporations' total cash distributions to stockholders, as reported on corporation income tax returns, with total dividend receipts as reported on forms 1040, after allowance for dividend receipts of other stockownership groups and a number of reconciliation items (see table 1).[10]

Total cash distributions of domestic corporations exceed the receipts of domestic individuals by the dividends paid to domestic corporations, nonprofit institutions, and foreigners and by the dividends paid to fiduciaries, but retained by them or used to pay taxes or defray expenses. Such dividends therefore had to be subtracted in arriving at the cash distributions paid to individuals.[11] On the other hand, cash distributions paid by foreign corporations to domestic individuals had to be added. These adjustments produce a figure of $20.5 billion for 1971 cash distributions by domestic and foreign corporations to domestic individuals (see table 1).

Some portion of this total is not reportable as dividend income on individual income tax returns: (1) distributions of small business corporations electing to be taxed as partnerships, (2) distributions taxable as capital gains, and (3) nontaxable distributions. For comparability with dividends actually reported on forms 1040 in 1971, these distributions had to be subtracted; this procedure yields a figure of $17.8 billion for dividends reportable on individual income tax returns. Compared with the $16.8 billion reported in 1971, there is a dividend gap of about $1 billion.

Table 1.—Estimation of Dividend Receipts by Individuals Not Reported on Individual Income Tax Returns, 1971

[Millions of dollars]

1. **Distributions (other than own stock) of domestic corporations**	32,580
2. Less: Domestic dividends (other than those paid by Federal Reserve Banks) received by domestic corporations	3,460
3. Plus: Distributions (other than own stock) by foreign corporations to domestic individuals, fiduciaries and tax-exempt institutions	110
4. Less: Domestic dividends paid to foreigners	840
5. **Equals: Distributions (other than own stock) by domestic and foreign corporations to domestic individuals, fiduciaries and tax-exempt institutions** [1]	26,390
6. Less: Dividends received by corporate pension funds	2,460
7. Dividends received by State and local government retirement funds	330
8. Dividends received by other tax-exempt institutions (including those distributed through fiduciaries)	1,440
9. Dividends retained by estates and trusts or utilized to pay taxes or administrative costs	1,660
10. **Equals: Distributions (other than own stock) by domestic and foreign corporations to domestic individuals** [2]	20,500
11. Less: Distributions of small business corporations taxed as partnerships	1,290
12. Nontaxable distributions	560
13. Distributions taxable as capital gains	850
14. **Equals: Dividends reportable on individual income tax returns**	17,770
15. Less: Dividends reported on individual income tax returns	16,700
16. **Equals: Dividend gap**	960

1. Includes a small amount of nondividend cash distributions paid to domestic corporations and foreigners.
2. Includes a small amount of nondividend cash distributions paid to other ownership groups.

Source: See appendix to part 3.

This dividend gap is presumed to consist of three components: (1) the small amount of illegal underreporting of dividends revealed by audit checks, (2) dividends received by nonfilers—either those with gross income so low that they were not legally required to file or those who escaped audit checks, and (3) dividends below the exclusion, which the recipients neglected to indicate on their tax forms and which were not found on audit.[12]

Since different procedures should be used in distributing the three components by income class, rough estimates of their relative magnitudes were made. An estimate of illegal underreporting at 2 percent of reported dividends gives a figure of $340 million. This percentage is considerably less than the 5 percent figure assumed in the 1960 study. The 5 percent figure, based on 1959 IRS estimates published by Holland, was derived by checking corporate information reports against stockholders' income tax returns.[13] No current estimates on this basis have been published, but unpublished IRS studies show a substantial reduction in underreporting since 1959. This reduction is partially attributable to increased enforcement effort by the IRS and partially to the policy of making available to the individual stockholder a statement of the dividends ascribed to him in corporate information reports to IRS. A lower limit to current underreporting is probably represented by the 1½ percent implied by the IRS 1963 Taxpayer Compliance Measurement Program data, which do not attempt to match individual reports with corporate information reports.

The dividends attributable to nonfilers are estimated at $430 million, or two-thirds of the remaining gap. This figure is considerably above the 1960 estimate, in part because the gross income requirement for filing was subsequently raised from $600 to $1,700 ($2,300 on joint returns and higher for retired persons). In addition, New York Stock Exchange (NYSE) figures indicate a very large increase (of almost 1 million from 1965 to 1970) in the number of minors owning stock,[14] a high proportion of whom are likely

10. A detailed explanation of the sources and procedures utilized in deriving the items in this table is given in the appendix to part 3. A comparable table for 1960 appears in Crockett and Friend, "Characteristics."

11. For some ownership groups, dividend receipts had to be inferred from the market value data provided by Government sources. This required that market value be multiplied by a ratio of dividend-paying stock to total stock appropriate to the types of stock held, to obtain the value of dividend-paying stock only. This figure then must be multiplied by a dividend yield (dividend-price ratio) appropriate to the portfolio held, to obtain dividends. For estates, trusts, nonprofit institutions, and foreigners, the proportion of stock paying dividends and the dividend yield utilized are those characteristic of listed stock and large unlisted issues traded over the counter (OTC). For simplicity, the two steps described were combined, and market value was multiplied by the ratio of dividends to total market value for the broad class of stock appropriate to the portfolio of a particular ownership group.

12. In 1971, there was no requirement that dividends be listed on schedule B if total dividend receipts fell below $100. While such dividends should have been indicated on the first page of the return (and thus caught by the SOI sample, though not by the 1971 special sample), it is probable that some filers may have neglected to do so since no tax liability was involved.

13. D. M. Holland, *Dividends Under the Income Tax*, Princeton University Press, 1962, p. 90.

14. NYSE, *Shareownership, 1970*, p. 6.

to have gross income below the current requirement for filing.[15]

The remaining $210 million of the dividend gap is attributed to the omission of dividend receipts from tax returns in cases where receipts were within the legal exclusion. Although about 4¼ million filers in 1971 listed dividends totaling less than the exclusion to which they were entitled, the NYSE stockholder census indicates that there were 12¾ million holders with portfolios under $5,000 at the beginning of 1970.[16] Receipts of a large proportion of these stockholders would be expected to fall below the $100 exclusion, so that the total number of individuals receiving dividends in this amount may substantially exceed the 4¼ million filers who reported dividends below the exclusion. The average dividend received in such cases would, of course, be very small.

Unlisted domestic stock

The information in table 1, augmented by data drawn from Government or industry sources and from the 1971 special sample of individual income tax returns described in the appendix to part 5, can be used to generate estimates of the aggregate market value of unlisted domestic stock and of its distribution among ownership groups. Such stock is a very substantial component of the total financial wealth of households, but existing estimates of its total value are subject to wide margins of error. While the Investment Company Institute (ICI) provides reliable figures on the market value and business and institutional holdings of mutual funds, and the Securities and Exchange Commission (SEC) estimates the market value of unlisted stock of banks and insurance companies, no similarly reliable estimates are available for other unlisted stock. This residual group is largely nonfinancial; and a significant proportion is not traded over the counter (OTC), in which case, price quotations are unavailable.[17]

Two basic approaches that have customarily been used to estimate the value of the residual group of unlisted stock are followed here. A third procedure, depending in part on the 1971 special sample of individual income tax returns, is also presented.

The first approach is based on aggregate cash distributions on all categories of stock, which can be determined with a high degree of accuracy from corporate income tax data. From this, dividends on listed stock, mutual funds, and unlisted stock of banks and insurance companies, which can be estimated with varying degrees of accuracy from industry and Government sources, are removed.[18] Next, nondividend distributions are removed, leaving dividends on other unlisted stock as a residual. (These computations are shown in the appendix to part 3.) An estimate of the aggregate value of dividend-paying stock in the residual category is obtained from aggregate dividends by dividing by an appropriate dividend yield, based on a large market value-weighted sample of stock in the category under consideration.

This method, however, provides no firm basis for estimating the value of nondividend-paying stock. Evidence indicates that a far higher proportion of unlisted than of listed stock pays no dividends. It is possible to estimate this proportion on a sample basis for the category of stock under consideration; and the aggregate previously obtained for dividend-paying stock can then be correspondingly augmented. However, little confidence can be placed in such an estimate because samples are necessarily drawn from an incomplete listing that consists only of issues for which price quotations are available, and because the large sample that is available from the Rodney L. White Center files almost certainly overrepresents large firms to a very substantial, but unknown, degree.[19] Since it is clear, from classifying this sample by market value of stock, that the proportion of nondividend-paying stock increases sharply as firm size decreases, the overrepresentation of large firms is a considerable disadvantage.

The second approach deals directly with market values, but on a sample basis. Data on number of shares outstanding are collected for individual firms for which price quotations can be found. The NYSE, in connection with its most recent census, *Shareownership, 1970*, contacted 7,450 unlisted firms (other than mutual funds) early in 1970 and determined their market value to be $366 billion. Such a sample aggregate, since it is not exhaustive, necessarily understates the universe total. At a minimum, the NYSE figure must be adjusted upward to account for unlisted stock (other than mutual funds) not traded OTC. From the adjusted figure, it is then necessary to eliminate the market value of unlisted stock of banks and insurance companies to arrive at the aggregate that is being measured.

Apart from the mutual fund component, any estimate of the market value of unlisted stock not traded OTC is subject to a wide margin of error. The procedure in this study follows that of Tri in basing the estimate on 1965 estate tax data, which distinguish privately held stock[20] from the holdings of traded stock reported in the 97,000 Federal estate tax returns filed in that

15. Furthermore, the 2 percent estimate used for illegal underreporting in 1971 may not fully correct for nonfilers who were legally required to file. If so, a small but undetermined amount of dividends received by such nonfilers, who are assumed to fall predominantly in the adjusted gross income (AGI) class under $5,000, may be included here.

16. NYSE, *Shareownership, 1970*, p. 9.

17. Unlisted stock not traded OTC (that is, stock in which transactions involving a dealer or broker-dealer do not occur) either is closely held for control purposes, as in a family corporation, or has a strictly local market, as in the case of a smalltown bank or retail enterprise. When the return on such stock is taxed as partnership income, the market value is excluded from the total. This is consistent with national income accounts procedure, which excludes such return from dividend income.

18. Where the sources supply market value rather than dividend data, it is necessary to estimate both the average dividend yield and the proportion of stock paying dividends on a sample basis. Dividend figures are highly accurate for NYSE stock and for mutual funds, less so for other listed stock and unlisted stock of banks and insurance companies.

19. Similar sampling limitations apply to the estimate of average dividend yield utilized in obtaining the aggregate value of dividend-paying stock, but the consequences are less serious since the sample of dividend-paying stock probably covers a large fraction of total market value for the universe sampled. No such presumption can be made for the sample of nondividend-paying stock.

20. Stock that was not identified by executors as traded was considered to be privately held if no price quotations were readily available.

year.[21] Such stock amounted to 15½ percent of other stockholdings, as reported in these returns.

In the 1971 special sample of individual income tax returns, a basis exists for approximating, for that year, the aggregate holdings that correspond to the category of traded stock recognized in the breakdown of stockholdings from the 1965 estate tax returns.[22] An estimate is then derived for individuals' ownership of privately held stock in 1971 by taking 15½ percent of traded holdings. This procedure assumes that the relationship of privately held to traded stock for all individuals in 1971 is similar to that for the decedents represented in the 1965 estate tax returns. To obtain the figure for total market value of privately held stock, a small allowance must be made for holdings of other ownership groups (which may be expected to constitute a rather small proportion of such stock), and the stock of small corporations electing to be taxed as partnerships must be deducted. (This last category of stock is apparently included in the privately held category in the estate tax data, although it is excluded here.)

Both approaches to estimating unlisted stock, other than that of mutual funds and banks and insurance companies, can be seen to involve questionable steps. The first approach encounters particular problems in the estimation of the nondividend-paying component and the second in the estimation of the privately held component. In addition, inaccuracies are certain to be introduced in any process that converts dividends to market value, or vice versa, on the basis of sample estimates of the ratio of one to the other for a particular class of stock.

The third procedure depends, as does the first, on an estimate of the total dividends paid on stock of the requisite type, but it uses the 1971 special sample of income tax returns in determining these dividends. The dividends received by individuals on direct holdings of unlisted stock other than mutual funds are immediately available from the sample. This is a fairly reliable figure, but it must be augmented by estimates of the dividends from unlisted stock held by individuals in agency and custodial accounts and in street name and by fiduciaries and other ownership groups.[23]

Total dividend receipts for stock held in agency and custodial accounts and in street name are obtained from the 1971 special sample; for fiduciaries and other ownership groups, dividend receipts have already been estimated for the purposes of table 1. (See appendix to part 3 for details.) If plausible assumptions are made as to the proportion of dividend income derived from unlisted stock, an estimate can be obtained of dividends on all unlisted stock not held directly by individuals. The assumptions as to portfolio composition for the various groups must meet one constraint: the total dividends allocated to listed stock (including individuals' direct holdings as determined from the 1971 special sample) must be consistent with the highly accurate external figure for total market value of listed stock, taking into account the average dividend yield and the proportion of stock paying dividends that characterize listed stock.[24]

To this estimate of the dividends on unlisted stock not held directly by individuals, the sample-based estimate of dividends on individuals' direct holdings of unlisted stock other than mutual funds must be added. After subtracting the small amount of mutual fund dividends received by groups other than individuals and the aggregate dividends on unlisted stock of banks and insurance companies, an estimate is obtained—alternative to that developed by the first approach—of dividends on the category of stock for which the market value is being determined. The market value of dividend-paying stock is then derived by multiplying dividends by the estimated dividend yield.

As with any approach based on dividend information, the problem remains of obtaining a satisfactory estimate of the value of nondividend-paying stock. However, the 1971 special sample provides some assistance here also. To derive a figure for nondividend-paying stock from the estimated aggregate of dividend-paying stock, it is necessary to estimate the overall ratio of nondividend-paying to dividend-paying issues for the class of stock under consideration. However, it is not feasible to obtain a large random sample from the relevant universe on which to base such an overall ratio. The available sample is believed to be strongly biased in favor of large firms, but it should provide a relatively unbiased estimate of the required ratio within each size class. If appropriate weights were available (ideally, the population aggregate of dividend-paying stock within each size class),

21. *Statistics of Income, 1965: Fiduciary, Gift, and Estate Tax Returns*, table 1. L. M. Tri, "The Market Value of Corporate Stock in the U.S.," SEC Office of Policy Research, June 1971, pp. 20–21.

22. Sample holdings that can be identified as listed stock, mutual funds, unlisted stock of banks or insurance companies, or other unlisted stock traded OTC are presumed to fall in this category, as is stock held in agency or custodial accounts or in street name—that is, stock held as nominee by a bank or brokerage house, for the interest of the beneficial owner. In all but the last case, the dividend data can be converted to market values with some confidence on a company-by-company basis. While the conversion is less precise for stock held in agency or custodial accounts or in street name, the overall figure for market value of individuals' holdings of the group of stock in question is a reliable one. (See part 5 for further details of the conversion procedures.)

Individuals' beneficial ownership of stock through fiduciaries is excluded here, in part because such stock will not necessarily appear as part of the beneficial owner's estate and in part because a significant proportion of the stock in nonbank-administered trusts may be privately held. The total obtained for individuals' holdings of traded stock probably falls short of the figure that would correspond precisely to the traded stock category as utilized in analysis of the estate tax returns—to the extent that traded stock held in trusts does appear in the estates of beneficial owners and to the extent that stock of unidentified paying corporations is in fact traded.

23. There is room for some difference of opinion as to how much, if any, of the dividends for which the paying corporation could not be identified represent listed stock incorrectly specified by the filer. In view of the care taken to identify corporate payers, at least as to listing status, the proportion cannot be large. The 10 percent assumed here is probably an upper limit. There is also an element of arbitrariness in determining how much of the dividend receipts attributed to banks represents dividends on bank stock and how much represents return on stock held in bank-administered trusts that has been distributed to the individual as beneficiary.

24. Since domestic corporations are known to invest heavily in unlisted as well as listed subsidiaries, the assumption is made that the proportion of intercorporate dividend receipts coming from unlisted stock is as high as for individuals' direct holdings, that is, 27 percent. The portfolios for estates and trusts and for agency and custodial accounts are assumed to be similar to those held directly by individuals, but a little more conservative than those held directly by individuals, so that a somewhat smaller proportion of dividend receipts is assigned to unlisted stock. For nonprofit institutions, individuals' holdings in street name, and foreigners, a very small proportion of dividend receipts is assumed to come from unlisted stock.

a weighted average of the ratios for individual size classes would provide a suitable estimate of the overall ratio. The 1971 special sample data on the relative importance of each size class in individuals' holdings of dividend-paying stock within the relevant category is used to indicate population weights.[25]

This use of sample information on individual holdings of dividend-paying stock to approximate population weights is equivalent to assuming that, for each dollar of dividend-paying stock held in a given size class, an amount of nondividend-paying stock is held equal to the ratio of nondividend-paying to dividend-paying stock for that size class. When this weighting scheme is used for averaging over size classes, the average ratio obtained is termed "sample-weighted ratio."

As a check on the sample-weighted ratio of nondividend-paying to dividend-paying stock, a random sample of 130 unlisted stock (not stratified by size) was drawn from the *Bank and Quotation Record*, a listing subject to somewhat less size bias than the large sample available from the Rodney L. White Center files. The small random sample provided an estimate almost identical to the sample-weighted ratio just described.

The estimates obtained by these three approaches are in fairly close agreement. The first approach yields a dividend figure of $5.2 billion and, utilizing sample-weighted averages for the dividend yield and for the proportion of nondividend-paying stock, implies a market value of $318 billion. The second approach yields a figure of $358 billion. This figure is derived by taking the $366 billion figure obtained by the NYSE in early 1970 for 7,450 unlisted firms that were traded OTC,[26] adding $33 billion for privately held stock, other than that of corporations electing to be taxed as partnerships, and subtracting $41 billion of unlisted stock of banks and insurance companies. The third approach yields a dividend estimate of $5.7 billion and, utilizing the same dividend yield and proportion of nondividend-paying stock as in the first approach, a market value of $350 billion—intermediate between the first two estimates, but close to the second. Thus the second and third approaches tend to confirm each other, and this provides some support for the assumptions as to portfolio composition that are utilized in the third approach.

Table 2.—Market Value of All Domestic Issues, by Market Type and Ownership Group, June 30, 1960 and 1971

[Billions of dollars]

Type of stock	All holders, 1960		All holders, 1971		Individuals, 1971: Direct holdings[1]		Individuals, 1971: Beneficial ownership[2]	Nonprofit institutions, 1971[3]	Domestic corporations, 1971	Foreigners, 1971
Listed		326		760		317	144	135	138	26
NYSE, domestic and foreign issues			731							
Other, domestic and foreign issues			54							
Less: Listed foreign issues			25							
Unlisted		160		458		273	43	18	121	3
Mutual funds	16		59		51					
Banks and insurance companies	36		41		33					
Other	108		358		189					
All domestic stock		486		1,218		590	187	153	259	29

1. Includes some stock held in street name. The 1971 special sample did not always permit the segregation of such stock.
2. Stock held by fiduciaries, in agency and custodial accounts and in street name, for the beneficial interest of individuals.
3. Includes pension funds and other nonprofit organizations. See text for complete coverage of item.

Sources: See text and appendix to part 3.

All domestic stock

Market value figures for domestic listed issues, mutual funds, and unlisted stock of banks and insurance companies, as obtained from industry and Government sources are combined with the second estimate for other unlisted stock to obtain total market value of domestic issues (table 2).[27] The second estimate, the largest of the three, is chosen partly because it utilizes a direct attempt to measure market value, rather than an indirect approach via dividends, and thus avoids the difficult problem of evaluating nondividend-paying stock by inference, and partly because its conceptual shortcomings lie in the direction of understatement rather than overstatement. This understatement arises because the NYSE sample cannot have completely exhausted the universe of unlisted traded stock other than mutual funds and because some price rise almost certainly occurred between early 1970 and mid-1971.

Total holdings of individuals (direct holdings plus beneficial ownership of stock held by fiduciaries or in agency or custodial accounts or in street name) are derived from the 1971 special sample of income tax returns, after adjustment to exclude holdings of foreign stock (see table 2). Those of foreigners and nonprofit institutions (corporate pension funds, State and local government retirement funds, foundations, and educational endowments) are derived from Government sources and adjusted as shown in the appendix to part 3. The stockholdings of fiduciaries have been allocated between individuals and charitable organizations in the same proportion as the distributions by fiduciaries shown in that appendix. While total receipts of domestic dividends by domestic corporations are known from corporate income tax data, the market value of the corresponding domestic stockholdings is not known, and so it is computed as a residual (see table 2).

Individuals' direct holdings of listed stock can also be obtained from the 1971 special sample. Information on other holdings of listed stock depends on the assumptions mentioned earlier as to portfolio composition. Specifically, the assumptions are that, (1) for estates and trusts and agency and custodial accounts, 25 percent of the market value (and hence a smaller percentage of the dividends) is assignable to unlisted stock, and (2) for nonprofit institutions, foreigners, and the stock of individuals held in street name, 10

25. Even on this basis, some bias probably still exists toward overrepresentation of large firms, leading to an underestimate of nondividend-paying stock.

26. In view of the unavailability of a broadly based price index for unlisted stock other than mutual funds, no adjustment is attempted to reflect the general price rise that occurred in the first half of 1971, after a very slight decline during 1970.

27. A detailed explanation of the sources and procedures used in deriving table 2 appears in the appendix to part 3.

percent of market value (and hence a smaller percentage of dividends) is assignable to unlisted stock.

Corporate holdings of listed stock are again determined as a residual. When this value is compared with the amount of intercorporate dividends previously assumed to arise from listed domestic issues (that is, 27 percent of the $5.5 billion aggregate obtained from corporate income tax returns), the resulting ratio of dividends to market value [28] is that characteristic of listed stock as a whole. This tends to confirm the reasonableness of the assumptions as to portfolio composition.

Since the stock of mutual funds and unlisted stock of banks and insurance companies is to a very large extent held directly by individuals, and since there are good external estimates of the total market value of such stock, individuals' direct holdings are obtained by adjusting total market value for the holdings of fiduciaries and other ownership groups. The market value of individuals' direct holdings of other unlisted stock is then obtained by removing, from the sample-derived dividends on all direct holdings, the dividends already accounted for by the estimated direct holdings of listed stock, stock of mutual funds, and unlisted stock of banks and insurance companies. The residual dividends are then converted to a market value figure.[29]

The value of unlisted holdings of fiduciaries, nonprofit institutions, and foreigners is already determined by the portfolio composition assumptions, given the data on total stockholdings. The holding of corporations are again determined as a residual.[30]

The total market value for domestic issues was $1,220 billion in mid-1971 (table 2). This is 2¼ times the corresponding estimate for 1960. (The total includes intercorporate holdings—financial and nonfinancial—unlike the SEC figures that are discussed in part 4.) The value for listed stock increased at a slightly lower rate, unlisted nonfinancial stock at a somewhat more rapid rate, and mutual funds, of course, at a much more rapid rate, than the total.[31] In view of the substantial trend during the intervening years toward the listing of bank holding company stock, it is perhaps not surprising that the market value of unlisted stock of banks and insurance companies increased very little.

In 1971, individuals' direct holdings accounted for over 40 percent of listed stock, somewhat over 50 percent of unlisted stock other than that of mutual funds and banks and insurance companies, and about 60 percent of all unlisted stock. Total stock of individuals, including beneficial ownership of stock held by fiduciaries and in agency and custodial accounts and street name, amounted to about 60 percent of listed stock and 70 percent of unlisted stock. Nonprofit institutions accounted for 18 percent of listed stock and, under the assumptions here, for very little unlisted stock. Intercorporate holdings accounted for 18 percent of listed stock and over one-fourth of unlisted stock. The latter result depends to some extent on the assumption that corporations are considerably more likely than individuals to hold substantial amounts of nondividend-paying stock in small unlisted firms other than mutual funds and banks and insurance companies.

28. This ratio is the product of the proportion of stock paying dividends and the dividend yield.

29. The ratio of dividends to total market value used is somewhat higher than the sample-weighted ratio for nonfinancial firms traded OTC. This is done in the belief that individuals probably would not be inclined to hold the very high proportion of nondividend-paying stock that characterizes the small unlisted firms (market value under $15 million) for which there is dividend information.

30. In comparing this residual market value with intercorporate dividends previously assigned to unlisted domestic issues, the ratio of dividends to market value is found to be somewhat lower than the sample-weighted ratio. This is a consequence of the decision to use a somewhat higher ratio in converting dividends on individuals' direct holdings to a market value figure, since the dividends on individuals' direct holdings and corporate holdings combined bear a relationship to the combined market value that is very close to the sample-weighted ratio. If the holdings of each group were made to conform precisely to the overall ratio for the residual category of unlisted stock, the effect would be to increase the total holdings of individuals by about $20 billion and to decrease the holdings of domestic corporations correspondingly.

31. Since 1971, the growth rate of mutual funds has no longer exceeded that of the market as a whole.

Part 4: Trends in Concentration of Stockownership Since Late 1950's

The most widely publicized structural developments in the securities markets over the past two decades have been the very substantial growth in the relative importance of financial institutions in the ownership of corporate stock and the even more rapid rise in their stock-trading activity. These developments, associated with a corresponding decline in the relative importance of individual investors, have been cited as having seriously adverse effects on market liquidity and, indirectly, on the ability of most corporations to raise equity capital. Thus, it has been argued that institutions tend to buy and sell large blocks of stock and to concentrate their activity on a relatively small number of large issues. Also, it has been asserted that, since they are subject to the same influences, have access to the same information, and closely follow each other's assessments and actions, institutions are more often than not on the same side of the market. The result is said to be much greater price volatility in the stock in which institutions trade than would exist in a market dominated by individual investors.[32] Price volatility, except to the extent it can be offset through diversification, increases the risk of stock investment and hence the cost of equity capital. Moreover, it has been claimed that, to the extent institutions divert funds that would otherwise have been invested in small and risky issues, they tend to depress the prices of such issues and, as a result, penalize new ventures.

Trends in institutional stockownership

Pension funds accounted for the largest growth in institutional stockowner-

32. There is no convincing evidence that institutional trading is in fact associated with greater price volatility. The Securities and Exchange Commission (SEC) *Institutional Investor Study* (1971) provides some contrary but generally inconclusive evidence. However, institutions have become much more important in the stock market since the period covered by that study.

ship. Mutual funds, which were a not-too-close second for the period as a whole, were of diminishing relative importance in recent years. Until this study, there had been no systematic examination of the types of individuals who accounted for the decline in the individuals' share of stockownership and trading. It has frequently been asserted, however, that it is the small investor who has left the market as a result of a loss of market liquidity and unfavorable investment experience. Before presenting the new data on trends since the 1950's in the distribution of stockownership among different family income classes, it is useful to review the available information on the changing relative importance of aggregate institutional and family stockholdings.

In 1950, stockholdings of financial institutions, other than stock in bank-administered personal trusts, were about 7.6 percent of the market value of all noninvestment company stock outstanding in the United States owned by domestic individuals, institutions, and foreigners.[33] This figure increased to 16.5 percent in 1960, 19.8 percent in 1969, 22.5 percent in 1971, and 24.0 percent in 1973. The share of the trusts remained relatively constant at 10 percent of all such stock during this period. The share of domestic individuals, inclusive of trusts, declined from 89.1 percent in 1950 to 72.3 percent in 1973. Institutions' relative importance in stockownership is greater for publicly traded corporations and especially so for corporations traded on the New York Stock Exchange (NYSE).

The changes in the proportion of the market value of stock held by institutions reflect the magnitude of their net purchases of stock compared with the size of net corporate stock issues and, presumably to a lesser extent, the price performance of the stock they held compared with the performance of the market as a whole.[34] For 1950–73, institutional net stock purchases of $153 billion substantially exceeded net corporate stock issues of $77 billion. (Net stock issues are defined as sales of stock issues less stock repurchases by U.S. corporations other than mutual funds.) Net stock issues moderately exceeded institutional net purchases until the late 1950's; since then, institutional net purchases have greatly exceeded net stock issues. This excess of institutional net purchases over corporate net sales of stock in recent years, averaging more than $7 billion annually since 1965, represented almost exclusively net stock sales by domestic individuals.

Trends in individuals' stockownership

Some insights into the characteristics of the individuals who sold these substantial amounts of stock to institutions can be obtained from data available before this study. Thus, it is known that odd-lot balances (purchases less sales) on the NYSE and American Stock Exchange (AMEX), which are relatively more important for small than for large investors, turned negative in the late 1950's. The rate of odd-lot net sales, which amounted to $5.0 billion for 1950–73, increased over the period and reached a level of about $2.0 billion annually after 1970.[35] Moreover, since 1971, these odd-lot sales balances have been in excess of net purchases of mutual fund shares, which are generally bought by small investors, and since 1972, more mutual fund shares have been sold than purchased. The rate of odd-lot net sales over the past two decades was only a small fraction of the total net sales by domestic individuals to financial institutions. There is thus some reason to believe that, over this period, larger individual investors were also selling stock on balance, that is, the dollar value of their sales was greater than their purchases.

This belief is further supported by the extremely rapid rate of increase in the number of stockholders after early 1959. This rate of increase was very much larger than the rate of growth in the value of all stock owned by individuals that is attributable to net purchases of stock rather than to changes in stock prices.[36] Thus the average stockholder owned a smaller proportion of all stock at the end of the period than at the beginning. These results seem to suggest an increase in the diffusion of stockownership among small investors.

However, none of this information provides very much insight into the extent of changes in the distribution of stockownership among different groups of families since the 1950's and, in particular, among the more and less affluent sectors of the population. Before the availability of the data provided in this article, there were two sources of data for investigating such changes.

The first consists of Smith's and Franklin's estimates, based on estate tax returns, of the share of corporate stock (and other major components of net worth) held by the richest 0.5 percent and 1.0 percent of the population in 1953, 1958, 1962, 1965, and 1969.[37] The second consists of the more comprehensive data on the income distribution of dividends by adjusted gross income (AGI) class available annually (currently through 1971) from the Internal Revenue Service (IRS) publication *Statistics of Income—Individual Income Tax Returns*.[38]

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33. Intercorporate holdings, other than investment company holdings of noninvestment company stock, are excluded from the total; foreign issues outstanding in the United States are included. The source of the estimated holdings of institutions, which includes nonprofit organizations, is the SEC *Statistical Bulletin*. Estimates of the total market value of outstanding stock were also obtained from the SEC for 1950 and 1960, and from the procedures outlined in this article for 1971. Rough approximations were obtained for 1969 and 1973 by extrapolating the 1971 figure on the basis of the trends shown by the corresponding SEC series. All figures are yearend.

34. A number of studies document that the investment performance of institutional investors (that is, rate of return for a given risk) has not differed significantly from that of the market as a whole and that the risk characteristics of stock held by individuals and institutions differ markedly only in the much higher proportion of non-NYSE stock owned by individuals. Therefore, the only noteworthy impact of differences in price performance on the relative importance of institutional holdings of stock would reflect differences in the price trends of NYSE and other stock. There is evidence to suggest that NYSE stock did not fare as well as other stock for much of the 1960's (SEC *Institutional Investor Study*), but the reverse was probably true in subsequent years.

35. SEC *Statistical Bulletins* for monthly 1973 data; NYSE *1973 Fact Book* and AMEX *1973 Data Book* for annual data for other years.

36. See part 2 of this article for historical and recent data on number of stockholders: R. W. Goldsmith, *A Study of Savings in the United States*, Princeton University Press, 1955, for historical data on net stock purchases by individuals; and the SEC *Statistical Bulletins* for recent data on net stock purchases.

37. J. D. Smith and S. D. Franklin, "The Concentration of Personal Wealth, 1922–69," *American Economic Review*, May 1974.

38. Both the estate tax and income tax data reflect ownership in the shares of investment companies, including mutual funds, as well as those of other corporations.

Smith's and Franklin's estimates point to a substantial decline in the share of the richest 0.5 percent and 1.0 percent of U.S. individuals in corporate shareownership over the 1953–69 period. This decline is associated with relatively little change in the share of such individuals in total net worth. There is some evidence of a decline of the share of these upper wealth groups in total net worth from 1965 to 1969; but given the margin of error associated with estimates based on estate tax data, little confidence can be placed on this evidence since it could be changed by a small revision in either the 1965 or 1969 figures. For corporate stock, the estate tax estimates indicate a decline in the share of the richest 1 percent of individuals, from 86.3 percent of the market value of all stock in 1953 to 74.4 percent in 1958, 62.0 percent in 1962, 61.2 percent in 1965, and 50.8 percent in 1969.

There are, however, a number of potentially serious inadequacies in the estimates derived from estate tax data. These include (1) possibly substantial biases involved in the assumption that the assets and liabilities of decedents are representative of the assets and liabilities of living individuals in the top wealth groups, (2) deficiencies in the mortality rates used to characterize specific groups in the population,[39] (3) systematic understatement in the estate tax estimates of the values of certain assets held by the top wealth groups (including closely held stock and large blocks of publicly traded issues) even after the reported values are adjusted on the basis of sample audits, and (4) the treatment of individuals rather than families or households as the basic consumer units. Moreover, Smith's and Franklin's estimates of the ratio of the holdings of the upper income groups to the total market value of stock owned by all individuals appear to include the shares and certificates of savings and loan associations as part of stockholdings, and they use earlier estimates of total market value, which are less reliable than the revised figures presented in this article.

39. These deficiencies and other problems of estate tax data, including the need to adjust for lifetime transfers, have been discussed most recently in J. D. Smith, *The Concentration of Personal Wealth in America*, Pennsylvania State University, 1973.

Table 3.—Percentage Distribution of Families,[1] Dividend Income, and Value of Stock by Family Income Level, 1958–71

Family income [2]	1958	1960	1964	1969	1970	1971
	Number of families					
Under $5,000	48.75	43.9	37.2	26.9	23.9	22.0
$5,000–$9,999	37.9	39.4	38.6	32.7	31.9	31.4
$10,000–$14,999	8.5	10.6	16.0	21.8	23.1	23.5
$15,000–$24,999	3.5	4.6	6.0	15.2	15.9	17.3
$25,000–49,999	1.1	1.2	1.7	2.3	4.3	4.5
$50,000–$99,999	.2	.25	.4	.7	.7	.5
$100,000 and over	.05	.05	.1	.2	.2	.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
	Aggregate dividend income					
Under $5,000	4.6	5.0	4.0	3.0	2.9	2.8
$5,000–$9,999	10.5	10.7	10.6	9.9	8.6	8.2
$10,000–$14,999	12.9	11.7	11.0	9.4	9.4	9.3
$15,000–$24,999	17.4	18.2	15.1	14.6	14.1	13.8
$25,000–$49,999	20.7	21.8	20.5	20.2	19.7	18.9
$50,000–$99,999	15.5	13.5	17.2	19.8	20.1	20.0
$100,000 and over	18.4	19.1	21.6	23.1	25.2	26.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
	Aggregate market value of stock					
Under $5,000	4.4	4.8	3.0	2.6	2.5	2.4
$5,000–$9,999	10.2	10.3	10.3	8.6	7.4	7.0
$10,000–$14,999	12.6	11.2	10.7	9.0	8.4	8.9
$15,000–$24,999	17.2	17.6	15.0	13.7	13.2	12.8
$25,000–$49,999	20.6	21.9	20.4	19.2	18.8	17.8
$50,000–$99,999	15.8	14.0	17.4	20.7	21.2	20.9
$100,000 and over	19.2	20.2	22.3	26.2	28.5	30.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

1. Definition of families includes unattached individuals.
2. Family personal income before income taxes.

Sources: BEA estimates on income distribution by family income class, IRS data on distribution of dividends by AGI, and results from two special samples of IRS returns for 1960 and 1971. See appendix to part 4 for details.

The second published source of data for analyzing changes in the distribution of stockownership by different income groups—the Statistics of Income (SOI) data on the income distribution of dividends—is subject to fewer deficiencies than the estate tax data. It also has the great advantage that both the total of dividends reported by all individual taxpayers (on forms 1040) and the specific amounts reported on each return are subject to check against external sources. These checks include the total of dividends reported paid by U.S. corporations on corporate tax returns, adjusted in the manner described in part 3 of this article, and the IRS audits of many individual returns, also mentioned in part 3. The check results provide a reasonable degree of confidence in these data as an indication of the AGI distribution of dividends received by individuals who are required to file tax returns, where AGI is defined as in the tax laws.

Even the income tax data, however, have three significant deficiencies for the purposes of this study. First, AGI per return is not a satisfactory economic measure of income for a household unit. It does not conform very closely to the concept of income used in the national income accounts or to the family unit used for distributional analysis in those accounts. The tax measure of income is deficient perhaps most notably because wealthy families have a tax incentive to distribute dividend income among different members of the family, each of whom would file a separate return, and because certain forms of income are fully or partially tax-exempt and therefore not properly reflected in AGI. Second, families or individuals with AGI below specified limits do not have to submit income tax returns. Third, the distribution of dividend income by income class may differ appreciably from the distribution of the market value of stock owned, since in view of the tax structure, high income families might be expected to hold stock with a relatively low dividend payout, a high growth rate of earnings, and, hence, a high price-dividend ratio.

Table 4.—Trends in the Distribution of Stockownership by Selected Total Income Percentiles, 1958–71

	Percentage of total income received by highest				Percentage of dividend income received by highest				Percentage of stock value owned by highest			
	1%	5%	10%	50%	1%	5%	10%	50%	1%	5%	10%	50%
1958	7.5	19.9	29.4	76.7	50.6	72.8	82.6	95.2	51.7	73.7	83.2	95.5
1960	7.2	19.4	29.0	76.8	48.4	69.8	78.3	93.5	50.5	71.3	79.5	94.0
1964	8.0	20.0	30.0	77.6	48.5	69.3	75.9	93.1	49.1	70.5	77.1	93.3
1969	n.a.	n.a.	n.a.	n.a.	45.9	63.9	72.1	91.3	50.4	66.6	74.5	92.5
1970	7.6	19.2	29.2	77.1	46.0	64.8	72.1	91.1	51.5	68.0	73.4	92.4
1971	7.5	19.1	28.9	76.7	46.9	63.8	71.6	90.5	51.1	67.1	73.1	92.0

N.a. Not available.
NOTE.—The percentages 1, 5, 10, and 50 refer to the specified percentage of families with highest total income.
Source: See appendix to part 4 for details.

Despite these deficiencies, the income tax data might be expected to provide a reasonably good indication of the trend in the income distribution of dividend receipts, from which the trend in market value can be estimated, in periods when there were only small changes in the relevant tax laws. Thus, in 1958–69, when there were no major changes in the definition of AGI or in the minimum income classes required to submit tax returns, there is again evidence of a reduction in concentration of dividend income by total income class.[40] The Lorenz curves for these years, with the cumulative percentage of returns on one axis and the cumulative percentage of dividends on the other, indicate a continued shift in dividend income (in percentage terms) away from the upper income groups. A further small movement in the same direction occurred in 1970, but in view of the very substantial upward revision in the minimum income classes required to submit tax returns, not too much reliance can be placed on this finding. No further change in the income distribution of dividends occurred in 1971.

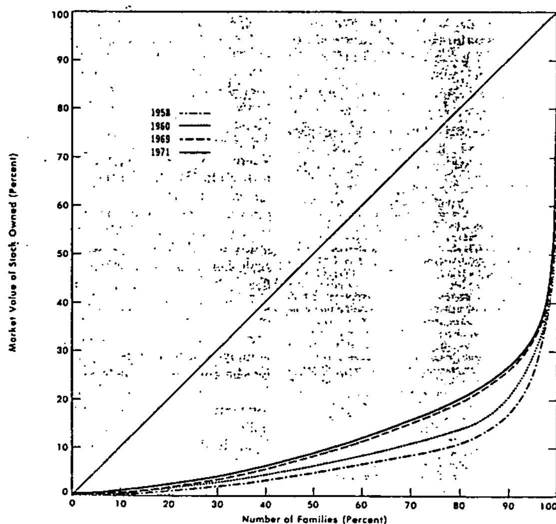
Thus, the income tax, like the estate tax, data point to some tendency toward a further reduction in the concentration of stockownership among the upper income groups after 1958. However, the reduction implied by the income tax data on dividends seems less than that indicated by the estate tax data on market value of stock held, unless the differential changes in price-dividend ratios for the upper and lower income groups are much larger than seems plausible. According to the income tax data, the 1 percent of returns with highest income received 52 percent of all dividends reported on tax returns in 1958, 49 percent in 1960, 43 percent in 1969, and 42 percent in 1971. This trend implies a much smaller decline in the concentration of stockownership than the estate tax estimates mentioned earlier.

New data on distribution of stockownership

More satisfactory estimates of the recent trends in the distribution of stockownership by income class can be obtained by extrapolating the BEA estimates of the distribution of dividend income by family income class. These estimates can be extrapolated from the one year for which they are available to other years on the basis of the IRS data on dividend income by AGI class. The resulting time series can then be converted to a series on the distribution of market value on the basis of

CHART 6

**Trends in the Distribution of Stockownership
Lorenz Curves, 1958-71**



40. In 1960, dividend income on form 1040A had to be reported separately for the first time and, hence, could be included in the SOI data. A special tabulation for that year, however, indicates that the amount of dividends involved was negligible, and the estimated income distribution of dividends in 1966 (as measured by a Lorenz curve) was quite close to that in 1965.

appropriate price-dividend ratios derived from the two special samples of individual tax returns for 1960 and 1971 discussed in the appendix to part 5.

The BEA estimates used for this purpose consist of the distribution of families and income by family income class for 1958, 1960, 1964, 1970, and 1971 and the distribution of dividend income by family income class for 1964.[41] The SOI data used are those on the distribution by AGI class of the number of income tax returns, AGI, and dividends for 1958-71. The methodology followed in combining these different sources utilized the SOI data on changes in the distribution of returns and dividends by AGI class in 1958, 1960, 1969, and 1971, relative to a 1964 base, to estimate the corresponding changes in the BEA distribution of dividends by family income class. Appropriate price-dividend ratios were then applied to obtain estimates of the distribution of the market value of stock held by different family income classes (see appendix to part 4 for details). The distribution of dividend income by BEA family income class, which was obtained as an intermediate step, shows a smaller shift in Lorenz curves from 1968 to 1971 and in the concentration of dividend income among the top income recipients than the income tax data described previously.[42]

The results of this analysis show a continued downward movement in the share of dividends received and stock held by upper income groups for the period 1958-69, with little change for 1969-71 (see tables 3 and 4 and chart 6). The share in stockownership of the richest 1 percent of the population changed very little over the entire period, in contrast to an appreciable decline from 1958 to 1969 in the share of the other upper income groups. The absence of any clear decline in the concentration of total family income (see table 4) may reflect the fact that the 1958 and 1960 income distributions tend to overstate somewhat the share of the bottom quintile in total income as compared with the 1964, 1970, and 1971 income distributions.[43]

Thus, for this period, there does not seem to be any support for the belief that small individual investors have been switching out of stocks to a greater extent than large individual investors. On the other hand, it is true that the substantial rate of decline in the concentration of stockownership among upper income groups, which characterized the period preceding 1958, seems to have slowed. To some extent, the slowing in the historical trend toward a more equal distribution in the direct ownership of stock among different income groups might be considered to reflect the rise in indirect ownership by the lower and middle income groups as a result of their growing beneficial ownership of stock through financial institutions that do not issue their own stock. However, such beneficial ownership largely reflects the growing importance of corporate pension funds, where, as a result of contractual obligations, the corporations are more likely than the employee beneficiaries to gain (or lose) by the composition of the funds' portfolios. As a result, there is little reason for families to take into account their indirect interest in stock held by such funds in determining the proportion of their own assets to invest directly in stock. While families may well treat equity in a pension fund as a partial substitute for other forms of saving as a whole, any effect of an increase in a family's pension equity on a single form of saving, such as investment in stock, is likely to be small.

A question that naturally arises is, How do these trends in the income distribution of stockownership compare with trends in the income distribution itself? Though the estimates on the distribution of total income by income class are subject to a considerable margin of error, they probably are sufficiently accurate to depict significant changes over time. The estimates show very little change in the concentration of total income by income class in the entire period after World War II. There is some evidence of a decline in the share of total incomes received by the top income brackets (the highest five or so percentiles).[44] However, the decline in concentration of income among the top five percentiles after the war was rather small, and the Census Bureau's Current Population surveys suggest that the share of the top percentile in total money income may have been rising since 1967.[45]

It would appear, therefore, that given the margin of error in these estimates, the most impressive finding is the relative constancy of income shares by different income groups. This contrasts to the substantial movement toward a more egalitarian distribution of income from the 1920's to the postwar period—a movement that would be even more pronounced on an after-tax basis.[46] Thus, while the distribution of both total and dividend income became much less concentrated from the 1920's to the end of World War II, only dividend income continued to show a significant trend toward less concentration in the

41. The 1964, 1970, and 1971 figures on the income distribution of family income were obtained from Radner and Hinrichs, "Size Distribution," the 1958 and 1960 figures were derived from the SURVEY OF CURRENT BUSINESS, April 1964, and the 1964 figures on the distribution of dividends were obtained from *Size Distribution of Family Personal Income: Methodology and Estimates for 1964*, BEA Staff Paper No. 21, June 1973. The 1964 estimates are the most reliable; the 1958 and 1960 estimates used a somewhat less satisfactory methodology than those for 1964, 1970, and 1971, and figures for the last 2 years do not incorporate as much information as those for 1964. The main conceptual differences between the pre- and post-1964 income estimates are the inclusion of income (including dividends) retained by fiduciaries and private pension and annuity benefits in the more recent, but not in the earlier, series, while the reverse change occurred for benefits received from health and welfare funds and employer contributions to pension funds. The conceptual differences will affect somewhat the comparability of the measures of total, but not dividend, income presented in this article, since the 1964 procedures for dividend income have been applied to the other years.

42. The BEA family income estimates differ from AGI reported on tax returns (1) by using a family (or unrelated individual) instead of the tax return as the basic economic unit, (2) by covering money income that does not have to be reported or is underreported on tax returns, and (3) by including nonmoney income and (4) by excluding all capital gains and personal contributions for social security.

43. Radner and Hinrichs, "Size Distribution."

44. E. C. Budd, "Postwar Changes in the Distribution of Income in the U.S.," *American Economic Review*, May 1970, and Radner and Hinrichs, "Size Distribution."

45. The more comprehensive BEA series are not available for the years between 1964 and 1970.

46. Kuznets, *Shares*. See also *U.S. Income and Output*, U.S. Department of Commerce, 1958, which presents estimates by S. F. Goldsmith for 1929 and 1956.

following years, and even that trend seemed to have been muted considerably in recent years.

Another question that can be raised is, How do the trends in the income distribution of stockownership compare with those in total wealth or net worth (that is, the market value of assets less liabilities)? While the data available for answering this question are rather weak, they again point to a decline in the share of wealth owned by the top income groups (highest 1 percent) from the 1920's to 1945, with no definite trend thereafter.[47]

The finding that a clear trend toward a more egalitarian distribution of individual income and stockownership persisted after 1945, unlike the behavior of net worth or income, may reflect the fact that the ownership of corporate stock was (and to a lesser degree still is) much more concentrated among upper income groups than is true of wealth generally. Thus, the observed trend is consistent with a greater diversification of asset structure by both upper and lower income groups. It may also reflect (1) the increased use by wealthy investors of other forms of investment (such as municipal bonds and real estate holdings) to minimize taxes, in view of the marked rise in tax rates from the prewar period, (2) the publicity given to the high stockmarket returns realized over the postwar period until recent years, and (3) the extensive efforts made by the Wall Street community to attract small investors into the market.

Finally, the reduction in concentration of stockownership among upper income groups that has taken place over the past half-century does not necessarily imply any reduction in the concentration of corporate control. What has occurred is that many individual holdings of all sizes have been replaced by a small number of very large institutional holdings, and an extremely large number of new and generally rather small stockholders have acquired shares through the reduction in holdings of a comparatively small number of much more substantial individual investors.[48] Both developments would appear to facilitate managerial control of U.S. corporations, at least until institutions play a more active role in corporate affairs.

Part 5: Distribution and Performance of Stockholdings by Types of Investors and by Types of Stock

Besides providing an estimate of the market value of stock held by individuals and permitting an analysis of the trends in the concentration of holdings the 1971 special sample of Individual Income Tax Forms 1040 collected for this study can be used to gain insight into the distribution and performance of stockholdings by types of investors and by types of stock.[49]

Employment status

The 1971 special sample of individual income tax forms reveals that employed persons, including (for this article) the self-employed, accounted for 60.3 percent of the forms 1040 filed in 1971, but only 49.0 percent of the market value of stock held by individuals (see table 5). As a group, therefore, employed persons accounted for a smaller percentage of stock held than of forms filed. Within this group, however, a more detailed breakdown shows that managers were responsible for only 10.2 percent of the forms filed, but accounted for 19.0 percent of the stock held by individuals.

In 1971, retired persons filed only 16.5 percent of the forms, but owned 19.3 percent of individual stockholdings. Like the retired, the other two broadly defined employment status groups, not gainfully employed and unknown, owned larger percentages of stock than the percentages of forms filed. The not gainfully employed undoubtedly included some unemployed, some housewives, some wealthy individuals who had no need to work, and some minors who filed forms separately from those of the economic head of the household. The unknown category represents forms for which the occupation box was left blank. These filers could have had any employment status, but data to be presented later suggest that most of these forms were filed by retired and not gainfully employed persons.

A more detailed analysis of the occupational data suggests that the larger percentage of stock held by managers relative to the percentage of forms filed, and the correspondingly

Table 5.—Distribution of Individuals' Stockholdings by Employment Status, 1960 and 1971

Employment status	Percentage of forms, 1971		Percentage of market value			
			1971		1960	Change 1960-71
Employed		60.3		49.0	55.2	-6.2
Managers	10.2		19.0			
Professional	14.4		10.9			
Clerical	4.6		1.4			
Sales	7.0		3.9			
Farmers	2.1		1.4			
Other	22.0		12.4			
Retired		16.5		19.3	13.6	5.7
Not gainfully employed		4.5		6.5	6.1	.4
Unknown		18.7		25.2	25.1	.1
Total		100.0		100.0	100.0	.0

NOTE.—Employment categories were defined by the Bureau of the Census. Self-employed persons are included in the employed category.

Sources: 1971 special sample and Crockett and Friend, "Characteristics."

47. Smith and Franklin, "Concentration"; J. B. Lansing and J. Sonquist, "A Cohort Analysis of Changes in the Distribution of Wealth," *Six Papers on the Size Distribution of Wealth and Income*, National Bureau of Economic Research, 1969; and Lampman, *Share*.

48. This is reflected both in the much more rapid increase in the number of individual stockholders than the growth in the value of outstanding stock attributable to new issues, and in the substantial reduction in the proportion of the market value of stock held by the upper income groups.

49. The appendix to part 5 describes the 1971 special sample in detail.

Table 6.—Percentage Distribution of Market Value of Individuals' Stockholdings in Various AGI Classes by Market Type of Issuing Firm, 1971

AGI class	NYSE by market value of outstanding shares (millions of dollars)				AMEX	OTC	Unidentified stocks		Agency, custodial, and street name	Mutual funds	Trusts and estates	Total
	500 or more	100 to 499	Under 100	Total			Banks and insurance companies	Miscellaneous				
Under $5,000	30.5	7.6	3.9	42.0	0.8	2.0	7.9	24.1	2.5	15.2	5.4	100.0
$5,000-$9,999	24.9	4.6	3.7	33.2	3.1	6.5	1.3	12.8	4.5	23.5	15.2	100.0
$10,000-$14,999	32.0	9.5	2.0	43.5	1.4	3.3	4.6	16.0	7.4	9.6	14.2	100.0
$15,000-$24,999	29.9	9.1	2.2	41.2	2.0	5.4	4.7	13.9	4.9	11.2	11.7	100.0
$25,000-$49,999	28.3	10.9	2.7	41.9	2.2	6.1	4.1	17.2	6.1	5.0	17.5	100.0
$50,000-$99,999	21.0	8.0	2.5	31.5	2.6	4.9	6.2	23.5	7.2	3.0	17.9	100.0
$100,000-$199,999	24.1	6.4	1.6	32.1	3.2	8.0	4.0	26.8	7.5	1.7	16.6	100.0
$200,000-$499,999	26.0	6.2	2.1	34.3	2.3	7.3	2.8	21.3	4.5	0.5	26.9	100.0
$500,000 and over	10.9	12.1	2.7	25.7	3.1	7.4	2.8	20.8	12.9	0.0	27.7	100.0

Source: See text.

smaller holdings of other employed persons, stem not from any greater predilection of managers, as managers, to hold stock, but rather from the fact that managers have higher incomes than other employed persons. If managers were to have a greater predilection for stock, one would expect that at any level of income, the ratio of the proportion of stock owned to the proportion of forms filed would be larger for managers than for other employed persons. However, an examination of such ratios for each of several income classes [50] reveals no such tendency. Thus, for any class of employed persons, the percentage of market value held by filers in any adjusted gross income (AGI) class of less than $50,000 is smaller than the percentage of forms filed, and greater for those in any AGI class of $50,000 or over.[51]

For each of the three remaining categories—retired, not gainfully employed, and unknown—filers in any AGI class in excess of $25,000 accounted for more stock than their numbers would have implied, while the reverse occurred for those in lower AGI classes. Since individuals in the first two categories would be receiving little, if any, wage income, it might be expected that more of their AGI would come from dividend income than for employed persons. Therefore, the levels of AGI at which the percentage of stock held exceeded the percentage of forms filed would be expected to be lower for these two groups than for the employed groups. A comparison of the percentage of stock owned with the percentage of forms filed in the unknown category reveals a pattern more like that of the retired and not gainfully employed than of the employed. This fact suggests that most of the filers in the unknown category were not employed.

Compared with the 1960 results, the share of the market value of individual holdings attributable to the employed filers fell by 6.2 percentage points.[52] Over the same period, the retired increased their share 5.7 percentage points. Since the proportion of retired in the population of persons over 21 increased by only 1.0 percentage point, this abolute increase in stockownership also represents a relative increase. Because the breakdown of the employed in 1960 appears to be based upon slightly different definitions, a satisfactory comparison with the new results is not possible.[53]

Types of stock held

To analyze the kinds of stock held by AGI class, the total value of each issue held by filers within each AGI class was estimated. Each issue was then classified into one of several broadly defined stock categories, and the total market value within each category was calculated. Table 6 lists these categories and the market values expressed as a percentage of the total stock held within each AGI class. With the exception of the unidentified stock, the descriptions are self-explanatory. The unidentified banks and insurance companies consist of the companies whose names are clearly those of a bank or an insurance company, but for which additional financial data are unavailable. For the most part, the stock in the unidentified miscellaneous category represents closely held over-the-counter (OTC) stock with limited markets or OTC stock with a small number of shares outstanding.

The proportion of stock invested in New York Stock Exchange (NYSE) issues and held in an individual's own name tends to decrease as income increases. The rank order correlation is −0.67, which is significant at the 10 percent level. Within the NYSE, this negative relationship is apparent for issues larger than $500 million and smaller than $100 million. For the middle-sized issues, $100 to $500 million, the relationship is positive but not significant (rank order correlation of 0.23). OTC, agency and street name, and estates and trusts are strongly positively related to AGI, with rank order correlations of 0.73, 0.60, and 0.88, respectively. (Street name stock is stock held as nominee by a brokerage house for the interest of the beneficial owner.) If not a statistical aberration, the large percentage of assets in agency and street name for those with AGI in excess of $500,000 may stem from the desirability for individuals with extremely large portfolios to delegate the custodial function. For the unidentified stock, the relationships between the

50. This analysis is based upon the income classes given in table 6.

51. As the previous part pointed out, there are distinct limitations of the use of AGI as a measure of economic earnings. Nonetheless, for lack of a better measure, this part uses AGI as a surrogate for such earnings.

52. Crockett and Friend, "Characteristics."

53. That the changes in the not gainfully employed and unknown categories—two categories that were presumably defined identically in 1960 and 1971—were small suggests that the identified breakdowns in both years were consistently defined.

percentage of stock held and AGI class are very weak.[54]

A percentage distribution for each AGI class by industry group instead of by broad market type was also prepared. An analysis of this distribution reveals a remarkable similarity in the percentages of each industry held across AGI classes. The only major differences across AGI classes occurred in the telephone and communication industry and in the utilities. Both of these industries tended to be a much more important part of the portfolios of lower income filers than of upper income filers.

For filers in AGI classes of less than $25,000, the percentages in utilities ranged from 4.7 to 6.5; for incomes of $200,000 and above, the percentages were less than 1.0. While the 1960 study found a similar pattern by AGI, it may be noted that the percentages of individual portfolios held in utility stock at all levels of AGI were larger in 1960 than in 1971.

For filers with incomes of less than $25,000, the percentages invested in the telephone and communication industry ranged from 5.0 to 10.5; for incomes of $200,000 and above, the percentages ranged from 0.6 to 3.6. In 1960, the comparative importance of holdings in this industry in portfolios of persons in the lower, relative to the upper, AGI classes was even more pronounced than in 1971.

Diversification and return characteristics

To measure the diversification and return characteristics of the portfolios of individuals, several statistics for each portfolio were calculated. Table 7 presents averages of these statistics by AGI class and in total. Before examining these averages, however, it may be useful to review some of the fundamental tenets of portfolio theory.

Under several alternative assumptions, it can be shown[55] that an investor, whether he be risk-averse or not, can evaluate a portfolio in terms of the prospective expected return and standard deviation of the return, where return includes all dividends and capital gains or losses.[56] Further, a risk-averse investor would always want to minimize the standard deviation of the return for any given level of expected return. In this theoretical framework, the risk of a portfolio might be equated with the standard deviation of returns. As long as returns on individual securities are not perfectly positively correlated, diversification will always pay.[57]

The 1971 special sample does not provide an ideal basis for estimating the extend to which individuals have diversified their portfolios of common stock because the sample contains information only on dividend-paying items. Yet an analysis of just these items does give a great deal of insight into the amount of diversification in individual portfolios of common stock.[58] The results are so strong that it is doubtful that the inclusion of issues with no dividends would substantially alter the qualitative nature of the conclusions.

One theoretically appealing index of diversification would be a function of the potential reduction in the variability of the returns on a portfolio through further diversification, holding expected return constant. Since the data needed to construct such an index are unavailable, other less satisfactory measures must be used. One measure of diversification that has been used in other other studies is the number of issues in a portfolio. The underlying assumption is that the greater the number of issues, the greater the potential for diversification. On average, this statistic ranges from 3.2 for filers with AGI of less than $5,000 to 18.7 for filers with AGI of $500,000 and over (table 7). It is not until an AGI of $100,000 is reached that the average number of items per form exceeds 10.0.

In 1963, the Internal Revenue Service (IRS) collected information on the number of payer corporations per return by AGI class.[59] Because of changes in the levels of income and definition of AGI, it is difficult to compare the 1971 results with those for 1963. Nonetheless, it does not appear that there have been marked changes in the number of issues held per port-

54. The large percentage for unidentified banks and insurance companies for the lowest AGI class may result from the misreporting, as dividends, of interest from privately owned banks and thrift institutions and "dividends" from participating policies of stock companies. As explained in the appendix to part 5, there was substantial evidence of such misreported dividends from mutual companies in the 1971 special sample of individual tax forms.

55. H. Markowitz, *Portfolio Selection: Efficient Diversification of Investments*, John Wiley and Sons, 1958.

56. In theory, such a portfolio should include all assets held by an individual, including human wealth. In practice, the risk of a portfolio of common stock is typically evaluated in isolation from other assets because of data limitations. The empirical work based on the 1971 special sample can only, and therefore will only, evaluate the characteristics of the common stock portion of an individual's assets.

57. P. A. Samuelson, "General Proof That Diversification Pays," *Journal of Financial and Quantitative Analysis*, March 1967.

58. The Federal Reserve Board's Survey of Financial Characteristics of Consumers in 1962 would seem to be an ideal survey to analyze diversification. The Rodney L. White Center is currently analyzing this file to provide confirmation of the results derived from the 1971 special sample.

59. SOI, 1963: *Individual Income Tax Returns*.

Table 7.—Measures of Risk, Diversification, and Realized Returns by AGI Class, 1971

AGI class	No. of items per portfolio	Diversification measure	Realized returns (percent)		
			NYSE only		All items
			1/70-12/70	7/71-6/72	7/71-6/72
Under $5,000	3.2	0.50	2	5	10
$5,000-$9,999	3.8	.55	3	−1	8
$10,000-$14,999	4.0	.47	4	5	9
$15,000-$24,999	4.3	.45	4	6	11
$25,000-$49,999	6.7	.47	0	5	11
$50,000-$99,999	9.2	.52	0	6	12
$100,000-$199,999	13.2	.56	−2	7	12
$200,000-$499,999	16.8	.55	−3	9	12
$500,000 and over	18.7	.64	2	3	10
Total	4.5	.52	1	5	11

NOTE.—The measures are weighted averages of the measures for the individual portfolios. The weight given to a specific portfolio is proportional to the product of the market value of the sample portfolio and the appropriate blowup factor given in the appendix to part 5.

Source: See text.

folio at comparable levels of AGI. Below an AGI of $50,000, the number of dividend-paying issues held per portfolio was less than 10 in 1963; above this AGI, the number was greater than 10. If an AGI of $50,000 in 1963 is roughly comparable to an AGI of $100,000 in 1971, the 1963 and 1971 results are strikingly similar.

With any reasonable estimate of the number of nondividend-paying items, the portfolios in 1971 or 1963 would not be considered highly diversified, even at the higher levels of AGI.[60] At the lower levels of AGI, diversification is extremely limited.

To achieve the full potential of diversification within a fixed number of issues, not too much of one's assets should be concentrated in any one or two securities. A better measure than number of items held of the extend to which the value of a portfolio is concentrated in a few issues can be constructed by summing the squares of the proportions invested in each security. Thus, a portfolio of two securities with 90 percent in one and 10 percent in the other would have a diversification measure of 0.82, the sum of the squares of 0.9 and 0.1, while an equally weighted portfolio of two securities would have a diversification measure of 0.5. In general, this diversification measure will be between 1.0 and the reciprocal of the number of items in the portfolio. The lower the diversification measure, the more diversfied the portfolio.

The average values of these measures, given in table 7 by AGI class, range from 0.47 to 0.64. This range is roughly consistent with the level of diversification achieved in an equally weighted portfolio of two securities. Thus, at least on average, individuals tend to concentrate their holdings in a limited number of issues, probably taking on considerably more risk than necessary.

The inherent danger in reporting only an average of some statistic is that there is always a tendency to attribute to each component the average value and not to recognize that the values for the components can vary quite widely. Consider, for instance, an average diversification measure of 0.46 for two portfolios, each of which contains 10 securities. This figure of 0.46 could be obtained from two poorly diversified portfolios in which 48 percent is invested in each of two securities and the remaining 4 percent spread equally over the remaining eight. The same average could be obtained from one well-diversified portfolio with 10 percent invested in each security and a virtually undiversified portfolio with 90 percent in one security and the remainder spread equally over the other nine securities.

For an examination of the dispersion in the diversification measures, the data underlying table 7 were further analyzed. This analysis shows that there is much variability in the extent of diversification of individual portfolios. It is estimated that 13 percent of filers reporting dividends and holding 24 percent of stock had a diversification measure of 0.23 or less, while more than 40 percent of filers holding 22 percent of stock had a diversification measure of 0.88 or larger.[61]

One reason why a person might hold an undiversified portfolio is to be able to realize the potential returns from superior security analysis. (In this connection, it might be noted that there is no evidence that any substantial group of investors, except for exchange specialists and, to some extent, corporate insiders, has outperformed the market consistently over long periods of time.) A second reason is that an individual may have a large holding in a particular security in order to maintain effective control over the company. A third reason is that, over time, the one or two securities with the highest returns will tend to dominate a portfolio if, because of tax considerations or other reasons, no adjustments are made. A fourth reason is that some investors do not understand the principles of diversification; therefore, the standard deviation of returns on a portfolio is not the appropriate measure of risk in explaining their behavior. The explanation for such poorly diversified portfolios must await further research.

Though these two measures of diversification suggest that some investors may be assuming greater risks than necessary through improper diversification, the measures are deficient in that they do not distinguish among stock with different degrees of nondiversifiable risk. A preliminary analysis using the so-called beta coefficient—a standard measure of nondiversifiable risk—shows that filers with larger AGI tended to hold stock with greater nondiversifiable risk.[62] This analysis also shows that managers tended to hold the riskiest, and retired and not gainfully employed the least risky, portfolios.

The final characteristic to be measured in this part is the rate of return, including dividends and capital gains, that individuals realized on their stock portfolios. Returns have been calculated for NYSE issues for 1970 and for July 1971 through June 1972. Returns were also calculated for all items in the latter period.[63] Since the composition of individuals' portfolios is estimated from the dividends received over all of 1971, the estimated composition would be expected to be closest to the actual composition on June 30, 1971—the midpoint of the year. Thus, the returns from July 1971 through June 1972 can be interpreted as those that would have been realized on the portfolios attributed to individuals in mid-1971 if there were no changes in these portfolios over the subsequent year. The rates of return for 1970 are more suspect, since they are based upon the composition of the portfolio as estimated from dividends in 1971, even though the 1970 composition would be expected to be somewhat different. However, the turnover rate of the aggregate of stock held by individuals is not great, so that these returns

60. The empirical evidence in Lawrence Fisher and James H. Lorie, "Some Studies of Variability of Returns on Investment in Common Stocks," *Journal of Business*, April 1970, shows that equally weighted portfolios of 128 securities are considerably better diversified than equally weighted portfolios of only 8 or 16 securities.

61. To determine whether trusts, custodial, or agency accounts might have biased the average values for the diversification measures, the measures were recalculated excluding any form with this kind of item. The averages were not substantially changed and, in some cases, even increased.

62. Marshall E. Blume, "On the Assessment of Risk," *Journal of Finance*, April 1971, contains a summary of the rationale underlying this measure and the procedures for calculating it.

63. Any item for which the return was unknown was assigned a default value, as explained in the appendix to part 5.

probably approximate quite closely the returns realized by individuals in 1970.

In 1970, individuals on average gained 1 percent on their NYSE dividend-paying investments. From the files of the Rodney L. White Center, it was determined that the value-weighted return on all dividend-paying stock was 0.7 percent; thus, individuals fared as well as the market.[64] On average, filers with AGI less than $25,000 realized somewhat greater returns than those with higher AGI.

From July 1971 through June 1972, individuals on average realized 5 percent on their NYSE stock and 11 percent on all items. The larger returns on all items resulted from the substantially better performance of OTC issues in this period. From the Center's files, it was found that the value-weighted return on all NYSE dividend-paying stock was 8.8 percent.[65] Individuals thus fared somewhat worse that the market, at least on their NYSE stock.[66] In contrast to the 1970 results, individuals with higher AGI averaged marginally higher returns than those with lower AGI.

Appendix to Part 3: Estimation of Aggregate Value and Distribution of Dividends and Stockholdings

The dividend gap (table 1)

Items 1, 2, and 11: These items were obtained from *SOI, Preliminary 1971: Corporation Income Tax Returns*, pp. 4 and 18. Item 2 was adjusted to exclude dividends paid by Federal Reserve banks, which did not enter into item 1. Item 11 was slightly reduced on the basis of later information.

Item 3: Market value figure was derived from R. B. Scholl, "The International Investment Position of the United States: Developments in 1972," SURVEY OF CURRENT BUSINESS, August 1973, p. 18. Dividends on the $7 billion of foreign portfolio stock held by domestic ownership groups were estimated by multiplying market value by the ratio of aggregate dividends to aggregate market value for NYSE, American Stock Exchange (AMEX), and large OTC issues combined as of mid-1971. The resulting figure was slightly increased to allow for cash distributions other than dividends, and $90 million was allocated to holding and investment companies on the basis of SOI information on the foreign dividends received by such companies. The remainder was assigned to individuals, fiduciaries, and tax-exempt institutions.

Items 4 and 6–8: Market value data were derived from SEC *Statistical Bulletin*, May 30, 1973, p. 520. Yearend values were adjusted to midyear on the basis of the NYSE index of stock prices; they were then multiplied by the ratio of dividends to market value utilized for item 3. For item 8, this estimate of dividend receipts was augmented by 8 percent of the dividend receipts of estates and trusts, to allow for dividends retained by fiduciaries on behalf of charitable organizations as beneficiaries. The estimate was further augmented by $150 million, estimated to be received by church and hospital endowments not covered by the SEC figure for foundations. The dividend receipts of corporate pension funds and of State and local government retirement funds, as derived from SEC market value figures, were increased by $150 million and $50 million, respectively, to account for stockholdings of union pension funds, corporate profit-sharing funds, and understatement of municipal retirement funds due to incomplete coverage.

Item 9: Market value of stockholdings of bank-administered trusts and estates were obtained from *Trust Assets of Insured Commercial Banks-1971*, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency. Dividends were derived by multiplying market value by the ratio utilized for item 3. This dividend estimate was then expanded to cover dividend receipts of all estates and trusts by multiplying by the ratio of the 1970

Table A.—Estimation of Dividend Income of Fiduciaries Distributed to Individuals, to Charitable Organizations, and Not Distributed, 1971

	Percentage allocation of gross income less business deductions and distributions to other fiduciaries		Estimated allocations of dividend receipts (billions of dollars)		
	1965		1971		
	Taxable fiduciaries	Nontaxable fiduciaries	Taxable fiduciaries	Nontaxable fiduciaries	All fiduciaries
Distributions to individuals	29.2	73.8	0.53	1.99	2.52
Distributions to charitable organizations	.8	12.4	.01	.34	.35
Retained income	52.2	3.4	.95	.10	1.05
Administrative costs	4.2	10.4	.08	.28	.36
Taxes paid	13.6		.25		.25
Total uses	100.0	100.0	1.82	2.71	4.53

Source: See text.

64. The NYSE Composite Index in 1970 fell 2.5 percent before adjustment for dividends. After a 3.1 percent adjustment for dividends, the Center's files and the NYSE index give virtually the same results.

65. In the same period, the NYSE Composite Index implies a return of 7.7 percent before adjustment for dividends and 10.8 percent after adjustment. It is not known what the actual reasons are for the difference of 2.0 percent between the Center's estimate and the NYSE's estimate. There are, however, several conceptual differences between the two indexes. First, the Center's return includes preferred stock, and NYSE-preferred stock returned only 1.5 percent in this period. Second, in determining market weights, the Center uses as the number of shares the number authorized to be issued and *issued*, less Treasury shares; the NYSE bases its index on the number of shares authorized to be listed and *listed*. The most significant difference from this source is the weights given to foreign companies traded on the NYSE. Third, the Center's returns include only dividend-paying stock. Although nondividend-paying stock performed better in this period, adjusting for them would change the Center's return by only 0.1 percent. Since the returns in table 7 were calculated from the Center's files, the Center's return of 8.8 percent is the most reliable benchmark for comparison.

66. That individuals performed less well in this period means that nonindividuals, primarily some groups of institutions, must have performed better. While mutual funds did not perform better than the market, there is some evidence that banks performed considerably better. (William G. Burns and Richard H. Klemm, "Performance of Bank Managers of Trust Funds," Rodney L. White Center for Financial Research, University of Pennsylvania Press, August 1973.)

SOI figure for dividend receipts for all estates and trusts (*SOI, 1970: Fiduciary Income Tax Returns*, p. 14) to receipts of bank-administered trusts and estates estimated, in the manner described previously, from the 1970 stockholdings reported to bank regulatory agencies by these fiduciaries. (The ratio of 1.5 thus obtained is somewhat below the ratio implied by 1962 SOI data, which segregate bank-administered from other trusts and estates (*SOI, 1962: Fiduciary, Gift, and Estate Tax Returns*, pp. 16, 22, and 26).)

The proportion of fiduciaries' dividend receipts not distributed to beneficiaries was estimated from the 1965 breakdown of the uses of fiduciary income from all sources (*SOI, 1965: Fiduciary, Gift, and Estate Tax Returns*, p. 25). In table A, the percentage allocation, among uses, of gross income less business deductions and distributions to other fiduciaries is developed from the SOI data and applied to the 1971 dividend total. (It is assumed that no business expense is incurred in the generation of dividend income and that administrative costs represent the same proportion of net income for dividend receipts as for all income.) Distributions to charitable organizations are included as part of item 8 in table 1. Distributions to individuals, augmented by a proportional share of undistributed dividend income and reconverted to a market value figure, provide a control total of $138 billion for individuals' beneficial ownership of stock through fiduciaries in the analysis of the 1971 sample.

Items 12 and 15: These items were derived from *SOI, 1971: Individual Income Tax Returns*, p. 62. Item 12 was adjusted upward by $50 million for estimated underreporting and for nontaxable distributions to ownership groups other than individuals. To the extent that liquidating dividends are successfully excluded from item 1, but are included in nontaxable distributions reported on individual income tax returns, this figure may represent an overadjustment. Item 15 was adjusted to delete $88.5 million (based on findings from the 1971 sample) for the misreporting, as dividends, of income received from such sources as credit unions, mutual savings and loan associations, mutual life insurance companies, and mutual savings banks.

Item 13: Net realized capital gains of mutual funds were obtained from *Mutual Fund Fact Book*, 1971, p. 54. This item was adjusted by adding an estimated $100 million for capital gains distributions of closed-end funds and of mutual funds not members of ICI. Item 13 substantially exceeds the $662 million reported on forms 1040 as distributions taxable as capital gains (*SOI, 1971: Individual Income Tax Returns*, p. 62), but the $662 million figure excludes capital gains distributions to ownership groups other than individuals.

Dividends on unlisted domestic stock

Aggregate dividends on unlisted domestic stock other than that of mutual funds and banks and insurance companies were derived from total cash distributions of domestic corporations, as shown in table B.

Market value of all domestic stock

The 1960 data, which were obtained from Crockett and Friend, "Characteristics," p. 163, were adjusted to remove foreign stock.

NYSE listed stock was calculated by summing data for individual firms. Foreign stock listed on NYSE ($12.4 billion) was obtained from the NYSE *1972 Fact Book*. Total stock and foreign stock listed on AMEX ($49 billion and $12.3 billion, respectively) were obtained from the exchange. Domestic stock listed on regional exchanges was estimated at $5 billion. Stock of mutual funds was obtained by increasing the figure given in the *Mutual Fund Fact Book*, 1972, by 10 percent to allow for nonmembers of the ICI. Unlisted stock of banks and insurance companies was based on SEC figures, increased by $2 billion to allow for privately held issues.

The estimate of unlisted stock other than that of mutual funds and banks and insurance companies was based on the NYSE figure of $366 billion for unlisted traded stock other than that of investment companies in early 1970. This figure was adjusted by subtracting the estimate for unlisted stock of banks and insurance companies and adding an estimate for stock of closely held companies derived by the following method. Based on 1965 estate tax data, individuals' holdings of such stock were taken to be 15.5 percent of their holdings of traded stock, as determined from the 1971 special sample. This figure, $75 billion, was increased by 25 percent to allow for holdings of other ownership groups, giving a total of $94 billion. However, much of this presumably represents the stock of small corporations taxed as partnerships, virtually all of which must fall in the present category. Based on dividends of $1.3 billion for such stock, an assumed dividend yield of 3.5 percent (relatively high to reflect low prices due to lack of marketability), and the average ratio of total to dividend-paying market value for nonfinancial firms traded OTC, the value of such corporations was estimated at about $61 billion, and this amount was subtracted from the $94 billion total.

Individuals' direct holdings of listed stock were based on the market value of identified NYSE and AMEX holdings in the 1971 special sample, with

Table B.—Estimation of Dividends on Unlisted Nonfinancial Stock, 1971

[Millions of dollars]

Item	
1. Distributions (other than own stock) of domestic corporations	32,580
2. Less: Distributions that are nontaxable or taxable as capital gains	1,440
3. Dividends taxable as partnership income	1,290
4. Cash dividends on domestic NYSE issues	21,230
5. Cash dividends on other listed domestic issues	1,080
6. Equals: Dividends on unlisted domestic stock (excluding small corporations taxable as partnerships)	7,520
7. Less: Mutual fund dividends	1,460
8. Dividends on stock of unlisted banks and insurance companies	880
9. Equals: Dividends on unlisted domestic nonfinancial stock (excluding small corporations taxable as partnerships)	5,180

Sources: For items 1, 2, and 3, see table 1, items 1, 11, 12, and 13. Item 4: Total cash dividends equal $21,616 million, NYSE *1973 Fact Book*, p. 79. Dividends on foreign issues were estimated at $366 million (based on a market value of $12.4 billion for listed foreign stock, NYSE *1972 Fact Book*, p. 31). Item 5: This was derived by dividing the $37 billion market value of domestic AMEX issues, plus an estimated $5 billion for stock listed on regional exchanges, by a ratio of dividends to market value characteristic of AMEX issues. Item 7: *Mutual Fund Fact Book*, 1972, p. 54. The published figure was increased by 10 percent for dividends of nonmembers of ICI. Item 8: SEC estimates of traded unlisted stock of banks and insurance companies were adjusted to midyear, increased by $2 billion to allow for privately held issues, and multiplied by a sample-weighted ratio of dividends to total market value for identified OTC financial firms (0.0214).

minor adjustments to incorporate a small fraction of the unidentified stock included in the sample and to remove estimated holdings of listed foreign stock. Individuals' direct holdings of mutual funds and unlisted stock of banks and insurance companies were obtained by removing, from the total outstanding market value in these categories, the relatively small holdings (13 percent and 20 percent, respectively) of other groups, including fiduciaries. Other direct holdings of unlisted stock by individuals were determined from the residual remaining after dividends already accounted for by the assigned amounts of listed stock, mutual funds, and unlisted stock of banks and insurance companies had been removed from total sample dividends for all direct holdings. The ratio of dividends to total market value used in converting this residual to a market value figure was the sample-weighted ratio for medium-sized nonfinancial firms traded OTC (market value, $15 million to $100 million). The figure for medium-sized, rather than total, OTC firms was chosen because it seems unrealistic to assume that individuals would be inclined to hold nondividend-paying stock of small corporations (market value under $15 million) in the proportions in which such stock is represented in the sample of firms in this size class.

Twenty-five percent of the stock held by fiduciaries or in agency accounts and 10 percent of stock held in street name was assumed to be unlisted. These proportions are consistent with the sample estimate of total dividends on beneficial holdings of individuals, when sample-weighed ratios of dividends to total market value for listed and unlisted stock, respectively, are applied.

Ten percent of the stock held in the portfolios of nonprofit institutions or foreigners was assumed to be unlisted. Again, this is roughly consistent with the dividends assigned previously to nonprofit institutions and foreigners, given ratios of dividends to total market value appropriate to the two classes of stock. The figure of $135 billion for holdings of listed stock by nonprofit institutions is reasonably consistent with an estimate by the NYSE of $124 billion of NYSE issues held by such institutions at the end of 1971 (NYSE press release, March 12, 1973).

Intercorporate holdings of listed and of unlisted stock were determined as residuals. As a rough check of reasonableness, the ratios of dividends to market value implicit in these estimates may be examined. If, as assumed earlier, unlisted stock accounts for about 27 percent of the $5.504 billion of domestic dividends received, the implicit ratios are 0.029 for listed and 0.012 for unlisted stock, equal to the sample-weighted ratio in the case of listed stock and somewhat lower than the sample-weighted ratio (0.016) that characterizes traded unlisted stock of firms other than mutual funds and banks and insurance companies. The latter finding results from the previous decision to apply a ratio somewhat higher than 0.016 in converting individuals' dividends on direct holdings of such stock to a market value figure.

Appendix to Part 4: Estimation of Distribution of Dividends and Stockholdings of Individuals by Family Income for Selected Years

The basic source of recent information on the distribution of dividend income by family income class is BEA Staff Paper No. 21, which presents such estimates for 1964. To derive comparable distributions for other years, average dividend receipts per family by income class were determined from the 1964 BEA estimates and adjusted to other years by the change in average dividends per return for roughly equivalent AGI classes, as obtained from SOI individual income tax data for those years. The adjusted average receipts were then combined with BEA esimates on number of families by income class for those years to yield aggregate dividends by family income class.

The first step in integrating BEA estimates on family income with the IRS data on AGI was to determine the approximate range of AGI corresponding to each of several fairly broad family income classes. The upper limit of the AGI range was established by (1) subtracting, from the upper limit of the family income class, an amount based on the average proportion of income due to transfer payments and to imputed income and (2) adding an amount based on the average proportion represented by personal contributions for social insurance, within that class, as determined from the 1964 BEA study. In addition, the average dividend exclusion claimed in 1964 and the average adjustment required to convert gross income to AGI for the most nearly corresponding AGI class were removed and the average net capital gain was added.

The equivalences thus established are very rough. It is not certain that the relative importance of transfers, imputed income, and other reconciliation items for 1964 are equally applicable for other years. More importantly, multiple returns may be filed by members of the same consumer unit; therefore, a return with relatively low AGI may relate to a member of a high income family. Thus, at low incomes, the returns in the equivalent AGI range, while reflecting the dividend receipts of consumer units in the corresponding family income class, will be somewhat distorted by the presence of other returns representing individuals from higher family income classes.

In particular, the number of returns in the AGI range corresponding to family income of $2,000 to $5,999 far exceeds the number of consumer units in that family income class. The same is true for family income under $2,000 (roughly corresponding to AGI under $600) if allowance is made for the fact that a substantial fraction of consumer units in this range may well be nonfilers. On the other hand, for families with incomes of $15,000–$49,999, and especially $15,000–$19,999, the number

of consumer units somewhat exceeds the number of returns in the corresponding AGI range. For family incomes of $6,000–$14,999, results are variable from year to year, but the general tendency is for the number of returns in the corresponding AGI range to exceed slightly the number of consumer units.

The second step was to estimate average dividends per consumer unit by family income class for years other than 1964. This was done by adjusting the 1964 value based on BEA estimates by the sometimes considerable change, from 1964 to the desired year, in average dividends per return for the corresponding AGI range. To the extent that this movement fails to reproduce movements in average dividends per consumer unit, errors will be introduced. Since underreporting of dividend income declined somewhat over the 1958–71 period and since this underreporting was somewhat more prevalent among the lower income families, the estimated concentration of dividend income among the upper income groups in the years after 1964 may be slightly understated relative to the earlier years. Finally, the average dividend thus obtained was multiplied by the number of consumer units in the appropriate income class in the given year, as determined in Radner and Hinrichs, "Size Distribution." The distribution of consumer units by family income class is not directly available for 1965–69; thus, the 1969 distribution was obtained by interpolation, utilizing the 1964, 1970, and 1971 distributions.

A check of the results thus obtained is available for 1960 and 1971. The summation over income classes of dividends derived as mentioned was compared with the total dividend receipts of individuals obtained by augmenting SOI-reported dividends by estimates of (1) illegal underreporting and (2) dividends received by nonfilers and by filers who fail to report dividends totaling less than the legal dividend exclusion. The two alternative estimates are very close for 1960 and within 4 percent for 1971, with the approach based on SOI aggregates yielding the higher figure.

The third step was to use the BEA distribution of dividend receipts to construct distributions of market values of holdings. Since the ratio of market value to dividends tends to increase with income, as demonstrated for 1960 by Crockett and Friend, "Characteristics," and for 1971 by the results presented in part 5 of this article, the distribution of market value should be somewhat more concentrated than that of dividend receipts. To make this adjustment, the logarithms of the ratios of total market value to dividends by AGI class were regressed upon the logarithm of $(100-p)$, where p is the average of the two percentiles from the distribution of all filers corresponding, respectively, to the lower bound and upper bound of an AGI class. Such a regression was fitted using the 1960 data (Crockett and Friend, "Characteristics") and the results from the 1971 special sample given in table G of this appendix to part 5.

Using the same definition of p, but calculated from the BEA distribution of income, the regressions were used to estimate price-dividend ratios applicable to each of the BEA income groups. The 1960 regression was used in 1958, 1960, and 1964; the 1971 regression, in 1969, 1970, and 1971. These estimated price-dividend ratios were interpreted as those applicable to the BEA classes up to a multiplicative constant varying from year to year. Multiplying the BEA dividends by the corresponding estimate from one of these regressions gives the distribution of market value up to a multiplicative constant. Expressing the resulting values as percentage distributions gives the required distributions of market value.

A final step was necessary to interpolate these distributions of dividend income and market value of stock by income class in order to obtain the percentage of each accounted for by specified percentiles of families with highest total income. For 1964, there is no significant problem of interpolation, since the BEA dividend distribution shows information for 22 income classes and since both linear and curvilinear interpolations give almost identical results. However, this is not true for the other years for which data, on dividend income and market value, are available only for seven broader total income groups. For these years, the method of interpolation used assumed that the distribution of families and dividends among the several narrower income classes corresponding to each of the seven broader income groups was identical to that in 1964. While the results of curvilinear and linear interpolations applied to the narrower income classes are fairly close, the curvilinear interpolation seemed preferable and was used. Curvilinear interpolation of data for the broader income groups gives similar results.

Appendix to Part 5: The 1960 and 1971 Samples of Individual Income Tax Forms 1040

This appendix presents detailed descriptions of the sampling procedures followed in selecting the 1971 special sample of individual Income Tax Forms 1040 and the adjustments made to the sample in deriving the various estimates presented in the text.[67] To preserve confidentiality, the IRS was the only group that had access to the actual forms.

The appendix is organized in three stages, according to the three stages in which the sample was selected and processed. The first stage describes the sampling design and analyzes the extent and magnitude of potential biases in the special sample relative to the population of forms 1040 filed in 1971. The second stage presents the procedures that the Census Bureau followed in preparing a tape for subsequent processing at BEA and indicates the steps taken to preserve complete confidentiality of the original returns. The third stage discusses the adjustments made to the sample and then derives estimates of the dividends received and

67. Crockett and Friend, "Characteristics," contains a similar description for the 1960 sample.

Table C.—The SOI Sample and the 1971 Special Sample by Sample Strata

Stratum	Description		Number of forms					Final blowup factors
			Population	SOI sample	Min. number expected in 1971 special sample	Actual number in 1971 special sample	Actual number in 1971 special sample w. sch. B, part 1	
	Total		74,841,993	259,421	16,912	17,456	6,441	....
	Nonbusiness, total		65,759,069	123,605	10,978	10,893	3,951	....
	Absolute size of largest income item—							
11	Under $10,000		43,027,780	21,529	2,153	2,005	129	20,539
12	$10,000-$14,999		12,935,622	19,475	1,948	1,896	160	6,623
13	$15,000-$19,999		5,795,563	17,164	1,716	1,672	319	3,467
14	$20,000-$49,999		3,660,142	21,724	2,172	2,114	623	1,731
15	$50,000-$99,999		273,848	21,952	2,195	2,139	1,654	128
16	$100,000-$199,999		52,042	18,030	451	582	494	89
17	$200,000 and over		13,731	13,721	343	395	352	35
	Business, total		9,082,725	135,607	5,929	6,126	2,470	....
	Absolute size of largest income item—	and business receipts—						
21	Under $10,000	Under $20,000	3,996,158	14,117	706	707	66	5,652
22	$10,000-$14,999 Under $10,000	Under $50,000 $20,000-$49,999	2,364,823	16,626	832	833	141	2,833
23	$15,000-$19,999 Under $15,000	Under $100,000 $50,000-$99,999	1,217,878	18,345	917	919	222	1,324
24	$20,000-$29,999 Under $20,000	Under $250,000 $100,000-$249,999	880,725	17,480	874	876	316	1,005
25	$30,000-$49,999 Under $30,000	Under $500,000 $250,000-$499,999	403,630	18,035	902	903	504	447
26	$50,000-$99,999 Under $50,000	Under $750,000 $500,000-$749,999	168,565	16,919	846	847	550	199
27	$100,000-$199,999 Under $100,000	Under $1,000,000 $750,000-$999,999	34,608	17,267	432	502	343	69
28	$200,000 and over Under $200,000	Any amount $1,000,000 and over	16,808	16,808	420	549	323	31
30	Tax preference: Size of minimum tax $17,000 and over		209	209	5	27	23	8

Sources: Population and SOI sample figures were obtained from *SOI, 1971: Individual Income Tax Returns*, p. 316. Actual number in 1971 special sample figures were calculated by dividing blowup factors into population. Final blowup factors were supplied by IRS.

the value of stock owned by individual investors by AGI classes.

The first stage

In the first stage, IRS designated a subsample of the 1971 SOI sample for further processing. The SOI sample itself is a sample of forms 1040 stratified by: (1) the presence or absence of business receipts and (2) the absolute size of the largest income item and, if a business return, (3) the value of receipts. In addition, one small stratum includes all forms with a tax in excess of $17,000 on tax preference items exclusive of those in sample strata where all forms were sampled. Within either the business or nonbusiness groups, the sampling rates increased with the absolute size of the largest income item or, where appropriate, receipts. Table C presents the criteria for the strata, the number of forms for each stratum in the population, and the number drawn in the SOI sample.

To be sure that, at the lower income levels, there would be sufficient numbers of forms with dividends for later statistical analysis, the 1971 special sample was selected in such a way as to reduce the magnitude of the oversampling of upper income forms in the SOI sample. To this end, the IRS selected a subsample of the forms in each of the SOI strata according to a procedure that should have yielded a predetermined minimum number of randomly selected forms from each stratum. This predetermined minimum number varied from stratum to stratum.[68]

A comparison of these minimum numbers with the actual numbers subsampled from the SOI sample shows that the actual numbers by sample strata are in excess of the minimum numbers, as they should be, except for nonbusiness forms with AGI under $100,000 (table C). IRS personnel could provide no plausible explanation of why the numbers subsampled for these nonbusiness forms were less than the predetermined minimum under the sampling design.[69] If it can be assumed that there was nothing unique about the forms that presumably should have been in the subsample, but were not, the ratios of the population number of forms to the actual number sampled in each stratum provide the appropriate blowup factors for subsequently estimating the market value and other characteristics of stock held by individuals (see table C).

As the forms were selected from the SOI sample, IRS personnel photocopied

68. Specifically, the procedure would have been expected for each of the strata 11-15 to yield a minimum of 1 out of 10 of the SOI forms, for strata 21-26 a minimum of 1 out of 20, and for the remaining strata a minimum of 1 out of 40.

69. Due to a clerical error at the IRS, an undetermined but, according to the IRS, small number of forms with attachments to schedule B's was not included. While the effect should be minor in any case, the subsequent adjustments should minimize the potential impact of this error.

all those with completed schedule B, part 1, for later processing by the Census Bureau. This photocopying was done in such a way as to exclude the names, addresses, and social security numbers of the filers. Table C shows the number of forms with schedule B's, part 1, in the 1971 special sample.

Schedule B, part 1, contains a list of the sources and corresponding amounts of any dividend income or capital gain distributions. The sum of these amounts less capital gain distributions is entered on the front of form 1040 in box 13a. After deducting the exclusion, which may range up to $200 for a joint return, the dividends in AGI are entered in box 13c. Any single or joint filing with dividends and other distributions in excess of $100 should contain a completed schedule B, part 1, even if there is ultimately no dividend income in AGI. Undoubtedly, some filings contain a completed schedule B, part 1, even though dividends and other distributions were less that $100. Likewise, some filings probably do not contain a completed schedule B, part 1 (even though required), particularly if, after the exclusion, there were no dividends in AGI.

Thus, the photocopied forms can be viewed as a sample of forms with completed schedule B's, part 1—henceforth referred to simply as schedule B. If schedule B's were properly completed, and only when required, the population implicit in the 1971 special sample would include all filings with dividends in AGI plus all filings with dividends and distributions in excess of $100, but with dividend income below the allowable exclusion. If, as is probably the case, some schedule B's were completed even though not required and some not completed even though required, this clear interpretation becomes blurred. Although implicit in this discussion, it should be pointed out explicitly that the photocopied forms do not include all dividends received by individuals; therefore, in estimating the market value of stock held by individuals, a series of adjustments for these omitted dividends were necessary.

Before describing the work done by the Bureau of the Census, the extent and magnitude of any biases in this subsample of the SOI sample will be assessed by comparing the blown-up figures for numbers of forms in the 1971 special sample and the average dividends reported per form with blown-up figures from the SOI sample (see table D). Unfortunately, figures tabulated from the SOI sample are not exactly comparable with the 1971 special sample of forms with schedule B's. Nonetheless, there are both published and unpublished figures from the SOI sample that can be used as rough checks.

Consider first the number of forms. The SOI sample for individual income tax forms in 1971 provides an estimate of the number of forms that included the receipt of dividends on the front of form 1040 in box 13a. Since not all of these forms would have a schedule B, these numbers should be larger than the pupulation number of forms implicit in the 1971 special sample that was subsequently processed by the Bureau of the Census. The SOI sample also provides population estimates of forms with dividends in AGI. Every form in this category should have had a schedule B attached. Since some filers may have attached unnecessarily a schedule B or were required to attach one even though no taxable dividend income resulted, the number of forms implicit in the 1971 special sample of forms with schedule B's would be expected to exceed the number with dividends in AGI. Only if a substantial number of filers reported dividends in AGI on the front of form 1040 and failed to complete a schedule B would this last expectation be in error.

Thus, the estimates of the number of forms with schedule B's from the 1971 special sample should fall between the SOI estimates of the number of forms reporting dividends in box 13a and the number of forms with dividends in AGI. Table D shows that for forms with AGI of less than $100,000, the estimates of the number of forms from the 1971 special sample do fall between the appropriate SOI estimates. For forms with AGI in excess of $100,000 or above, the estimates from the 1971 special sample are marginally below the expected range.

Next consider dividends per form. Again tabulations based upon the SOI sample do not contain figures exactly comparable with those from the 1971 special sample with schedule B's, but perhaps conceptually the closest number available from the SOI sample is dividends in AGI per form. This number differs from the corresponding number for the 1971 special sample in two principal respects. First, dividends in AGI are after deduction of capital gains and nontaxable distributions and after provision for the dividend exclusion, which could range up to $200 per filing. Second, the 1971 special sample undoubtedly includes some forms with schedule B's, but no dividends in AGI. The first effect should result in some tendency for the dividends per form from the 1971 special sample to exceed the SOI estimate. The second effect should

Table D.—Comparison of Blown-Up Number of Forms and Dividends Per Form from SOI Sample and the 1971 Special Sample by AGI

Size of AGI	Number of forms			Dividends per form	
	SOI sample		1971 special sample	SOI sample	1971 special sample
	With dividends and other dist.	With dividends in AGI		With dividends in AGI	
Under $5,000	2,340,424	1,535,734	1,595,845	717	730
$5,000–$9,999	2,623,800	1,520,075	1,649,438	967	1,267
$10,000–$14,999	2,535,590	1,428,073	1,629,254	1,013	1,022
$15,000–$24,999	3,118,856	1,688,032	2,118,620	1,634	1,292
$25,000–$49,999	1,333,920	967,150	1,054,527	3,426	2,848
$50,000–$99,999	334,327	290,744	306,169	8,601	7,881
$100,000–$199,999	66,003	62,130	59,762	26,870	24,848
$200,000–$499,999	14,272	13,858	13,266	62,143	79,345
$500,000 and over	2,953	2,916	2,680	323,667	362,935
Total	12,673,175	7,518,621	8,429,581		

Sources: *SOI, 1971: Individual Income Tax Returns* and the 1971 special sample.

cause the reverse; but, on balance, particularly for the larger AGI classes or sampling codes, the first effect is probably more important than the second.

An examination of table D discloses that the dividends per form as estimated from the 1971 special sample tend to be marginally less than those estimated from the SOI sample for AGI between $15,000 and $199,999. Most of the understatement in these middle-income categories can be traced to the nonbusiness forms, though there is some evidence of a slight understatement in the business forms. IRS personnel were unable to provide any adequate explanation of these phenomena. For most of the analyses in this article, the adjustments in stage 3 will provide appropriate corrections. The only analysis that might be affected is that of diversification presented in part 5, but external figures presented in part 5 suggest that this bias is not serious.

The second stage

Next, IRS forwarded the photocopies to the Bureau of the Census for coding. As pointed out above, names of filers, addresses, and social security numbers were deleted from these photocopies. The Bureau prepared a file that included socioeconomic and sociodemographic characteristics, the names of all sources of dividends and other distributions listed on schedule B, and the associated dollar amounts. From the resulting file, the Bureau prepared a list of these dividend sources and sent it to the authors. Personnel at the Rodney L. White Center copied onto this list an identification number for each stock that was contained in the ISL tapes. The ISL tapes are a standard source of security prices and cover all NYSE and AMEX stock, roughly 400 mutual funds, and more than 3,000 OTC issues. In addition, a small number of issues not listed on the ISL tapes, principally small OTC companies, were assigned unique identification numbers.

For each of these identified issues, the Center's data files and standard financial publications were used to develop stock characteristics. If the value of an important characteristic for an identified stock was missing, what is technically known as a default value was assigned. These default values, listed in table E, were usually based upon available data for similar kinds of assets.[70]

Table E.—Default Values for Identified Securities by Types

Type of securities	Size of issue[1] (millions of dollars)	Ratio of divid. & dist. to price (6/71)	Ratio of total stock to stock with divid. or dist.[2] (6/71)	Return from 7/71 to 6/72 (percent)
NYSE-common	500 and over	3.05	1.0172	10.2
	100-499	3.14	1.1315	5.4
	Under 100	3.66	1.3404	8.0
NYSE-preferred		4.54	1.2076	1.5
AMEX-common	100 and over	2.24	1.1693	24.6
	15-99	2.30	1.9936	5.2
	Under 15	3.42	2.9000	6.7
AMEX-preferred		6.26	1.2502	11.2
Mutual funds		3.03	1.0049	11.1
OTC-financial-common	50 and over	2.68	1.0505	14.3
	10-49	2.80	1.2159	16.7
	Under 10	3.03	2.7138	12.0
OTC-financial-preferred		2.83	1.0000	13.3
OTC-industrial-common	100 and over	2.40	1.1418	18.0
	15-99	3.04	1.6397	12.4
	5-14	3.33	2.8975	5.9
	Under 5	4.25	6.7595	7.9

1. Any issue for which the size of issue was unknown was classified in the smallest category of its type.
2. The ratios for banks and bank holding companies irrespective of other characteristics were 1.0025 and 1.0116, respectively.

Source: See text.

A dividend or distribution source was not assigned a unique identification number if the ISL tapes did not cover the company or if the name of the source was incomplete, like "First National Bank." These sources were classified as accurately as possible into one of several generic categories by using the names of the sources as guides. Table F lists these categories, the percentage of sample dividends falling in each, and

70. For any category of stock in table E, generally less than 1 percent and never more than 2.5 percent of the blown-up dividends used default values in ascertaining the associated market values. These market values are the basic input for estimating the distribution of market value of stock held by AGI class.

Table F.—Default Values, Names, and Importance of Generic Categories

Generic category	Percentage of sample dividends in category	Ratio of divid. & dist. to price (6/71)	Ratio of total stock to stock with divid. or dist. (6/71)	Return from 7/71 to 6/72 (percent)
Agency or custodial accounts	4.34	(1)	(1)	10.4
Agency, custodial, or trust accounts	1.10	(1)	(1)	10.4
Banks	3.54	3.04	1.0025	25.3
Bank holding companies	.25	3.88	1.0116	18.1
Brokerage houses	2.24	(1)	(1)	10.4
Insurance companies (stock)	.69	2.61	1.0000	10.4
Investment clubs	.03	3.10	1.0916	10.4
Holding companies	.11	2.87	1.0558	19.2
Mutual funds	.47	3.03	1.0049	11.1
NYSE (oil companies)	.08	5.00	1.0000	10.4
NYSE (unidentified)	.06	3.14	1.0520	9.0
Professional partnerships	1.13	3.00	1.0000	10.4
Real estate and mortgage trusts	.02	6.76	1.0000	−.1
Trusts and estates	18.27	(2)	(2)	9.0
Miscellaneous (preferred)	.75	4.54	1.2047	40.4
Miscellaneous (unidentified)[3]	17.14	2.71	1.6667	16.4
Deleted items:				
Credit unions	.00			
Insurance companies (mutual)	.01			
Other nonstock items	.43			

1. The ratio of dividends and other distributions to price, and the ratio of total stock to stock with dividends or distributions, was calculated separately for each of the AGI classes shown in table D. The first ratio was calculated as the ratio of the total dividends and distributions received by filers in a given AGI class on all dividend-paying items other than those received through agency, custodial, and street name accounts to the market value of these items. The second ratio was calculated as the ratio of the market value of all items other than those received through agency, custodial, and street name accounts to the previously derived value of dividend-paying items.
2. The ratios were calculated as in the previous footnote, except that they were based only on identified NYSE issues.
3. The ratios were derived from the total holdings of industrial OTC stock with no control for AGI.

Source: See text.

Table G.—Dividends, Other Distributions, and Market Value of Stockholdings of Individual Investors by AGI

Size of AGI	Dividends and other distributions, 1971	Dividends, 1971	Market value, 1971	Dividends to market value (ratio)	
	(millions of dollars)			1971	1960
Under $5,000	1,973	1,827	65,731	.028	0.035
$5,000–$9,999	2,132	1,932	64,656	.030	.034
$10,000–$14,999	2,068	1,922	70,554	.027	.034
$15,000–$24,999	3,160	2,924	112,776	.026	.035
$25,000–$49,999	3,718	3,515	143,056	.024	.036
$50,000–$99,999	2,926	2,812	126,084	.022	.033
$100,000–$199,999	1,861	1,807	85,118	.021	.031
$200,000–$499,999	1,340	1,303	59,202	.022	.031
$500,000 and over	1,143	1,102	52,606	.021	
Total	20,322	19,144	780,783	.025	.034

Source: *SOI, 1971: Individual Income Tax Returns*, 1971 special sample, and Crockett and Friend, "Characteristics."

the default values of selected characteristics used in the subsequent processing. Because of the diversity of these categories, the miscellaneous (unidentified) stock are most likely to be closely held or small publicly traded industrial corporations. Some items, such as interest payments, should not have been reported as dividend income. These items were deleted in some of the calculations presented in the text.

The third stage

The Census Bureau merged the stock characteristic file with the tax form information and forwarded the resulting file to BEA for final processing. To estimate the dividend and market value of all stock held by individuals by size of AGI, the following calculations were performed:

1. The population estimates of the dividends and other distributions for filers with dividends and the distributions reported on schedule B's as derived from the 1971 special sample were made to conform to the corresponding SOI estimates for all filers for each of the AGI classes given in table G. The specific adjustment was to multiply every dividend and distribution on all forms within a specific income class by the ratio of the SOI aggregate estimate for that class [71] to the 1971 special sample aggregate estimate.[72] This adjustment accounts for the dividends reported on the front of the forms 1040 but not on schedule B's. It also has the desirable property of making the 1971 special sample less sensitive to any sampling bias that may be associated with the level of AGI.

2. From the estimates prepared in part 3, the dividends that should have been reported on schedule B's, but were not, are estimated at roughly $336 million. This sum was distributed over reported dividends and other distributions in such a way that the noncompliance ratio for each income class would be a multiple of that for persons with AGI of $50,000 or over. For AGI less than $10,000, the multiple was 4.0, for AGI of $10,000–$14,999, 5.5; for AGI of $15,000–$24,999, 4.5; and for AGI of $25,000–$49,999, 3.5. These relative ratios of noncompliance were derived from an IRS study in 1959 [73] by equating the fractile ranges of AGI in 1959 with those in 1971.

3. From the estimates prepared in part 3, it is determined that $433 million represent dividends received by persons not required to file. These dividends were allocated to the lowest AGI class.

4. From the estimates prepared in part 3, it is determined that $217 million of dividends were received by filers who had dividend income less than the allowable exclusion and failed to report them in box 13a of form 1040. This sum was distributed according to the same distribution by AGI as returns that did report dividends, but failed to exhaust the exclusion. This distribution was taken to be proportional to the difference in each AGI class between the SOI estimates of the number claiming dividend exclusion [74] and the number of returns with dividends in AGI. About 60 percent of such returns fall in the AGI range $15,000–$24,999, with 90 percent under $25,000.

5. To allow for dividends retained by estates and trusts for their beneficial owners, each dividend from a trust was increased by 57 percent. This adjustment moves the market value of these kinds of assets implicit in the 1971 special sample to $130 billion, which is in rough conformity with the external estimate developed in part 3.

6. All but $7.5 million of dividends reported as received from publicly traded brokerage firms were reclassified as dividends received on stock held in street name accounts.

With these adjustments, the 1971 special sample implies that individuals received $20.3 billion in dividends and other distributions. Table G shows the breakdown by AGI class. After subtracting the SOI estimates of capital gain and nontaxable distributions,[75] the dividends received by individuals, including retentions by estates and trusts, are estimated at $19.1 billion (see table G). The dividends and other distributions, together with the stock characteristics and the default values in tables E and F, imply a market value of individual stockholdings of $780 billion.

Finally, table G gives the dividend yield rates that were used in analyzing the change in the concentration of holdings over time in part 4. For comparison, table G also presents dividend yield rates for 1960 that were calculated conceptually in the same way as those for 1971.

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71. *SOI, 1971: Individual Income Tax Returns*, p. 62, col. 2.

72. The 1971 special sample estimate excludes items that should not have been reported on schedule B. A similar adjustment, however, was not made to the SOI estimate. This lack of adjustment will result in an approximately 0.5 percent overstatement of dividends and other distributions. To offset this overstatement, no adjustment was made for the underreporting of capital gain and nontaxable distributions, which is roughly of the same magnitude.

73. Holland, *Dividends*.

74. This fails to allow for the probable increase, as income rises, in the average dividend of those falling short of the exclusion. However, the distribution of dividends received by this group cannot be determined from available data without an arbitrary assumption as to the average exclusion by income class on joint returns for those with dividends in AGI.

75. *SOI, 1971: Individual Income Tax Returns*, p. 62.

Chairman HUMPHREY. Mr. Fay, I know you had to make some adjustments. We will come to you. You have to catch an airplane a little bit later.

You speak from the corporate point of view, is that correct?

Mr. FAY. No, sir. I speak as a tax lawyer who is practicing in the area of employee benefit plans, and I speak as a tax lawyer, not for any firm or any other person, but myself.

Chairman HUMPHREY. Go right ahead. We are pleased to hear from you.

STATEMENT OF RICHARD H. FAY, ATTORNEY, REED, SMITH, SHAW & McCLAY

Mr. FAY. I understand your time constraints, and that you would like us to summarize. Therefore, I would like to give briefly what I feel are the major points of my prepared statement, and to paraphrase Upton Sinclair—I have been to the future as envisioned by ESOP's and it does not work.

One, most of the interest in the creation of ESOP's—with some exceptions, but most of the interest has nothing to do with making the worker an owner. In most of the cases, ESOP's will not be a fable, it will be a fraud.

Two, workers have a right to think of deferred compensation plans as offering something of value they should expect to receive. This is recognized in law. It is recognized in ERISA.

ESOP's would defeat that expectation.

Three, we are taking an inherently dangerous situation, as far as workers are concerned, and maximizing the risk to the worker with leverage.

As I said, I will not read the prepared statement, but let me to back to some parts of the prepared statement.

These hearings must try to clarify why the reasons given in public forums like this for the establishment of ESOP's are so entirely different, in fact, contradictory, to the reasons I hear at the presentations by these same spokesmen before businessmen.

At such meetings, you hear about a cheap way to obtain corporate financing and how to handle wealthy taxpayers' estate planning, reasons having nothing to do with making the worker an owner and a capitalist. At such meetings, the employee is not mentioned first; he is not mentioned last; he is not mentioned at all.

ESOP's can be a very complex topic involving highly technical rules of tax and other applicable laws, but some commonsense principles can be enumerated to place the magic of ESOP's in context. First, the American businessmen are not in the business of giving their businesses away. They may feel overtaxed and overburdened by the Federal Government, but they have not thrown in the sponge.

Businessmen are in business to make money. I see nothing wrong with this, which is why I can state it so plainly.

Second, when talking about ESOP's, we seem to have developed a certain Gertrude Stein mentality, that a corporation is a corporation is a corporation. In fact, corporations are very, very different, and they vary greatly. Probably the greatest difference is that between a publicly held corporation whose stock is publicly traded, subject to

extensive governmental regulations, protecting the shareholder, and whose value therefore can be easily ascertained; and a private, closely held corporation whose stock, operating totally without regulations, having no market whatsoever and whose value, therefore, is highly arbitrary.

This is true for most closely held private corporations, regardless of how successful they are. This is one of the reasons for the inordinate interest in ESOP's.

The ESOP can create a market where none has existed before under terms and conditions dictated by the seller, free from Governmental regulation. Once this contrived market has been created, it permits the ESOP to be used for a variety of purposes that have nothing to do with the worker, for example, a corporate bailout.

Let us take the example of the corporate bailout. It is not my word, but the word used by people advocating the use of an ESOP. Businessmen incorporate for many valid reasons.

In a small incorporated business, however, you face a problem when you come near to retirement how to get your value out. The tax code is unfortunate from their viewpoint. It insists that they be taxed at ordinary income. If they do not try to take their value out, it is left to their estate, and the heirs have the exact, same problem.

What do you do?

This problem, which has been so troublesome to small businessmen, is now going to be solved. We are going to create an ESOP trust, establish a value—I can tell you, gentlemen, one of the most controversial areas in the tax law, even before the present interest in ESOP's, is the value placed on a stock in privately held corporations—which is highly arbitrary. You create the trust, you assign a value, and now you give the stock to your employees, and you receive cash taxed at capital gains rates.

This is sort of like calculating the future performance of a race car based on the past performance of the engine and driver, then taking that driver, that engine and prize money away and leaving the pit crew to carry on.

There have been some questions about what labor's position is. I think they are probably as confused about the complexity of the subject as everyone else is. I think that traditionally labor has viewed employee benefit plans as a form of deferred compensation. This view is recognized in labor law.

That is the reason why benefits under a pension plan and benefits under profit-sharing plans are mandatory items of collective bargaining. Also, under the tax code, we provided these taxable provisions because it was felt that they serve the socially useful purpose of providing retirement income for a substantial number of employees. These tax provisions deviate from the normal tax treatment in that you allow a deduction, but nobody has any taxable income.

This concept that you are serving some purpose for the worker was picked up by ERISA, and if ERISA had any thrust at all, it said that the worker had some reason to expect some value from the creation of these programs. It is my contention that the worker will see little, if anything, of value in the creation of most ESOP's.

Third, and last, when I say this is inherently dangerous for a worker, I mean you are placing him in double jeopardy. He now has his job,

his retirement income, and his deferred compensation riding on the same horse. He loses his job if the company goes out of business and also he loses everything else.

I might add that for this reason the Senate Finance Committee, in reporting its version of the pension reform bill in the 93d Congress, limited investment by a profit-sharing plan in the securities of an employer whose securities were not traded in an established market to not more than 10 percent of the trust assets.

The report of the Senate Finance Committee stated: "This limit is needed because of the greater difficulty in selling such securities and, therefore, the greater risk involved in the situation."

I am sure we have all heard the phrase that those who do not learn from history are doomed to repeat it, and the concept of investing in stock is not new. It is interesting that today's solution was yesterday's scandal.

In 1939, a subcommittee to the Committee on Finance issued a detailed study on the experience in profit-sharing plans when they invested exclusively in employer stock, and that report documented case after case where thousands of workers lost both their jobs and their savings, seriously jeopardizing their faith in the American capitalistic system.

The committee report concluded, in discussing investment by profit-sharing plans, that "common stock should not be sold to employees, thus subjecting them to the hazardous and speculative fluctuation of the market," and it also recommended that "in any case where this policy is adopted, the company should establish reserves guaranteeing the purchase price of the stock sold."

Of course, the ESOP is just the reverse of creating reserves to make sure there is some value there. This is a leverage transaction. The most recent popular leverage transaction is called REIF's—real estate investment funds—which at least have some diversification. Leverage increases the risk to the employee.

For example, if an ESOP buys a share of a publicly traded security and borrows 90 percent of the purchase price, a 10-percent decline in the market value of the stock would completely wipe out the equity of the participants.

So what is new about ESOP's is that to meet corporate financing needs, we maximize, to the fullest extent possible, the risk to employees.

I have a list in my prepared statement of recommendations. I would like to add two more.

One, I would strongly recommend that existing profit-sharing plans and other plans not be converted into ESOP's. Even if one is convinced that ESOP is a terribly sound principle, it seems daring and unfortunate in the extreme to take existing funds and jeopardize them.

Two, you will hear a great deal of testimony about how ESOP's will work. There is really very little evidence that they do work, but people are going to make a claim. If they do, I think that they should also open up their books and see just who is benefiting.

Thank you.

Chairman HUMPHREY. Thank you, Mr. Fay. Your prepared statement will be placed in the record at this point.

[The prepared statement of Mr. Fay follows:]

Prepared Statement of Richard H. Fay

I. INTRODUCTION: HEARING URGENTLY NEEDED BECAUSE OF CONFLICTING REASONS GIVEN FOR ESTABLISHING AN ESOP

Mr. Chairman, it is an honor and a privilege to have the opportunity to testify before the Joint Economic Committee on ESOP's. These hearings are urgently needed. For while Congress has passed four major pieces of legislation containing provisions favorable to ESOP's, these hearings are the first in-depth congressional analysis of ESOP's. Businessmen who are being bombarded by propaganda on ESOP's and their lawyers who have many questions and doubts are told by ESOP advocates not to worry, that ESOP's have obtained a congressional mandate, that Congress supports them and that any problems that may arise in the future will be resolved by Congress.

Also, these hearings are needed to clarify how it is that advocates of ESOP at public forums like today's hearing can give reasons for establishing ESOP's, such as participatory democracy and every worker should be a capitalist and other such noble themes, which are directly contrary to the reasons given for ESOP's by these very same advocates in their sales presentations before business groups. At such meetings you hear about a cheap way to obtain corporate financing and how to handle wealthy taxpayers' estate planning, reasons having nothing to do with making the worker an owner and a capitalist. At such meetings, the employee is not mentioned first; he isn't mentioned last; he's not mentioned at all.

II. GENERALLY: BUSINESSMEN ARE NOT IN THE BUSINESS OF GIVING THEIR BUSINESS AWAY UNLESS:

ESOP's can be a very complex topic involving highly technical rules of tax and other applicable laws, but some common sense principles can be enumerated to place the magic of ESOP's in context. First, businessmen are not in the business of giving their businesses away. They may feel overtaxed and overburdened by the federal government, but they haven't given up. Businessmen are in business to make money. I see nothing wrong with this, which is why I can state it so plainly. Second, when talking about ESOP's, we seem to have a Gertrude Stein mentality, a feeling that a corporation is a corporation is a corporation. Corporations are not all alike; they vary greatly and the greatest difference between corporations is the difference between a publicly held corporation whose stock is publicly traded, subject to extensive governmental regulations, protecting the shareholder, and whose value, therefore, can be easily ascertained, and a private, closely held corporation whose stock, operating totally without regulations, having no market whatsoever and whose value, therefore, is highly arbitrary. This is true for most closely held private corporations regardless of how successful they are. And this is one of the reasons for the inordinate interest in ESOP's. An ESOP can create a market where none existed before under terms and conditions dictated by the seller, free from governmental regulation. Once this contrived market has been created, it permits what I consider to be the most vicious use of an ESOP—a corporate bailout.

This country can be rightfully proud of the great number of businessmen who have made a success of their businesses. For the most part, these businessmen and their associates choose to incorporate that business for valid tax reasons. Incorporation resulted in the shareholders paying less taxes than if they had not incorporated. Now they wish to retire and they face a real problem. The tax code is structured so that if they try to take out some of the value in the company, either in cash or in stock, they will be taxed at an ordinary income tax rate, and the corporation will not obtain a tax deduction for that distribution. If they leave their shares in the corporation to their estates, they have merely transferred this problem to their heirs. How to turn that stock into cash? They can't even give it away. A businessman could receive a great deal of the alleged cash flow and balance sheet advantages incident to establishing an ESOP by making a charitable contribution of his stock, for example, to the Salvation Army, but the Salvation Army, while deeply grateful, will tell them that they need cash to feed the poor and his stock, regardless of what value may be placed on it by the highly competent and independent accountant hired by the company, cannot be converted into cash because there is no market. Aren't the employees of the corporation in the same situation of not being able to use these pieces of paper?

Therefore, this businessman faced with this dilemma of passing on to his heirs pieces of paper which usually have no liquidity or trying to take the value out of the corporation now and usually being taxed at the ordinary tax rate suddenly discovers a solution which apparently has the congressional imprimatur—an ESOP. Let's create a trust and foist on his employees the problem that the highly creative and energetic entreprenuer was unable to solve.

Of course, a value will be ascribed to the stock and because there is no real market for it, the person doing this, no matter how independent, has to use some highly arbitrary assumptions. Even before the emergence of ESOP's, the valuation of closely held corporate stock was one of the most controversial and litigated areas of the law. This appraiser or accountant who is as competent and honest as the businessman's lawyer are both in the business of trying to make their client's dream come true. They will achieve what the busimessman wishes to accomplish if it is permissible under the law. Neither the businessman, the accountant, nor his lawyer can nor will be concerned with what constitutes proper public policy. Establishing public policy is the job of Congress.

And so a value will be established for the stock and the stock will be sold to the employees, and then the people who were the reason for the company's success and value will modestly withdraw. This is like assessing the likely track performance of a specially built racing car based on the prior record of the driver and engine and then removing both driver and engine and leaving the pit crew the rest of the car. Or to use another metaphor, it is like sucking the lemon dry and leaving the rind.

III. ESOP: HOW TO GET SOMETHING FOR NOTHING

Of course, not every businessman wishes to retire, but even for him the ESOP's advocates maintain that an ESOP can solve many of his corporate financing problems, including incredibly enough, creation of a tax loss carry-back, thereby obtaining a tax refund. Understandably enough, a businessman is interested in making money, not in giving up his business, and for him the ESOP salesman say he doesn't have to. By the most artful hopscotching through the tax code and the provisions relating to ESOP, it is possible to devise an ESOP which results in substantial tax savings to businessmen with little, if any, loss of corporate control. An ESOP is created, but control of the stock in the ESOP trust remains firmly in the hands of the employer because he either selects or is the trustee of the ESOP trust. Just as an extra measure of safeguard, many ESOP advocates maintain, and I agree, that you can fund an ESOP with nonvoting, nondividend, common stock. Of course, eventually there may be a day of reckoning and some stock may have to be distributed to employees, but do you have any idea of the practical value of the minority interest in the stock of a privately held corporation? And again, as a further safeguard, the ESOP can be drafted so that stock can be repurchased by the employer at a value established by their friendly independent accountant. I hope this discussion has given some idea of how ESOP's, in reality, all too often, mock their rhetoric and how ESOPs are not just subject to abuse, but are vehicles of abuse.

IV. ESOP FROM THE WORKER'S VIEWPOINT

While I speak primarily as someone practicing in the field of employee benefit plans, I would like to discuss briefly what I would suspect might be the attitude and concern of the labor movement about ESOP's. From the workers' viewpoint, the establishment of an employee benefit plan represents the choice of deferring compensation instead of receiving additional wages now. In other words, he is giving up something now for something of even greater value in the future. This view of an employee benefit plan being a form of deferred compensation is recognized by law. Under labor law, for example, pension benefits, including benefits under a profit-sharing plan, are a mandatory item of collective bargaining because they constitute wages. Under the tax law, substantial tax benefits are provided to a qualified plan because it is felt that they serve the socially useful purpose of providing retirement income for a significant number of low-paid employees. So from both the tax and labor law prospectives, a qualified plan is a form of deferred wages which the worker has some reason to expect to receive.

The realization of this expectation was the whole purpose of ERISA. Congress, in passing ERISA, established minimum vesting and funding standards and so forth because it believed that workers were not wrong in expecting something from these deferred compensation plans. ESOP advocates argue that workers have no righ to complain if they receive nothing of value as long as they get employer stock, and perhaps if you read the fine print of an ESOP, the advocates are right; the worker gets what he was promised—nothing.

V. THE INHERENT DANGER OF AN ESOP

Finally, it should be understood that some forms of employee benefit plans are inherently dangerous for employees. If, for example, a profit-sharing plan is totally invested in employer stock, the worker is placed in double jeopardy. If the business fails, and more businesses fail than succeed, the worker loses not only his job, but also his deferred compensation. It guarantees turning a tough position into a really miserable one for the worker.

For this reason, the Senate Finance Committee, in reporting its version of the pension reform bill in the 93d Congress, limited investment by a profit-sharing plan in the securities of an employer whose securities were not traded in an established market to not more than 10 percent of the trust assets. The report of the Senate Finance Committee stated that "this limit is needed because of the greater difficulty in selling such securities and, therefore, the greater risk involved in the situation."

I am sure we have all heard the phrase that those who do not learn from history are doomed to repeat it, and the concept of investing in stock of the employer is not new. It is interesting that today's solution was yesterday's scandal. In 1939 a subcommittee to the Committee on Finance in the U.S. Senate issued a study on the experience in profit-sharing plans. The report documented case after case where thousands of workers lost both their jobs and their savings, seriously jeopardizing the American worker's faith in the capitalist system. The Committee Report concluded, in discussing investment by profit-sharing plans, that "common stock should not be sold to employees, thus subjecting them to the hazardous and speculative fluctuation of the market," and it also recommended that "in any case where this policy is adopted, the company should establish reserves guaranteeing the purchase price of the stock sold." And now, we come to the only thing that is truly new about ESOP's—maximizing the risk for the employee. For besides being something old, something borrowed, and something blue, there is something new and that is leverage. Leverage increases in an inherently dangerous situation the risk to the employee. For example, if an ESOP buys shares of a publicly traded security and borrows 90 percent of the purchase price, a 10 percent decline in the market value of the stock would completely wipe out the equity of the participant in their account. So what is new about ESOP's is that to meet corporate financing needs, we maximize to the fullest extent possible the risk to employees.

VI. RECOMMENDATIONS

For all these reasons I hardly think that the ESOP concept is one that should be approved without reservation and reform. In the right circumstances, and ESOP can achieve its stated goals, but safeguards are urgently needed to prevent abuse.

(1) ESOP's should be permitted only for companies whose stock is traded on national exchanges, or in circumstances where it can be clearly demonstrated that a viable business is being created or continued.

(2) It should be made clear that, as a matter of public policy, ESOP's are subject to all the fiduciary rules of ERISA other than diversification requirements.

(3) It should be required that an ESOP invest only in common voting stock and that this stock be voted by the employee, not by the employer or his representative.

(4) It should be required that there be immediate vesting in the stock for the employees so that they are truly owners.

Chairman HUMPHREY. Mr. Kelso, I know you are listening very intently. You will have some critical examination. We will come back to you.

We will have Mr. Brems, followed by Mr. Brannon.

Mr. Brems, you are from the University of Illinois, I believe. We are very honored to have you.

Mr. BREMS. I am very pleased to be here and see my own Senator here.

Mr. Chairman, may I, too, ask that my prepared statement plus the exhibits in it be made a part of the record. I have already deposited this statement and the photograph with the committee.

Chairman HUMPHREY. We have it. It is an excellent prepared statement, and it will be printed in the record. We have questions based on it for you.

Go ahead.

STATEMENT OF HANS BREMS, PROFESSOR OF ECONOMICS, UNIVERSITY OF ILLINOIS, URBANA-CHAMPAIGN CAMPUS

Mr. BREMS. Qua economist, no economist can set ends. Ends are set by Congress. The useful job that economists can do is to study the economic effects of a proposed new arrangement to see if the arrangement would, in fact, serve the given ends. Perhaps the economist can also think of alternative arrangements that serve the same end, or ends.

What I am going to say will take only about 6 or 8 minutes. I am going to talk a little bit about the alternatives first, and the effects later.

First, the alternatives.

Keynes, 35 years ago, offered the idea of a wage earners' investment fund for the first time. The Keynesian origin has been forgotten, but the idea itself has been viable. For 20 years it has been debated in Continental Western Europe, and nationwide German and French systems have existed since 1961 and 1967, respectively.

In a somewhat different form, the idea is now emerging in the United States. It might be useful at this point to see what the similarities and dissimilarities are between the European and the ESOT concept.

In the ESOT concept, voluntary wage earners' investment funds are being set up by, and confined to, individual firms—well, I call it ESOT because I like to talk about the thing itself, the employee stock ownership trust, rather than just the plan. The principal differences between the Western European concept and the ESOT concept are the following. I mention the most important ones; I have more in my prepared statement.

ESOT is set up by, and confined to, an individual firm. A Western European fund is usually not. Relying on an employer's initiative spurred by a tax incentive, ESOT is set up instantly by borrowing; employer cash contributions will slowly pay off its debt, as time goes on. Relying on the initiative of employees and their unions, Western European funds engage in no borrowing; employer stock contributions will slowly build up the fund. At least initially—perhaps permanently, I cannot find out—ESOT is not free to diversify its portfolio; a Western European fund usually is: Diversification is considered to be an important characteristic of an investment fund.

So much for the forms. Now, for the effects.

In my prepared statement, I examine the effects of a wage earners' investment fund on four things: First, control of corporate industry; second, the propensity to save national output; third, the inducement to invest it; fourth, labor productivity and resource allocation.

Under these four headings, I divide my attention evenly between the Western European and the ESOT concepts, to try to find out if the effects are different.

I begin with No. 1, control of corporate industry. Under the Western European concept, the funds may become as large as one-tenth of total physical capital stock, and since corporate stock is about one-fourth of the physical capital stock owned by corporations, these funds will be large enough to establish some degree of labor control of corporate industry. The fund, of course, in some cases will be by far the largest stockholder, even though it will not have a majority.

ESOT's, probably for the reasons that I set out in my prepared statement, would be a somewhat smaller fraction.

No. 2, the propensity to save national output. Wage earners' investment funds could raise the propensity to save national output, and thereby help accelerating capital formation, by reducing the national disposable-income fraction of the national output. A Western European fund as well as an ESOT coming into existence without any tax incentive would do so. With a tax incentive, a universally adopted ESOT would reduce the corporate profits tax liability very substantially—I made some attempts to figure out by how much in my prepared statement—resulting, everything else being equal, in a large fiscal deficit. That deficit could be avoided by fiscal reform restoring the lost revenue from somewhere else. If it were, an ESOT might still reduce the national disposable-income fraction of national output.

This would perhaps increase the propensity to save national output, depending on how much the propensity to save disposable income differs between wage earners and nonwage earners. Any wage earners' investment fund, including ESOT, will redistribute disposable income from capitalist-entrepreneurs on the one hand to wage earners on the other hand. Therefore, if the propensity to save of the wage earners is substantially less than the propensity of the others, then the propensity to save national output overall may fall.

I do not think, though, that this would happen. On the other hand, it is not enough that the propensity to save is up. If there is going to be any more capital formation out of this, the inducement to invest also would have to be up.

Both the Western European concept and the ESOT concept do something to corporate finance. They force the firm to give up self-financing and resort to issuing stock. If it is true that the riskier the investment project considered, the stronger is the firm's preference for self-financing, then a wage earners' investment fund could reduce the inducement to invest, thus decelerating capital formation rather than accelerating it.

Under ESOT, as we all know and have heard many times this morning, there is rich compensation in the form of tax deductibility and tax credit, which primarily has the effects of dramatically reducing the cost of capital to the parent firm. Similarly, rediscounting by the Federal Reserve System of notes issued by ESOT would also dramatically reduce the cost of capital.

I heard—I was not sure I heard correctly—I heard a number, 1 percent or 2 percent, something like that.

Chairman HUMPHREY. Mr. Kelso said, I think, a maximum of 3 percent.

Mr. BREMS. Such rediscounting would no doubt have the effect of dramatically reducing the cost of capital, but it also, of course, would just as obviously expand the money supply, and you had better talk to Mr. Burns about that.

It should be fully understood—this is a point I want to make very strongly—that if the dramatic reduction of the cost of capital does accelerate capital formation—I think it might well do that—then the same effect could have been produced in non-ESOT ways, such as reducing the overall Federal corporate profits tax rate, by raising the overall investment tax credit, by further accerlerating the accelerated depreciation allowance, or by expanding the money supply and

reducing the rate of interest. The effect is the effect of specific—liberal—Federal fiscal and monetary policies rather than effects inherent in the ESOT idea.

Finally, a few words about labor productivity and resource allocation. The effects on labor productivity and resource allocation depend very much on the degree of centralization of the wage earners' investment fund. In my prepared statement, in five steps, I examine such effects by running the gamut from the extreme decentralization case, which is an ESOT, to the extreme centralization case, which is the national fund.

Generally, I find that under extreme decentralization and no diversification of the portfolio of the ESOT fund, local labor productivity at the plant floor may well be raised in tangible ways, less vandalism, less carelessness, less waste of materials, more attention to the job, so on and so forth. This would happen within existing technology, with the individual firm, and in the short run.

As decentralization becomes less extreme and diversification of the portfolio becomes more complete, these effects at the plant floor may be lost, because the fund may not own stock in your particular corporation. Whatever you can do on the plant floor may have no effect on the value of the stock that the fund does own. Therefore, you have lost that incentive.

Instead, new effects would emerge that do not meet the eye so readily. Historically, and practically, labor productivity has been raised by reallocating resources in response to new technology. Capital has moved from low-return to high-return uses, and labor has moved from low-wage to high-wage jobs.

There is something I must say at this point, as I listen to Mr. Kelso.

I missed something very much. When Mr. Kelso talks about labor productivity, when he talks about labor, he is thinking of the labor that operates the machine, on the plant floor. He is never thinking of the labor that designs and builds these machines. In other words, he is overlooking the white collar workers that constituted 17 percent of the labor force in 1900, but constitute 47 percent of the labor force now.

The higher productivity of white collar workers is a result of investment in the kind of capital, which, I deplore very much, does not appear in the national income accounts; namely, human capital. When we talk about capital formation in the national income accounts, we mean physical capital only, plant and machinery. But the human capital is important. If we can't measure it directly, we have indirect measurements of it.

I would say if there has been a revolution at all in the American economy as an economist would see it since the Second World War, it is this: In 1940, 15.6 percent of the population aged 18–21 was enrolled in higher education. In 1970, 51.4 percent was enrolled. We have more than trebled the number of people who have some kind of higher education, and we have raised labor productivity correspondingly. So there is a tremendous technological change going on. The technological change is the result of the ideas that all these people who have had all this higher education are having. These new ideas demand a constant reallocation of resources.

We accomplish that reallocation of resources by making labor and capital as mobile as we can. I am pleased to say that in all the coun-

tries I know, I know of nowhere where labor and capital are more mobile than in the United States.

The question is, if wage earners' investment funds might do something to help mobility of labor and capital? I think, in the less decentralized forms, in the more diversified forms, they might well do that. If they do, they might help us to adjust resources more quickly and more easily to new technology.

Finally, a word on policy conclusions. ESOT's appeal to business lies, no doubt in the tax incentives offered. Under those tax incentives, widespread adoption of ESOT could well accelerate capital formation. But if it does, the same effect could have been produced in non-ESOT ways by liberal Federal fiscal and monetary policies.

If it is felt that public policy should, in one scoop, both accelerate capital formation and do something about the unequal distribution of wealth, then the liberal fiscal and monetary policies could be combined with incentives to set up wage earners' investment funds. I must emphasize that wage earners' investment funds come in a wide variety, almost a bewilderingly wide variety of forms. Among those forms, ESOT is only one, and it is a rather special one.

ESOT asks the employee to own corporate wealth in a form so risky that no stockholder, individual or institutional, that I have ever known, voluntarily chooses to do it that way. For that reason, U.S. labor—presumably the beneficiary of the whole thing—has shown not much, if any, interest in ESOT.

My conclusion is that more diversified funds, funds owning voting stock only and funds more acceptable to their beneficiaries, might be considered. Suprafirm funds, funds extending beyond the individual firm, might do less for labor productivity at the plant floor than ESOT does, but might do more for capital and labor mobility in the economy at large, and thereby ultimately do more for labor productivity at large. Thank you, Mr. Chairman.

Chairman HUMPHREY. Thank you, Mr. Brems. Your prepared statement will be placed in the record at this point.

[The prepared statement of Mr. Brems follows:]

PREPARED STATEMENT OF HANS BREMS*

WAGE EARNERS' INVESTMENT FUNDS—ALTERNATIVE FORMS AND THEIR ECONOMIC EFFECTS

I. INTRODUCTION

1. *The Purposes of a Wage Earners' Investment Fund*

While the income distribution generated by capitalist economies is generally more equal than that generated by pre-capitalist ones, much public policy has been directed towards redistribution and equalization of income. Wealth distribution is much less equal than income distribution. But until recently, it has attracted less attention.

*For travel assistance to a short trip to Western Europe in 1974 and for a sabbatical leave of absence there in 1975, the writer is indebted to the University of Illinois at Urbana-Champaign.

For discussions during seminar presentations in the spring of 1974 at Cornell University, the Erasmus Universiteit at Rotterdam, and the Universität Mannheim, the writer is indebted to Walter Galenson, P. J. Verdoorn, Wouter Siddré, and Jürg Niehans. For private conversation he is indebted to Jürgen Siebke of the Christian-Albrechts-Universität at Kiel. For very active participation, he is indebted to his Danish and Swedish students at two workshops conducted by him during the spring of 1975 on the economics of wage earners' investment funds at the universities of Copenhagen and Lund. For discussion during a seminar presentation in March 1975 at the Rijksuniversiteit te Groningen, he is indebted to Frits J. de Jong and his graduate students. For private conversation he is indebted to Steffen Möller of the Danish Metalworkers' Union, to Rudolf Meidner of the Swedish Confederation of Trade Unions, and to Gunnar Eliasson and Per-Martin Meyerson of the Federation of Swedish Industries.

Finally, for a critical reading of the present statement the writer is indebted to his colleague Marvin Frankel of the University of Illinois.

A wage earners' investment fund would be one step in the direction of equalizing wealth distribution. Directly it would serve the dual purpose of giving labor a share of, first, the capital gains accruing to stockholders in an inflationary economy and, second, the co-determination rights inherent in stock ownership.

Less direct effects have also been hoped for. Perhaps the fund would be a step towards a labor-managed economy [2], [7], [19], and [30]. Perhaps the fund would raise the propensity to save national output and thus relieve a possible capital shortage [8]. Perhaps a tax-exempt fund would enable the parent firm to borrow on more favorable terms and thus raise the inducement to invest [15]. Perhaps the fund would reduce alienation and raise labor productivity [15]—or at least raise labor tolerance of profit-making and of income policies involving money-wage restraint [8] and [22].

2. *The Purpose of the Present Testimony*

Thirty-five years ago, Keynes [16] offered the idea of a wage earners' investment fund. The Keynesian origin has been forgotten, but the idea itself has been viable: For twenty years it has been debated in Continental Western Europe, and nationwide German and French systems have existed since 1961 and 1967, respectively. In a somewhat different form the idea is now emerging in the United States.

The spectacular postwar growth, employment, capital-formation and trade record of Continental Western Europe indicates that some social experimentation may be compatible with a high-performance capitalist economy. I shall therefore divide my attention evenly between the Western European and the United States concepts of a wage earners' investment fund.

The purpose of my testimony must be to describe and to analyze: To describe alternative forms of wage earners' investment funds and to analyze the economic effects of such alternative forms. Such analysis would seem useful, first because little [1] has been done so far. Second, because the funds could conceivably become quite large, representing a significant modification of corporate capitalism and having significant effects upon the generation of disposable income, the propensity to save national output, the inducement to invest it, and labor productivity and resource allocation. I shall analyze such effects, but before I can analyze I must describe.[2]

II. THE WESTERN EUROPEAN CONCEPT, PLANS, BILLS, AND STATUTES

3. *The Concept*

The general idea of a wage earners' investment fund as typically proposed or enacted in Western Europe may be briefly expressed as follows.

A wage earners' investment fund would be serving the dual purpose of giving labor a share of, first, the capital gains accruing to stockholders in an inflationary economy and, perhaps second, the co-determination rights inherent in voting-stock ownership. By law or collective agreement, or of their own free will, and primarily in the form of corporate stock, employers would contribute a fraction of either their wage bill or their profits bill to the fund. Call the former contribution an investment wage, the latter profit sharing.

The fund would not be confined to any particular firm. Not being so confined, the fund is free to sell its share of any firm at any time and buy shares of other firms, thus diversifying its portfolio. Here the fund would exercise its own independent judgment, steadily comparing the quality of the stock of one firm to that of others. The fund would belong to the employees and would issue nonnegotiable fund certificates to them. A specified number of years after its issue a fund certificate would become redeemable in cash at a price which would include the share of that certificate in the original contribution to the fund as well as all capital gains and dividends made on that contribution during the lifetime of the certificate.

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[1] Western European advocates of wage earners' investment funds have produced readable pleas like those by Bergström [2], Cars [7], Landsorganisationen [18], and Meidner [19]. Serious economic analysis is offered—in non-English languages only—by the Danish council of economic advisers (Det ökonomiske Råd) [8] and in the applied parts of Krelle, Schunck and Siebke [17], 87–491. Recent German theoretical work on the redistribution of wealth ignores fund accumulation, Jaeger [14], the theoretical part of Krelle, Schunck and Siebke [17], 52–86, Mückl [21], and Ramser [23].

In the United States Kelso [15] and elsewhere, has offered his plea and his underlying philosophy but no serious economic analysis.

[2] For a comprehensive recent six-country survey, see my [4], 14–31. For a less recent but more comprehensive survey, see O. E. C. D. [22] and Robinson [24].

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4. *The Plans*

What Keynes [16] proposed in 1940 was a compulsory investment wage. With the purpose of paring down consumer demand to wartime output of consumers' goods, he proposed a "deferred-pay" scheme calling for £550 million in annual compulsory saving. The complete scheme, including the "accumulation of working-class wealth under working-class control," would embody, Keynes said in his preface, "an advance towards economic equality greater than any which we have made in recent times." Keynes' proposal was adopted strictly as a wartime measure and to less than a quarter of his suggested sum [20].

Compulsory profit sharing was first proposed by Gleitze [12]. Employers should not be deprived of the use of any of their capital, he said, Hence, in the form of corporate stock rather than in the form of cash, employers should contribute compulsorily a fraction of their profits to the fund. The Gleitze Plan was endorsed by the German federation of labor unions [9] in 1961.

5. *The Bills*

In 1973 a bill [1] proposing a compulsory investment wage failed to pass in the Danish parliament. The bill was a modified proposal by the Danish federation of trade unions [18]. Both proposed a single national fund and a contribution fraction of 5 per cent of the wage bill. The bill proposed a seven-year (the federation of trade unions had proposed a five-year) redemption period.

In 1974 the coalition government of the Federal Republic of Germany [10] agreed on the principles of a bill proposing compulsory profit sharing. The bill would propose a number of suprafirm funds among which the individual wage earner would be free to choose. The contribution fraction was to be progressive, reaching a maximum of 10 per cent of very large profits bills. A seven-year redemption period was proposed. No actual bill has been put before parliament as yet

6. *The Statutes*

In 1961 a voluntary investment-wage scheme was enacted by the Federal Republic of Germany. Funds were to be set up by collective bargaining and could simply be blocked accounts in savings banks or banks. Contributions may take the form of stock, bonds, or cash. If agreed upon within a maximum of 624 DM per wage earner per annum they are generously supplemented by government cash subsidies. The scheme was revised twice and is now so appealing that two-thirds of all wage earners are participating. The redemption period is seven years.

In 1967 a compulsory profit-sharing scheme for larger corporations was enacted in France. Here, too, funds could simply be blocked accounts in savings banks or banks. Contributions may take the form of stock, bonds, or cash as agreed and entitle the firm to an equivalent tax credit. The redemption period is five years.

III. THE UNITED STATES CONCEPT AND STATUTES

7. *The ESOT Concept*

Voluntary wage earners' investment funds set up by, and confined to, individual firms were proposed and are being assisted by Kelso [15] under the name of "employee stock ownership trusts"—let us call them ESOT for short. An ESOT comes into existence as follows.

It begins with an act of borrowing: In its own name but guaranteed by the parent firm, ESOT borrows a sum in the capital market. Next comes an act of issuing stock: The sum borrowed is turned over to the parent firm which issues stock in return and turns it over to ESOT.

So far, to the parent firm this looks much like financing new investment by issuing new stock. But there are two differences, and the first one is seen at once: The parent firm has guaranteed ESOT's borrowing. The second difference becomes visible later: Over the years, the parent firm undertakes a succession of acts of contributing cash to ESOT, enabling the latter to pay interest on its debt as well as amortize it. In return for its contributions, the parent firm receives nothing tangible from ESOT: Specifically it doesn't get back the stock issued to ESOT.

In the absence of an ESOT, had a firm financed new investment by issuing new stock, no debt would ever have come into existence, hence no amortization would have been called for. The new stock would have diluted ownership. Should the firm later find itself with cash to spare, and should it wish to re-concentrate

ownership, it could choose to spend the cash buying back its own stock. On the other hand, still in the absence of ESOT, had the firm financed its new investment by borrowing, no new stock would ever have come into existence.

By contrast, under the ESOT concept the parent firm has issued the new stock *and* borrowed as well. In the end it has diluted ownership *and* amortized as well. What makes the firm take such a double burden upon itself? The answer lies in the statutes.

8. *The Statutes*

United States statutes offer old and new tax incentives for the parent firm to set up an ESOT. The Internal Revenue Code has long allowed tax *deduction* on contributions to an ESOT amounting to a maximum of 15 per cent of the wage bill of the parent firm. The code, in other words, established a new principle, i.e., tax deductibility of the amortization of the principal of a loan—not just the interest payments. The 1975 Tax Reduction Act adds the further incentive of tax *credit* for contributions to an ESOT amounting to a maximum of one per cent of the investment in capital equipment by the parent firm.

9. *Differences Between the Western European and the ESOT Concept*

Eight differences [3] between the Western European and the ESOT concepts of a wage earners' investment fund stand out.

First, to the dual purpose of Western European schemes ESOT adds a third purpose, i.e., that of enabling the parent firm to borrow on favorable terms including tax deductibility and tax credit. For the parent firm to take advantage of such favors, an ESOT must be set up *instantly*, borrowing cash from the outside; employer cash contributions will slowly pay off the debt of ESOT. Western European schemes rely on no borrowing, hence cannot set up the fund instantly. Employer stock contributions will slowly build up the fund.

Second, the second of the two purposes of Western European schemes was to give labor a share of the co-determination rights inherent in voting-stock ownership. ESOT may defeat that purpose: In return for granting tax deductibility the law does not require the parent firm to issue voting stock to ESOT. In return for granting tax credit it does. Firms wishing to preserve existing control patterns will issue *nonvoting* stock.

Third, ESOT is a voluntary scheme relying on an employer's initiative spurred by a tax incentive. No employee or labor union initiative is foreseen, and none has been forthcoming! The employee is assigned the role of a presumably sympathetic but passive *bystander*—sympathetic because he will eventually own something for nothing. By contrast, if like the West German investment-wage system (in which two-thirds of West German wage earners are now participating), Western European schemes are voluntary, they rely on the initiative of the employees and their unions rather than on that of the employer.

Fourth, ESOT represents the *extreme-decentralization* case of a wage earners' investment fund. ESOT is set up by, and confined to, an individual firm. A Western European fund is not confined to any single firm—we could call it a suprafirm fund. At most a Western European fund might be confined to a single industry or a single geographical region.

Fifth, at least initially [15], 29, 35, ESOT is not free to sell its share of any firm at any time and buy shares of other firms, thus *diversifying* its portfolio. A Western European fund is usually free to do so.

Sixth, the contribution to an ESOT may be neither an investment wage nor profit sharing. Tax deduction is allowed on contributions amounting to a maximum of 15 percent of the wage bill of the parent firm. Fully utilized such a tax deduction would make the contribution an investment wage. Tax credit is allowed for contributions amounting to a maximum of one percent of the investment in capital equipment by the parent firm. Fully utilized such a tax credit would make the contribution *neither* an investment wage *nor* profit sharing. Profits would not be shared: Entitling the parent firm to a full tax credit, the contribution would cost the firm nothing. In other words, employees would benefit at the expense of the Federal government rather than at the expense of the parent firm.

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[3] Western European schemes are not, of course, uniform. Consequently items duplicating ESOT may be found: (1) The German Friedrich Plan [4], 19–20, too, served the purpose of enabling the parent corporation to borrow on favorable terms. (2) The French profit-sharing system [4], 23–25, too, allows tax credit for contributions to a wage earners' investment fund. (3) The Danish Blacksmiths' and Machinists Union [4], 25, too, proposed funds confined to a single firm. (4) The three Dutch trade-union federations [4], 23, too, proposed freezing of contributions until the individual employee reached retirement age.

Seventh, ESOT *freezes* merely the original contribution to the fund [15], 29. Western European schemes usually freeze the original contribution and all capital gains and dividends made on that contribution during the lifetime of the fund certificate.

Eighth, most ESOTs are designed to permit *redemption* either at termination of employment or at retirement [15], 29. Western European schemes make contributions redeemable a specified number of years after they were made.

Several of these differences will turn out to be decisive, as I now examine four major economic effects of a wage earners' investment fund, i.e., the effects upon

1. control of corporate industry,
2. the propensity to save national output,
3. the inducement to invest it,
4. labor productivity and resource allocation.

IV. ECONOMIC EFFECTS OF FUNDS: LABOR CONTROL OF CORPORATE INDUSTRY?

10. *Size of Funds Under Western European Concept*

How large a fraction of total physical capital stock would wage earners' investment funds ultimately be?

In the form of corporate stock let all employers contribute either a fraction of their wage bill or a fraction of their profits bill to wage earners' investment funds. The funds will then be growing for two reasons. First, what is being put into them is growing: The wage bill or the profits bill themselves are growing. Second, once put in, the contributions will earn a return. Let the earnings of the funds be compounded continuously, and let all wage earners present their fund certificates for redemption as soon as the latter become redeemable. Redemption at time t is the accumulated value at time t of the contribution made at time $t-r$ where r is the length of the redemption period. The size of the funds at time t is the accumulated value at time t of all contributions made between time $t-r$ and time t. To find that size one must use integral calculus and computer simulation. Elsewhere in technical papers [5] and [6] I have done that. It turned out that for a redemption period $r=8$ years, an investment wage with a contribution fraction of $1/20$ of the wage bill would generate funds equalling 0.100 of total physical capital stock. Profit sharing with a contribution fraction of $1/10$ of the profits bill would generate funds equalling 0.069 of total physical capital stock. Such a redemption period and such contribution fractions are on the high side of anything ever proposed, see Sec. II above. Would such ambitious and universal funds be large enough to establish labor control of corporate industry?

In the United States, corporate stock is about ¼ of total physical capital stock owned by corporations.[4] Applying my findings[5] to the United States corporate sector, then, I find that funds of between 0.069 and 0.100 of total physical capital stock would not establish majority control of corporate industry. But as we know, less than majority may be needed for effective control.

11. *Size of Funds Under ESOT Concept*

How large a fraction of total physical capital stock would ESOT funds ultimately be? Probably a smaller one. There are two reasons to expect this.

First, ESOT freezes merely the original contribution. The Western European concept freezes not only the original contribution but also all capital gains and dividends made on that contribution during the lifetime of the fund certificate.

Second, ESOT redeems more permissively. Most ESOTs are designed to permit redemption either at termination of employment or at retirement. In the former case the average redemption period may be rather short.

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[4] U.S. Bureau of the Census [29], 479. For our purpose the denominator is overstated by including land and intangible assets.

[5] The capital stock in my computer-simulation models was thought of as business physical capital stock only, and all business was thought of as corporate business.

How large a fraction of actual physical capital stock does belong to business? In the United States, business nonresidential physical reproducible assets are merely 36 per cent of all physical reproducible assets; government, institutions, consumer durables, and residential structures account for the remaining 64 per cent, see U.S. Bureau of Economic Analysis [26], Series A 129–A 154, 202–207, quoting Goldsmith [13] and Tice and Duff [25].

How large a fraction of actual business physical capital stock does belong to corporations? In the United States corporations own perhaps between ⅔ and ¾ of all physical capital stock owned by business; the U.S. Bureau of the Census [29], 483, doesn't tell us: We don't know what (1) the share held by corporations *smaller* than the 200 largest; (2) by *non-manufacturing* corporations, or what (3) the shares of *physical* assets alone would be.

12. *Motivation of Funds*

Should wage earners' investment funds become large, powerful, and diversified, how would they behave? Would they be like any other institutional stockholder, always on the lookout for high-return stock, always trying to get rid of low-return stock?

They might well be. Existing and proposed Western European funds are usually free to sell their share of any firm at any time and buy shares of other firms, thus diversifying their portfolio. Return maximization may be explicitly foreseen. The Danish union proposal [18], Sec. 14 and bill [1], Sec. 22, both specifically ordered an "active" placement of the fund and defined "active" as guaranteeing, first, a share of the capital gains and, second, a maximum dividend. When not explicitly foreseen, return maximization may still be likely, especially if a number of suprafirm funds were set up among which the individual wage earner would be free to choose—as he would in the German coalition government proposal [10].

But then occasionally a wage earners' investment fund might not be like any other institutional stockholder. Occasionally it might try to protect jobs in less profitable firms. Such attempts could keep less capital-intensive, less rapidly growing, and less well-managed firms alive at the expense of more capital-intensive, more rapidly growing, and better-managed ones. A genuine conflict may thus exist between the interests of a wage earner *qua* owner of the fund and *qua* holder of a particular job. As I have shown elsewhere [4], 54–58, such malallocation of resources would be more likely under an investment wage than under profit sharing.

V. EFFECTS UPON CAPITAL FORMATION: PROPENSITY TO SAVE NATIONAL OUTPUT

13. *Capital Formation and the Generation of Disposable Income*

Could a wage earners' investment fund accelerate capital formation? It would have to do so by raising the propensity to save national output. Given the propensity to save disposable income, this, in turn, would have to be done by reducing the national disposable income fraction of national output.

But raising the propensity to save national output would not in itself accelerate capital formation. The inducement to invest would have to be raised, too—by reducing the cost of capital to the firm.

These things lie at the heart of economic theory, but we shall have to come to grips with them. We begin with the generation of disposable income. As usual we distinguish between the Western European and the ESOT concepts of a wage earners' investment fund.

14. *Disposable-Income Generation Under the Western European Concept*

Fiscal policy is less heavily involved in the Western European concept than in ESOT, so we ignore it.

Under an investment wage, wage earners' disposable income at any time t is the wage bill *minus* contribution *plus* redemption at that time. Under the Western European concept what is being redeemed at time t is the accumulated value at time t of the contribution made at time $t-r$ where r is the length of the redemption period. The accumulated value includes all capital gains and dividends made on that contribution between time $t-r$ and time t. Because the wage bill is growing, the original contribution was smaller than the current one. But under realistic assumptions the capital gains and dividends made will more than make up for the original smallness. As a result, redemption at time t will exceed contribution at time t. Consequently, wage earners' disposable income is larger than it would have been in the absence of a wage earners' investment fund.

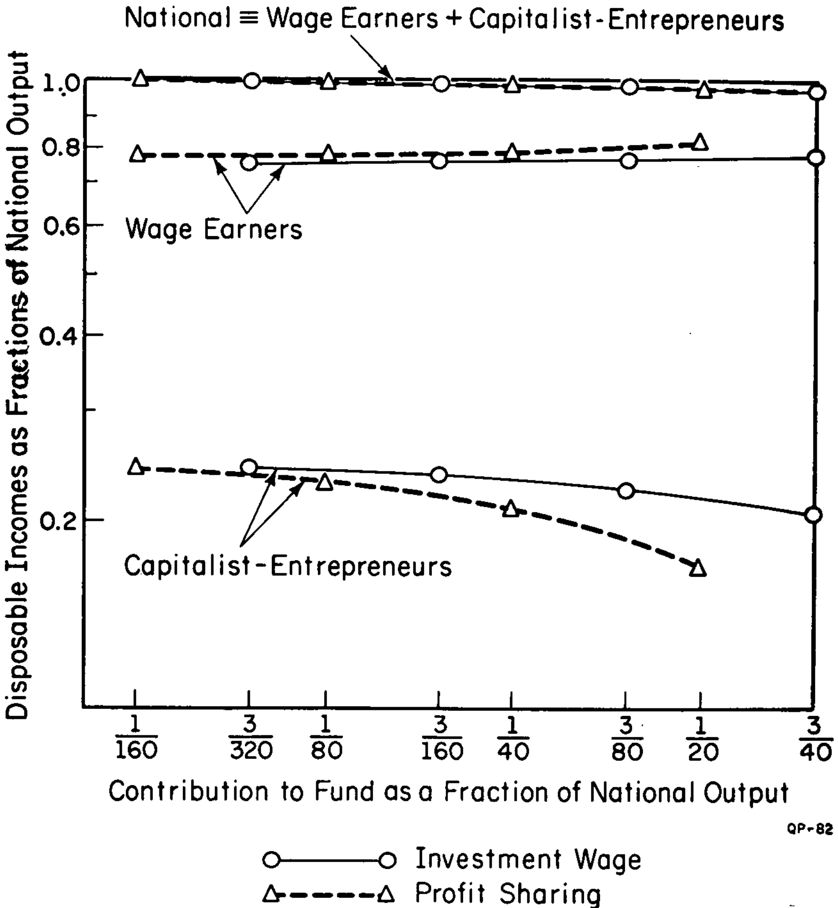
This holds even more under profit sharing. Here wage earners' disposable income at any time t is the wage bill *plus* redemption at that time. There is no reduction here, only enlargement!

Under an investment wage, disposable income of capitalist-entrepreneurs is their profits on all capital stock except the fund. So a wage earners' investment fund reduces their disposable income by the profits they used to make on the capital stock that now belongs to the fund. Consequently the disposable income of capitalist-entrepreneurs is smaller than it would have been in the absence of a wage earners' investment fund.

This holds even more under profit sharing. Here the disposable income of capitalist-entrepreneurs is their profits on all capital stock except the fund *minus* their contribution to the fund. There is a further reduction here and no enlargement!

Until now everything has been straightforward: A wage earners' investment fund raises the disposable income of wage earners and reduces that of capitalist-entrepreneurs. But what will it do to national disposable income? Will the reductions be greater than, equal to, or less than the enlargement? The reductions are, first, the profits the capitalist-entrepreneurs used to make on the capital stock that now belongs to the fund and, second, the contribution to the fund either in the form of the investment wage or in the form of profit sharing. The enlargement is always the redemption.

Whether the reductions will be greater than, equal to, or less than the enlargement is not intuitively obvious. Where intuition fails, one must build numerical models and try to make their structure as realistic as possible. Within the framework of a conventional growth model [3] I have done so in the technical papers [5] and [6] mentioned in Sec. IV, 10 above. For a redemption period of $r=8$ years, the results are summarized in my diagram.



The horizontal axis of my diagram shows the contribution to the fund as a fraction of national output. Employers contribute either the fraction a of their wage bill or the fraction b of their profits bill. The wage bill, in turn, is the fraction α and the profits bill the fraction β of national output. Consequently an investment wage will contribute the fraction αa and profit sharing the fraction βb of national output. Under United States conditions $\alpha=3/4$ and $\beta=1/4$.

The vertical axis of my diagram shows national disposable income, wage earners' disposable income, and capitalist-entrepreneurs' disposable income, all three of them as fractions of national output.

Two results stand out in the diagram. First, an investment wage and profit sharing contributing the same fractions $\alpha a = \beta b$ of national output reduce the national disposable-income fraction of national output identically. Second, both redistribute disposable income in favor of wage earners, but the former less so that the latter.

15. *Disposable-Income Generation Under ESOT Without Fiscal Policy*

For the moment assume an ESOT to come into existence without any tax incentive. Then we may still ignore fiscal policy.

Under ESOT, earnings of the fund are not compounded but paid out currently to the members of the fund. This simplifies things. The reduction of national disposable income is now merely the contribution to the fund. The profits the capitalist-entrepreneurs used to make on the capital stock that now belongs to the fund, are now paid out currently, hence are no longer a reduction of national disposable income.

The enlargement of national disposable income is still the redemption, and the redemption is somewhat different under ESOT. ESOT permits redemption only at termination of membership—at retirement or termination of employment. What is being redeemed to an individual ESOT member at time t is therefore his share of the accumulated corporate contributions made between time $t-m$ and time t where m is the length of his membership period. This redemption does not include the capital gains and dividends made on those contributions between time $t-m$ and time t. Because everything is growing, the original contributions were smaller than the current ones, and there is no longer anything to make up for the original smallness. As a result, for all fund members taken together, redemptions at time t will fall short of contributions at time t: Enlargement will fall short of reduction, and we need no mathematical model to see that ESOT, too, will reduce the national disposable-income fraction of national output. The extent to which ESOT will do so will depend upon two things.

First the size of the contribution fraction: The higher the fraction, the more debt ESOT can amortize, hence the more stock it can acquire. ESOT tax credit has a maximum of one per cent of investment—a low fraction by Western European standards. But ESOT tax deduction has a maximum of 15 per cent of the wage bill of the parent firm—a very high fraction by Western European standards.

Second the length of the average membership period. If redemption is permitted at termination of employment, a redemption-seeking employee may be induced to change jobs. In that case the average membership period may be short. If, on the other hand, redemption is permitted only upon retirement the average membership period will be long.

16. *The Fiscal Effects of ESOT*

Few ESOTs would come into existence without any tax incentive, so we must consider their fiscal effect. How much corporate profits tax revenue would the Federal government be losing if ESOT' were universally adopted?

We begin with the tax *deduction* allowed on contributions to an ESOT amounting to a maximum of 15 per cent of the wage bill of the parent firm. In 1972 the United States nonfinancial corporate wage bill was $429 billion [27]. In the unlikely event that all nonfinancial corporations had set up ESOTs and contributed, say, 10 per cent of the wage bill to them, total contributions would have been $42.9 billion. Claiming this sum as a deduction would have reduced profits before tax from its actual $74.3 to $31.4 billion, hence have reduced the profits tax liability from its actual $35.0 billion to some $15 billion.

Next the tax *credit* allowed on contributions to an ESOT amounting to a maximum of one per cent of the investment in capital equipment by the parent firm. In the United States in 1972, purchases of physical assets by nonfarm nonfinancial corporations were $100.7 billion [28]. Claiming one per cent of this, $1 billion, as tax credit would have meant a total reduction of the corporate profits tax liability from its actual $35.0 billion to some $14 billion—to exactly ⅖!

17. *Fiscal Reform*

A $21 billion reduction of the corporate profits tax liability is a $21 billion increase in corporate or personal disposable income. But long before that happened, fiscal reform would have become necessary. Either the reform would call for higher

tax rates recovering lost revenue or it would have to sacrifice government services hitherto rendered. The effect of such fiscal reform upon national disposable income as a fraction of national output would be part and parcel of the overall economic effects of a widely adopted ESOT. Examining such effects would carry me far beyond my present statement and deeply into the realm of fiscal policy. Rather than doing that I return to my immediate question: Could a wage earners' investment fund raise the propensity to save national output, thus helping to accelerate capital formation?

18. *The Propensity to Save National Output*

Sec. 14 found that the Western European concept of a wage earners' investment fund would reduce the national disposable-income fraction of national output. Sec. 15 found that an ESOT coming into existence without any tax incentive would do the same. Sec. 16. estimated the fiscal effects of a universally adopted ESOT. With such effects neutralized by the fiscal reform mentioned in Sec. 17, ESOT might still reduce the national disposal-income fraction of national output.

Armed with those findings we are ready to draw conclusions about the propensity to save national output. We begin with the simplest alternative, i.e., that the propensity to save disposable income is the same for wage earners and capitalist-entrepreneurs. A wage earners' investment fund reducing the national disposable-income fraction of national output will then unequivocally raise the propensity to save national output.

Next we examine a less simple alternative. If the propensity to save disposable income is not the same for wage earners and capitalist-entrepreneurs the propensity to save national output may conceivably fall: We saw that a wage earners' investment fund will redistribute disposable income in favor of the wage earners. Consequently, if wage earners have a substantially lower propensity to save disposable income than do capitalist-entrepreneurs, then redistributing disposable income from capitalist-entrepreneurs to wage earners may conceivably overwhelm the effects of reducing the national disposable-income fraction of national output. The net effect may be a fall in the propensity to save national output. Such a fall is perhaps less likely than a rise [6]. It is particularly unlikely under an investment wage, because the latter has a weaker redistributive effect than does profit sharing.

But raising the propensity to save national output would not in itself be enough to accelerate capital formation. The inducement to invest would also have to be raised. Could a wage earners' investment fund do that?

VI. EFFECTS UPON CAPITAL FORMATION: INDUCEMENT TO INVEST

19. *The Cost of Capital*

What is the cost of capital to a firm? To be marketable corporate stock must offer a prospect of dividends and capital gain. Offering such a prospect, then, is the price to be paid for capital raised by issuing stock. Interest is the price to be paid for borrowed capital. Neither price has to be paid for self-financing, hence the firm's preference for the latter. In the United States nonfarm nonfinancial corporate business [28] the ratio of internal sources of funds to purchases of physical assets stays close to 3/4. The riskier the investment project considered, the stronger the preference for self-financing.

If issuing stock, borrowing, and self-financing carry different price tags, could a wage earners' investment fund affect the cost of capital to the firm? As usual we distinguish between the Western European and the ESOT concept of such a fund.

20. *The Cost of Capital Under the Western European Concept*

Under the Western European concept the firm contributes to the fund in the form of corporate stock. No cash is contributed, so the cash equivalent of the contribution is still available for financing—in accordance with Gleitze's [12] leading idea. But the contribution has generated new stock. Perhaps we should visualize the contribution as follows. The firm would contribute cash to the fund, then issue new stock and sell it to the fund in order to retrieve the lost cash. The firm would end up with the cash and the fund with the stock, as they should.

[6] Forsyth [11], 66 and 72, merely expected a wage earners' investment fund to prevent a drop, but never mentioned a rise, in the propensity to save national output. Det Økonomiske Råd [8], 43 and 49, did expect fund accumulation to raise substantially the propensity to save national output.

But it would have become more transparent that a wage earners' investment fund forces the firm to give up some of its self-financing and to resort to issuing stock [7].

But would a wage earners' investment fund be like any other institutional stockholder unwilling to hold stock not offering a prospect of dividends and capital gains? A fund free to sell its share of any firm at any time and buy shares of other firms, thus diversifying its portfolio, may well be. But even lacking such freedom the fund will still eventually have to sell stock to meet its redemption obligations. Stock originally contributed to the fund may then fall into the hands of ordinary stockholders unwilling to hold it unless it offers a prospect of dividends and capital gains. Should they sell it, its market value might suffer, jeopardizing the marketability of future stock issues by the firm.

Suppose it is true that the riskier the investment project considered, the stronger is the firm's preference for self-financing. By forcing the firm to give up self-financing and resort to issuing stock, a wage earners' investment fund would then be inducing the firm to substitute less risky for more risky investment projects. This could decelerate capital formation. To avert such a danger, even the Western European concept of a wage earners' investment fund may need a tax incentive!

21. *The Cost of Capital under the ESOT Concept*

Does ESOT, too, force the firm to give up self-financing and resort to issuing stock? As we saw in Sec. III above, if in the absence of an ESOT a firm had financed new investment by issuing new stock, no debt would ever have come into existence. Had the firm financed its new investment by borrowing, no new stock would ever have come into existence. Under ESOT both come into existence. Having amortized its debt, the parent firm has still issued the stock and is left with a permanently diluted stock ownership. So far, just like the Western European concept, the ESOT concept forces the firm to give up self-financing and resort to issuing stock.

But under ESOT there is a rich compensation. Under current United States statutes an ESOT will dramatically reduce the cost of capital to the parent firm. The Internal Revenue Code has established tax deductibility of the amortization of the principal of a loan *via* ESOT. In business jargon we may say that the principal may be paid back in pre-tax rather than post-tax dollars. With a corporate profits tax rate of roughly one-half the difference is significant. To this should be added the further compensation of tax credit for contributions to an ESOT amounting to a maximum of one percent of the investment in capital equipment by the parent firm.

22. *Fiscal and Monetary Policies*

The dramatic reduction of the cost of capital to the parent firm under ESOT is accomplished not at the expense of the lender but at the expense of the Federal government. Consequently the reduction may be properly seen as the effect of a specific—liberal—Federal fiscal policy rather than inherent in the ESOT idea. If the reduction of the cost of capital accelerates capital formation—as it well may—the same effect could have been produced in non-ESOT ways such as by reducing the overall Federal corporate profits tax rate, by raising the overall investment tax credit, or by further accelerating the accelerated depreciation allowance.

Similarly the Federal Reserve System is being asked [15] to "monetize" the new capital formation by rediscounting notes issued by ESOT and already discounted by its lender. Such rediscounting would expand the money supply and reduce the rate of interest. Again, if such reduction of the cost of capital accelerates capital formation, the same effect could have been produced in non-ESOT ways—this time by more liberal monetary policies.

VII. EFFECTS UPON LABOR PRODUCTIVITY AND RESOURCE ALLOCATION

23. *Extreme Decentralization: ESOT Without Diversification*

Could a wage earners' investment fund raise labor productivity and help resource allocation to adjust more easily to new technology? Whether or not it could will depend upon the degree of centralization of the fund. So in five steps let me run the gamut from extreme decentralization to extreme centralization.

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[7] It is misleading, therefore, to imply that the firm's liquidity is not affected by contributions in the form of corporate stock, as Gleitze [12] and Bergström [2], 62, do.

ESOT represents the extreme-decentralization case of a wage earners' investment fund. At least initially it is wholly confined to the parent firm. The fund may not sell its share of that firm and buy shares of different ones. It cannot spread its risks among firms, industries, and geographical regions. It doesn't have much scope to maximize its rate of return.

One way, however, is open to it. Confined to the parent firm, the fund may induce the individual employee to raise his labor productivity. As an owner of the ESOT he himself would benefit from such a rise.

What kind of labor productivity is being raised here? Labor productivity is being raised by improving the quality of labor input at the plant floor in ways that readily meet the eye: Workmanship may be improved, pilfering, waste of materials, vandalism, and irregular work stoppages may be avoided, etc. Raising labor productivity in such tangible and important ways may be accomplished within *existing technology*, within the individual firm, and in the short run.

But there is a different way in which labor productivity may rise—has indeed risen historically [26], 37, 38—that does not meet the eye so readily. What happens in normal economic growth is that labor productivity is being steadily raised by a combination of (1) *new technology* (2) necessitating higher physical capital per man as well as higher human capital per man, invested in the form of better education of the men made redundant at the plant floor—or of their children—enabling them to engage in the designing of all the new physical capital or in all the new service industries.

That new technology does make white-collar workers out of blue-collar workers is seen from United States Census and Bureau of Labor Statistics data [26], 28, 197. In the United States since the turn of the century white-collar workers have constituted a rapidly growing percentage of the experienced civilian labor force: Growing from 17.6 per cent in 1900 to 47.6 in 1970. Since 1950 nonfarm blue-collar workers have constituted a declining percentage: Declining from 40.2 per cent in 1950 to 36.1 in 1970.

Raising labor productivity by making white-collar workers out of blue-collar workers may be accomplished with new technology, within the economy as a whole, and in the long run. It requires a new allocation of capital and labor, matching the new technology. In a capitalist economy free capital and labor markets take care of such allocation: Capital is free to move from low-return to high-return uses; labor is free to move from low-wage to high-wage jobs.

Would ESOT help or hinder such mobility? In other words, will ESOT help or hinder raising labor productivity in the sophisticated way just described?

I begin with labor mobility. If redemption is not permitted at termination of employment, the employee will be reluctant to leave the firm, and labor mobility is reduced.

ESOT's effect upon capital mobility is more complex. ESOT comes into existence by an act of borrowing cash from the outside. Through this act of borrowing ESOT and its parent firm submit to normal capital-market screening. The borrowing activity of ESOT in no way reduces the mobility of capital. With the borrowed cash ESOT buys newly issued stock of the parent firm. In its placement of the borrowed cash, ESOT initially has no choice. It cannot buy stock other than that of the parent firm. Unlike the less confined Western European funds, ESOT is not an agent exercising its own judgment, steadily optimizing the composition of its portfolio. While the borrowing activity of ESOT in no way reduces the mobility of capital, its placement constraint does.

As the contributions to ESOT start coming in, it may do one of two things. First, ESOT may pay off debt but simultaneously borrow new cash to buy more newly issued stock of the parent firm. New debt replaces old debt. By borrowing new cash, ESOT once again submits to normal capital-market screening.

Second, if choosing not to borrow new cash ESOT will eventually have paid off all debt. At that time, if contributions keep coming in, two alternative forms of ESOT must be distinguished. Either an ESOT having paid off its debt may *still* not be allowed to buy stock or firms other than the parent firm. Such a placement constraint premanently reduces the mobility of capital. Or an ESOT having paid off its debt may *now* be allowed to buy stock of firms other than the parent firm, thus diversifying its portfolio [15], 29.

That carries us to the next step.

24. *Less Extreme Decentralization: ESOT With Diversification*

Having paid off its debt ESOT is now free to sell its share of any firm at any time and buy shares of other firms in any industry or region, thus diversifying its portfolio. Does the right to diversify have any consequences for labor productivity and resource allocation?

As soon as the fund is permitted to diversify its portfolio, some or all of the inducement to raise labor productivity at the plant floor is lost: As an owner of the fund the individual wage earner can benefit from the rise only to the extent the fund is placed in the stock of *his* firm.

But there is compensation: In its own small way a diversifying ESOT may help increasing mobility of capital and thus help raising labor productivity in the sophisticated economy-wide way described in Sec. 23. And now our third step.

25. *Suprafirm Funds Confined to an Industry or Region*

Consider a fund not confined to a single firm—a suprafirm fund. But let the fund be confined instead to an industry or a geographical region. According to his industry or his residence, an individual wage earner would then automatically belong to one fund. He has no freedom of choice. Consequently there could be no competition among such funds.

The fund would receive shares of firms solely within that industry or region. The fund may sell its share of any firm and buy shares of others. But a genuine industry or regional fund would only be allowed to buy shares of firms within that industry or region. Consequently the fund could not spread its risks among industries or regions and would be of limited help in raising labor productivity in the economy-wide way described in Sec. 23 above.

But at least the suprafirm fund confined to an industry or region would somewhat soften the redemption dilemma of a wage earner's investment fund: Some of the reason to permit redemption at termination of employment has now disappeared. Since the suprafirm fund is not tied to any single firm, a fund member's change of job *within* his industry or region would no longer terminate his membership, hence constitute no reason for redemption. But for job changes beyond his industry or region the dilemma remains. That carries us to our fourth step.

26. *Suprafirm Funds Not Confined to an Industry or Region*

Again consider a fund not confined to a single firm—a suprafirm fund. But now let the fund be confined to neither an industry nor a region. Let there be a number of such funds among which the individual wage earner would be free to choose—as proposed by the German coalition government [10].

Each fund would be free to sell its share of any firm at any time and buy shares of other firms in any industry or region, thus diversifying its portfolio and spreading its risks amohg firms, industries, and regions. There is plenty of scope for the fund to maximize its rate of return. Furthermore, funds decentralized in this way may be under powerful competitive pressure to do so. Such funds would very likely choose to compete on rates of return offered. If some of them did, the rest would have little choice: They would have to follow suit.

Because a fund under this kind of decentralization would have plenty of scope for maximization of its rate of return, and would be under competitive pressure to do so, it could help raising labor productivity in the economy-wide way described in Sec. 23 above.

In addition, it would completely eliminate the redemption dilemma. The last reason to permit redemption at termination of employment has now happily disappeared: Since the fund is tied to neither a firm nor an industry nor a region, a fund member's change of job within the economy at large would no longer terminate his membership, hence constitute no reason for redemption.

Our last step into extreme centralization remains.

27. *Extreme Centralization. A Single National Fund*

For logical completeness I round off my picture and consider the ultimate centralization: A single national fund free to sell its share of any firm at any time and buy shares of other firms in any industry or region. But already the nonconfined funds considered in Sec. 26 had every such freedom, so the national fund would have no more scope than they had for maximizing its rate of return. It would be under no competitive pressure to do so, however. It would be a colossal fish in the pond: The Danish bill [1] anticipated a national fund owning 35 per cent of all Danish corporate stock by 1986! Its mistakes would be colossal ones, too. As a result it would be of little help in raising labor productivity in the economy-wide way described in Sec. 23.

VIII. SUMMARY OF FINDINGS

28. *The Two Forms*

There are many proposed and existing forms of a wage earners' investment fund. Several of them are described in Secs. 3 through 9. The two principal forms are the United States ESOT concept and the Western European concept. The principal differences between these two are the following.

ESOT is set up by, and confined to, an individual firm; a Western European fund is not. Relying on an employer's initiative spurred by a tax incentive, ESOT is set up instantly by borrowing; employer cash contributions will slowly pay off its debt. Relying on the initiative of employees and their unions, Western European funds engage in no borrowing; employer stock contributions will slowly build up the fund. At least initially, ESOT is not free to diversify its portfolio; a Western European fund usually is.

29. *The Four Effects*

Postwar growth, employment, capital-formation, and trade performance of Continental Western Europe compares favorably with our own. There, social experimentation has far from destroyed capitalist vigor. Consequently, in my examination of the economic effects of wage earners' investment funds I divided my attention evenly between the Western European and the ESOT concepts. I examined the effects upon—

1. control of corporate industry,
2. the propensity to save national output,
3. the inducement to invest it,
4. labor productivity and resource allocation.

Secs. 10 through 12: *Control of corporate industry.* Under the Western European concept funds might become as large as $1/10$ of total physical capital stock—large enough to establish some degree of labor control of corporate industry. ESOT funds would probably be a smaller fraction.

Secs. 13 through 18: *The propensity to save national output.* Wage earners' investment funds could raise the propensity to save national output by reducing the national disposable-income fraction of national output. A Western European fund as well as an ESOT coming into existence *without* any tax incentive would do so. *With* a tax incentive, Sec. 16 found the corporate profits tax liability reduced to $2/3$ by a universally adopted ESOT to which parent firms contributed 10 per cent of the wage bill. With such a colossal fiscal deficit avoided by colossal fiscal reform, ESOT might still reduce the national disposable-income fraction of national output.

If the propensity to save disposable income is the same for wage earners and capitalist-entrepreneurs, the fund would then unequivocally raise the propensity to save national output. If wage earners have substantially lower propensity to save disposable income than do capitalist-entrepreneurs, the propensity to save national output may fall.

Secs. 19 through 22: *The inducement to invest.* Such a fall is perhaps less likely. But even so, a higher propensity to save national output would not in itself be enough to accelerate capital formation. The inducement to invest would also have to be higher.

The Western European concept and the ESOT concept alike force the firm to give up self-financing and resort to issuing stock. If it is true that the riskier the investment project considered, the stronger is the firm's preference for self-financing, then a wage earners' investment fund could reduce the inducement to invest, thus decelerating capital formation. Under ESOT at least there was a rich compensation: Tax deductibility and tax credit to an ESOT would dramatically reduce the cost of capital to the parent firm. So would rediscounting by the Federal Reserve System of notes issued by ESOT and already discounted by its lender. Such rediscounting would expand the money supply and reduce the rate of interest.

But it should be fully understood that if the dramatic reduction of the cost of capital accelerates capital formation—as it well might—the same effect could have been produced in non-ESOT ways such as by reducing the overall Federal corporate profits tax rate, by raising the overall investment tax credit, by further accelerating the accelerated depreciation allowance, or by expanding the money supply and reducing the rate of interest. The effect is the effect of specific—liberal—Federal fiscal and monetary policies rather than one inherent in the ESOT idea.

Secs. 23–27: *Labor productivity and resource allocation.* The effects upon labor productivity and resource allocation depend very much upon the degree of centralization of the wage earners' investment fund. So in five steps such effects were examined by running the gamut from extreme decentralization to extreme centralization.

Generally it was found that under extreme decentralization and no diversification of the portfolio of the fund, local labor productivity—at the plant floor—might be raised in tangible ways. This would happen within existing technology, within the individual firm, and in the short run.

As decentralization became less extreme and diversification more complete, the effects at the plant floor would be lost. Instead new effects would emerge that did not meet the eye so readily. Historically—and practically—labor productivity has been raised by reallocating resources in response to new technology: Capital has moved from low-return to high-return uses, and labor has moved from low-wage to high-wage jobs. Within the economy as a whole and in the long run, wage earners' investment funds less decentralized and more diversified than ESOT might raise the mobility of capital and labor, thus helping resource allocation to adjust more easily to new technology.

IX. TENTATIVE POLICY CONCLUSIONS

30. *Means and Ends*

Qua economist, no economist can set ends. Ends are set by Congress. The useful [8] job that economists *can* do is to study the economic effects of a proposed new arrangement to see if the arrangement would, in fact, serve the given ends. Perhaps the economist can also think of alternative arrangements serving the same ends.

31. *Accelerating Capital Formation*

ESOT's appeal to business lies, no doubt, in the tax incentives offered. Under those tax incentives, widespread adoption of ESOT could—as pointed out in Sec. 22—well accelerate capital formation. But if it did, the same effect could have been produced in non-ESOT ways by liberal Federal fiscal and monetary policies.

32. *Accelerating Capital Formation and Equalizing Wealth Distribution*

If it is felt that public policy should in one scoop accelerate capital formation *and* do something about the unequal distribution of wealth, then the liberal fiscal and monetary policies could be combined with incentives to set up wage earners' investment funds. But wage earners' investment funds come in a wide—almost bewildering—variety of forms. Among those forms ESOT is only one, and a rather special one at that.

ESOT asks the employee to own corporate wealth in a form so risky that no stockholder, individual or institutional, that I know, voluntarily chooses it. Perhaps for that reason, United States labor—presumably the beneficiary—has so far shown no interest in ESOT.

More diversified funds, funds owning voting stock only, and funds more acceptable to their beneficiaries, might be considered. Suprafirm funds might do less for labor productivity at the plant floor than ESOT does but more for capital and labor mobility [9]—and thereby more for labor productivity at large.

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[8] To that job the Kelso writings contribute little. Vast productivity increases are expected from ESOT, but nowhere is any use being made of anything economists know about production functions and their behavior over time—and we have been at it for a century and a half, from von Thünen in the 1820's *via* Paul H. Douglas, member of this Senate, to Denison in the 1960's.

[9] The significance of the stock market as an allocator of capital among industries and firms is dismissed by Kelso [15], 16–17, as a myth. Kelso relates stock issue to total source of funds. Since long-run sources should be related to long-run uses, I would rather find the ratio between stock issue and purchases of physical assets. For nonfarm nonfinancial corporations 1969–72 [28] I find that ratio to be 8.4 percent.

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[27] U.S. Bureau of Economic Analysis, "Gross Corporate Product," *Survey of Current Business 53* (July 1973), 23.
[28] U.S. Bureau of Economic Analysis, "Sources and Uses of Funds of Nonfarm Nonfinancial Corporations; Size and Composition of Personal Saving," *Survey of Current Business 54* (Jan. 1974), 31–32.
[29] U.S. Bureau of the Census, *Statistical Abstract of the United States* (Washington, D.C., 1973).
[30] Vanek, J., *The General Theory of Labor-Managed Market Economies* (Ithaca, N.Y. 1970).

Chairman HUMPHREY. I am going to excuse myself for a moment and go down and vote. I will turn the Chair over to Congressman Long.

Professor Brannon, he will conduct the inquiry here while I am away. I shall return.

At this point, I want to place in the record a letter from Mr. Burns in response to my communication to him at an earlier date relating to the Federal Reserve's commentary on the desirability of establishing a special relationship between the Federal Reserve lending

facilities and any private sector financing arrangements, such as the employee stock ownership plans.

Mr. Burns does not, may I say, feel that the involvement of the Federal Reserve in financing stock ownership plans would be desirable. He does not reject it; he just does not say that it is desirable.

[The letter referred to follows:]

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., November 28, 1975.

Hon. HUBERT H. HUMPHREY,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your invitation to make available a Federal Reserve representative to testify on Employee Stock Ownership Plans. Unfortunately, because this subject is considerably removed from our responsibilities, I regret that the Board has no special expertise to offer apart from the implications, discussed below, of one such plan for the functioning of the discount window. Accordingly, I respectfully request that the Federal Reserve be excused from testifying at the upcoming hearings.

Your letter makes reference to one plan that would involve the extension of Federal Reserve credit through the discount window. I have strong reservations about the desirability of establishing a special relationship between Federal Reserve lending facilities and any private-sector financing arrangement such as Employee Stock Ownership Plans. The nation's private financial markets are sufficiently broad to provide access to funds for creditworthy borrowers. Involvement of the Federal Reserve in financing stock ownership plans would inevitably cause others to seek access to Federal Reserve credit, and would unduly interfere with the implementation on monetary policy.

I appreciate the opportunity to offer these comments on private plans that might involve the use of Federal Reserve credit.

With kind regards,

Sincerely yours,

ARTHUR F. BURNS.

Representative LONG [presiding]. Mr. Brems, have you finished your presentation?

Mr. BREMS. Yes.

Representative LONG. We will come back to you.

Mr. Brannon, as a professor of economics at Georgetown, we are happy to have you here. If you would proceed, please.

STATEMENT OF GERARD M. BRANNON, PROFESSOR OF ECONOMICS, GEORGETOWN UNIVERSITY, WASHINGTON, D.C.

Mr. BRANNON. Thank you, Congressman.

I would like to summarize the already short prepared statement I have submitted. There is much that I find likable and much repugnant about ESOT's.

The basic issue, I think, is as Mr. Kelso articulated it, a matter of the impact of our tax system on the whole process of savings and investment.

I would like to put that issue in a bit broader context. In the first place, our tax system as a whole, when you look at the basic features of how we tax in the United States, is very unneutral against the process of savings and investment. Our property taxes, our corporate taxes, the whole treatment of savings—I spell that out at somewhat greater length in the prepared statement.

It might be related to these facts that these days, we talk a great deal about capital shortage. I do not want to get into the detailed economic evidence as to whether or not we have enough capital. The kind of evidence that I would like to submit is that the Congress itself acts as though it has a guilty conscience about all of this burden that it puts on savings and investment.

Opposite this tax structure that works against savings and investment, we have built an enormous set of devices to encourage savings and investment. It is a remarkable achievement. It is the finest monument to Rube Goldberg I have ever seen. We knock savings and investment on one hand, we go around constructing elaborate things to put it back on the other hand. In the immortal words of Pogo, we have found the enemy, and he is us.

Why do we do this?

I think the basic reason we have gotten ourselves into this trap is the liberal belief that by and large low-income people consume more of their income and save less, high-income people save more of their income and consume less. So it is almost a standard political belief that directly taxing consumption is a no-no. A sales tax is regressive, because it hurts poor people.

We think we have to do things that put a relatively heavy tax on savings and investment, because that is what rich people do.

This argument is basically wrong. To emphasize this, the point I want to make is that we can deal with the tax treatment of savings and investment quite differently than from the distribution of income. We can treat savings one way and still are quite free as to encouraging a different distribution of income.

This is what Mr. Kelso's plan is about, in the basic sense. He wants to increase savings and have low-income people participate in the savings.

We can do this in much simpler ways. We could adopt the sales tax without making the tax system the least bit more regressive. The easy way to do this is to impose a sales tax, provide a refund of the sales tax, for an amount of income equivalent to the amount of income that we exempt from income exemptions and return that to every family. Above that level, you can reduce the income tax in each bracket just enough to cut income taxes as much as the average sales tax paid in that bracket. You come out with exactly the same income distribution.

The result would be that you would tax consumption more heavily and tax savings less heavily. You could do this in more systematic ways by going through an expenditure tax. It distinguishes between savings and consumption.

What we have done is take an antisavings tax system and build all of this jimcrackery to get around it. My prepared statement criticizes one set of things that we do in this direction, which is things like direct investment subsidies and investment credit, immediate deduction for oil well drilling, things like that.

Mr. Kelso has pointed out very specifically what you are doing in this whole approach is providing extra benefits for people wealthy enough to invest anyway, and it is atrocious from a distribution standpoint.

Another set of things that we do to get around this basic burden on savings and investment is this whole set of employee investment plans

The fact is under our present law that these are very much of a group. There are technical differences between an ESOP and a pension plan and a profit-sharing plan, but I think that you ought to recognize at one level that we are talking about the common set of things, and I will address the very specific features as an employee investment plan which is in the ESOP form.

The first reaction that I had to these is that they are all very highly structured. It is as though we would remove this tax penalty on savings if you save in a plan that has been written at midnight and you have a rabbit's foot. Less facetiously, the important thing is it has to be blessed by a lawyer-priest.

We have these enormously complex rules in the whole employment profit-sharing area that generate enormous income for lawyers to see to it that the plans go through these tricky roads of integration, nondiscrimination, appropriate treatment of vested interests, and all this business, instead of having some simple way of favoring savings and discouraging consumption.

You end up by saying, you only get the savings investment if you do it our way.

Now, this has a lot of drawbacks. If you design this thing to say, our way has to involve employee-stock ownership, what do you do about government employees, who make up a large part of our citizens? What do you do about employees of unincorporated businesses? What do you do about people who want to save in other ways?

Some people want to save for pensions which may be the plan adopted by the majority of the people in the work place. Other people want to save to help their child go to college.

A fairly important savings is investment in one's own business. It is an interesting feature about these self-employed pension plans, these Keogh plans adopted several years ago, that the adoption is heavy in the professional employment area where the feature is that the owner-employee does not have much need to invest in his own business. It is very little used by farmers, who also want to save, but you cannot conveniently set up a stocks savings account for them. They would have to go through an elaborate business first, incorporating their own business, taking credit for buying stock in their own business. Going through the mechanics of calling it a pension or profit-sharing plan, and all the rest of it.

Another feature of these employee investment plans that I find objectionable is that they are not structured to deal with savings as such, but rather savings in a particular form. One of the things that, in practice, makes the pension rules quite discriminatory is that a fellow does not have to increase his savings to join the pension plan. He has to put something in the pension plan. If he has some other savings—say his inheritance—that he can reduce at the same time, he can get the benefit of the pension plan without increasing his savings at all.

The particular situation of bringing about a heavy investment of these plans in the employer's stock is, I find, an unattractive feature. I would like to bring out something Senator Percy said about this a little while ago. He said in a particular situation it turned out that there was a great increase in productivity.

I have enough confidence in individuals to believe that they can make this judgment for themselves.

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If it turns out to be an increase in productivity, they will be the ones who will enjoy the increased productivity, the workers in the company involved, and they can very well work out these plans.

In a sense, I interpret this great emphasis on requiring the employee fund to invest this way would be like telling the worker, "You dumb jerk, we had a committee meeting in Washington and voted 7 to 5 that investment in your own company's stock increases productivity. If you do not have sense enough to realize that, we are going to take away the tax benefit from your savings, and only give it to you if you do it our way."

This is certainly a very funny way to run a democracy.

Finally, I think I should point out, when I described a systematic way of encouraging savings by taxing consumption more heavily, I rather specifically described to you a way in which you could do this without making the tax system less progressive.

What we have done, in fact, is adopt a helter-skelter of things which, by themselves, make the tax system very much less progressive.

As Mr. Kelso said, this is what the investment credit does. In this whole set of employee investment plans, what we provide as an attraction is some tax deferral. The value of this depends entirely on how much tax you have. If you are in a high bracket, this will be very attractive to you. If you are in a very low bracket, it will hardly make any difference.

You should look in more detail at the literature on the existing pension plans to see how much they are adopted by the high-income people and the extent to which this does build up a real discrimination.

Earlier today, Assistant Secretary Walker talked about his problem, and he was satisfied to say, let us patch it over with this piece of scotch tape. He urges you to extend this technique to individuals who do not happen to be in an employer plan, and as long as they are able to make this kind of investment, then we have salved our conscience.

There is a lot of evidence on this. Canada has had such a plan for 20 years. By and large, low-income individuals do not go into it very much. The tax deferral attraction to them is negligible. It is high-income people who can defer a very large amount of tax and find that the tax exemption makes an enormous increase in the benefit.

And all of this is really accentuated by the very complex rules connected with all of our employee investment plans. One of the very complex ones has to do with integration of the social security, and in meetings with lawyers and actuaries talking about employee investment plans, I have repeatedly heard the comment, "if Congress ever understood what integration was all about, they would repeal it." How would one expect that the worker would know what integration is all about?

What kind of discrimination arises from the operation over time of nonvested benefits? Does it work out?

While there are some similarities in the contract, it is low-income people that move out under nonvested provisions more often than high-income people.

Because of this highly complex set of rules that you make when you build up this whole pattern of rules that will give you some savings and some encouragement to invest, if you do it our way, the lawyers run around you.

Thank you.

Representative LONG. Thank you, Mr. Brannon, I think we understand your concept. Your prepared statement will be placed in the record at this point.

[The prepared statement of Mr. Brannon follows:]

PREPARED STATEMENT OF GERARD M. BRANNON

Mr. Chairman and members of the committee, this paper offers some broader perspectives about employee stock ownership plans (ESOP's). My comments apply to profit sharing plans, stock bonus plans, and money purchase pension plans, as well as to the narrowly defined ESOP covered by the Employee Retirement Income Security Act of 1974.

I find some attractive features in these plans and I find much that repels me. My paper argues that what is attractive in these plans is related to the fact that they are a partial offset to a major problem in our present tax structure, the treatment of savings. What is unattractive is that they are only partial, or narrow, approaches to dealing with the savings problem.

The tax system and savings

On balance, I believe that the U.S. tax system imposes an unneutral penalty on savings and investment. This arises from a number of features of our current tax law.

Our decision to follow the Haig-Simons definition of income imposes what is commonly called a double tax on savings. The point can be seen most readily by considering one specific savings decision. One could without an income tax consider consuming $100 of income now or investing it at 6 percent for 10 years and consuming $200 in 10 years. If we introduce a 50 percent income tax, the current consumption possibility is reduced by $50. The savings alternative becomes $50 invested for 10 years at 3 percent interest, or only $75. The income tax reduces current consumption possibilities by 50 percent, but it reduces the future consumption associated with savings by 64 percent. Whether this is fair is a complex question. Suffice it to note here that the tax system reduces the incentive to save more than it reduces the incentive to consume.

Our unintegrated corporate income tax imposes an extra burden on the principal form of business investment, that done through corporations.

The property tax is now generally recognized as a tax on capital, that is, on accumulated savings and investment.

The estate and gift taxes are taxes on accumulated savings. They impose no extra burden on rich people who squander family estates but only on those who cumulate them.

I have argued that the tax system in a technical way is unneutral against savings. There are, of course, considerations of equity that have led us to prefer heavier taxes on the income from capital than on the income from labor.

Without pushing my own judgment as to what is the best balance between the equity of taxing capital more heavily and the possible economic efficiency of taxing capital less heavily, let me simply put on the record the implicit views of the Congress and some parts of the public.

The Congress has attempted to offset the heavy taxation of savings and investment in a number of ways:

We provide a 10 percent investment credit for most equipment investment and for some investment in structures.

We allow unrealistic depreciation schedules for investment in buildings to provide investment incentives.

We allow instant write-off for some investment such as oilwell drilling.

Investment in owner-occupied housing is blessed with negative income tax rates.

Investment in the capital of state and local government is made tax-free.

One form of income from savings and investment, capital gains, is permitted to pay income tax at half-rates.

Income from capital invested in much mining is subjected to reduced tax rates.

Wage and salary income is provided with generous tax deferral if it is invested in pension, profit sharing, and stock bonus plans.

On top of this, much concern is expressed about a capital shortage.

In the present context I do not propose to debate whether or not the nation would be better off with more efforts to stimulate investment at the expense of consumption. I intend to talk instead about how we provide investment incentives.

The method calls out for some attention. On the face of it, we are taking away with the left hand and giving back with the right. In the immortal words of Pogo, "We have met the enemy and he is us."

Ways to encourage savings

The problem which this Committee should consider is the following: "Why do we have this two-faced attitude toward taxing savings and investment?"

I think the answer goes back to a deep-seated liberal belief that poor people consume most of their income and that saving is done mostly by the rich. This belief suggests to the liberal that taxes on consumption are bad because they are regressive, and that a tax system which imposes heavy burdens on savings is progressive.

This deep-seated belief is simply wrong.

Let me put this error in a most striking form. The common liberal belief that a sales tax should not be enacted because it is regressive is irrelevant. We could change some of the present income tax into a sales tax without changing the progressivity of the system one iota. The technique would be to refund to every family the sales tax on an amount of expenditure equivalent to the income that we exempt from income tax (the personal exemption and the minimum standard deduction). Then reduce income taxes in each bracket so that the income tax reduction at each income level would be equal to the average sales tax paid in that bracket.

The substance of my argument is that a modern government can deal explicitly with problems of income distribution. We are not constrained to decide issues of substance on the grounds of their presumed income effects. We could if we wanted change part of the present income tax into a progressive tax on consumption.

The importance of recognizing this basic character of the problem is quite evident when we recognize that our tax system, once having decided to tax savings heavily, doubles back on itself and provides all manner of reliefs, investment credits, rapid depreciation, employee benefit plans, and the like.

Direct investment incentives

From the standpoint that I have articulated here, the combination of overtaxing savings and providing investment incentives for direct investment, investment credits, deduction of intangible drilling expenses, and the like, is a very poor combination. We are in effect providing a very select form of relief for people who are already rich enough to invest and the richer they are, the more they can invest.

The regressivity of these direct investment incentives are seen most clearly in the area of corporate investment. Our unintegrated corporate income tax amounts to imposing a 45 percent tax on the share of corporate income owned by the poorest investor, as well as the richest. For the rich investor, income left in the corporation is effectively taxed at a rate lower than the 70 percent applicable to individual income. When the high income investor is further blessed with tax credits and rapid depreciation, his cup runneth over.

There is a more basic problem that needs to be recognized in connection with direct investment incentives: their success ultimately depends on increasing savings. If savings are not increased, all that happens is that those investments favored with special credits are able to bid for available savings. Interest rates would rise until available savings were reallocated, but there would be no increase in investment.

Savings incentives

Another approach which the present U.S. tax law takes to offsetting the overtaxation of savings is to provide exclusion from taxable income for investment of wages in a variety of employer plans: pension, profit sharing, stock bonus, ESOP.

These plans have a feature which make them attractive relative to the plethora of direct investment incentives, like the investment credit, or expensing oil and gas well drilling. These are not confined to providing relief for people rich enough to invest anyway. They potentially are designed to bring in new savings and they can encourage this saving by middle and low-income people.

My problem with employee investment plans is that they are narrow and highly structured, and when they are simply added on top of an existing tax structure, they tend to reduce progressivity by providing greater benefits for high income people.

I think that the proper way to evaluate these employee plans is by comparing them with a more systematic way of encouraging savings; for example, by converting part of our income tax into a sales tax or a value-added tax with out changing progressivity or by converting part of our income tax into a progressive expenditure tax.

Let me spell out the shortcomings of employee investment plans.

In the first place, they provide benefits only for a limited kind of saving. For the most part the plans are designed to provide retirement savings; but people can save for other reasons: to put the children through college, to go into business on one's own, to put the children into business. If an employee is in a firm with a pension plan, this effectively ties up a large portion of income that would have been used for savings and thus makes other savings more difficult.

It is instructive that in the area of pension plans for the self-employed, the biggest area of application is among professionals who have limited opportunities to invest in their own business. An unincorporated farmer wants to invest in his farm but tax benefits are available for investment in securities. For a Congress that professes much interest in small business, this should be a peculiar outcome.

Another feature of the employee benefit plan approach is that credit is given not for saving as such, but for a particular investment. The employee who has other assets can enjoy considerable tax benefits by getting some of his wages in the form of a qualified savings account while selling off other savings. A proper incentive to saving would be one that looked to net saving, and not one that gave generous benefits for transferring assets.

Effectively, employee benefit plans work to the advantage of large safe businesses. For a risky business, the employee already carries much risk, namely, the risk of losing his job if the business folds. An employee in this situation should not be encouraged to invest life savings in stock that would also drop in value at the time the job was lost.

A further defect of the employee investment plan approach when it is enacted in little pieces is that it makes the tax system less progressive. When I argued earlier that we could adopt a non-regressive sales tax, the case was based on the assumption that we would deliberately make changes in the income tax rates that preserved the progressivity of the structure. I see no analogous process in the history of our enactment of various employee investment plans. These are simply adopted with little recognition of the fact that they will be used more by high-salaried employees than by low-salaried one.

Another problem with employee investment plans is one that is characteristic of much of our tax law, the plans are highly complex. This involves expensive overhead for legal and actuarial advice, and great uncertainty for employees. The area of non-vested benefits presents problems for employees as well as grounds for arguing with revenue agents. The most serious complexity is the set of intricate rules dealing with integration of plans with Social Security. I have often heard the comment by people in the pension business that if the Congress ever understood what integration was about, they would repeal it. This whole set of rules serves to make employee investment plans far more attractive for high-income people.

The unique feature of ESOP's is the opportunity of leveraged investment which introduces new opportunities for abuse.

Conclusion

I see the argument for ESOP as analogous to the argument for a new vitamin pill. There are some demonstrable benefits from a pill that provides more iron, or more niacin, or more vitamins PDQ. Most physicians will tell you, however, to look at the basic diet first before you start popping more pills.

I think that from the evidence of the actions of this Congress, it doesn't agree with our basic tax diet. From the legislation that I have alluded to, it seems clear to me that the Congress does not approve of the bias against savings and investment in our basic tax structure.

The Congressional solutions, however, have been more vitamin pills—in investment credits, fast write-offs, capital gain benefits, along with highly structured pension, profit sharing, and stock bonus plans, and ESOP.

These plans all serve to make the tax system less progressive. We could, if we wanted, work systematically at restructuring our tax system so as to encourage savings by middle and low-income people.

We could adopt a non-regressive sales tax or an expenditure tax as a substitute for part of our income tax. We could integrate the corporate income tax with respect to retained earnings.

The sales or expenditure tax alternatives produce a systematic extra tax on consumption and leave to individual choice the decision on how to save. The integration proposal would make corporate investment a far more attractive prospect for low-income people than it is now.

Representative LONG. Gentlemen, I wanted to, if we could, just get in 5 or 10 minutes of questioning here before we break up.

Mr. Kelso, you find yourself in the unenviable position that I often find myself in, of throwing a new idea out, at least a new form of an idea, and perhaps an existing one, and allowing other people to attack it.

Why don't we give you a couple of minutes to answer all the attacks that have been made on the plan? We will be overly generous.

Mr. KELSO. Thank you, sir.

I would like to say at the outset that none of the three witnesses really understand ESOP's to begin with. and they do not understand two factor economics, which is far more profound.

Let me make some special comments.

One of the main criticisms appears to be the question of lack of diversification. It happens that this problem is easily solved. There is pending in the Ways and Means Committee, a bill called H.R. 462. This is attached as an exhibit to my prepared statement, containing a number of provisions, one of which would permit the committee operating the trust to call in an employee a few years, maybe 4 or 5 years before his retirement, and ask him in what he would like his capital estate invested prior to his retirement. Does he want a diversified portfolio? Does he want a joint and survivor annuity? This provision, if enacted, would permit the employee to convert, without any tax impact on him, his holding of employer stock into a diversified investment portfolio.

The result is that the corporation and its employees would have the motivational advantage of the employee's ownership of an interest in the company he works for during his working lifetime, but diversifying his investment at the end of his working career. This seems to be the best of both possible worlds.

I find in the critics a great lack of any knowledge as to how rich people got rich. I defy any of my critics to identify a single individual, anywhere, any time, whoever got rich through a diversified portfolio. The prudent man rule laid down by the Supreme Judicial Court of Massachusetts in 1830 is a rule as to how a rich man stays rich, by protecting his principal and living on his interest or dividend income or other income.

By applying the rich man's prudent man rule to the poor man through profitsharing plans and pension plans, after 50 years of these plans, 5 percent of the people own all of the capital.

What more proof of a dismal, absolutely unworkable, useless technique? What better proof, I cannot imagine.

There is another prudent man rule which has been very much neglected. It is called the poor man's prudent rule. This was laid down by Andrew Carnegie in his biography. He said—and I paraphrase it—"You want to get rich? There is nothing to it. Just put all of your eggs in one basket and watch the basket very closely."

The cruel facts of life are that this is the only way to get rich. I am not talking about rich in the Henry Ford sense of the word. I am talking about rich in the sense of the word of an employee who retires from Sears, Roebuck with $300,000 or $400,000 in a portfolio, that makes him self-sufficient, gives him enough productive power so that he can produce his income all of the rest of his life, and be happy.

So the diversification problem is easily solved.

I might add one other thing.

There is a group in California—I expect others will spring up to do the same thing, because I believe that it will be very profitable to business; that is, preparing to issue insurance policies to ESOP participants.

These policies would insure that the worker at retirement would receive not less than the amount that has been allocated to his account, so that he has got downside protection, and I am told by a statistical and analytical group called Techchron, made up of a hundred or more Ph. D.'s and technicians at Berkeley, Calif., that actuarily, the insurance written over a group of a hundred or more corporations can be very modestly priced.

The final reply that I would like to make is that none of the critics polled so far have any idea what pure credit is. This is not surprising. Apparently Mr. Burns does not, either. This is a concept which is based upon the power of people to contract with each other. Lest anyone believe that it has not been used, let me say that without pure credit, Japan could never have been an industrial nation at the time of World War II. It had no savings and it had no borrowings from anyone. It simultaneously financed the growth of capital, and financed the growth of consumption.

You can only do that with pure credit.

Consumption, and investment in production facilities are not alternatives. One does not crowd the other out. They go together. You increase consumption as you increase production. That is commonsense.

To believe that the U.S. economy has a great need for productive power and to think that you can invite the workers to take money out of their pockets to save, is to overlook the fact that mass production needs customers. If everybody really turned to, and saved all they could, businesses would all go bankrupt.

Chairman HUMPHREY [presiding]. I hope that you have some luck in preaching that kind of heretical doctrine to the more conventional people. I happen to agree on that.

I grew up in a small business where everything that counted was the customer. My father used to tell me there are two kinds, customers with money and customers who visit—and the visiting is expensive. There are a lot of folks in high finance that never understood that.

Mr. KELSO. That is exactly right. It is because they do not have their feet in the real world, like you have, Senator.

Chairman HUMPHREY. I had to have them in the real world. We did not have any money, either. We had to earn it, or get it on pure credit.

Mr. KELSO. Exactly. So that I believe that all of the criticisms are easily answerable. I believe, as a matter of fact, they are all answered in the prepared statement.

Under ESOP financing and related techniques of finance, the growth of new capital formation and the growth of ownership by the employees go together. My firm strongly recommends designing the ESOP so the income of a share of stock that has been paid for flows right into the workers' pockets. This shifts the tax impact from the corporation to the employees, but it provides them with the wages of their newly acquired capital, too.

It also puts money in their pockets.

A final point, left out of my presentation. I think it is important to mention it here. Shockingly enough, although we call this a capitalist economy, the stockholders of our business corporations have virtually no private property in their corporate stock. The Roman law developed the law of property very highly. It was really raised to an absolute art by the great English jurists. Vis-a-vis property in producer goods, like a piece of land, a factory, or any kind of productive instrument, private property consists of the right to receive all that the thing owned produces.

In other words, you do not have private property in capital and in capital stock unless you get the wages of capital paid out fully and regularly like the wages of labor. You can only do this if you offer to business as a financing alternative, access to pure credit as the full use of two-factor financing would do.

In other words, we are going to have to pay the wages of capital fully and regularly; and we are going to have more and more people dependent upon capital ownership to get those wages, so that they can enjoy life and consume and buy what industry wants to produce. Therefore, we must use pure credit to accelerate both the healthy growth rate of the economy and full employment.

We finally have, in this technique, a system that monetizes productive power instead of the system that we have today under which we are forced to monetize welfare. No wonder it is inflationary. When you monetize welfare, you are monetizing something that dies overnight. You feed the man today and he is hungry tomorrow. It is an endless thing.

The monetary system designed through two-factor theory [1] is a logical monetary system. It is deflationary.

Long after that credit is reversed, those tools go on pushing goods and services into the economy, so you have a typically deflationary formula: More and more goods and services chasing fewer dollars.

The productive power of those capital instruments is preserved by depreciation.

Representative LONG. What you are saying, Mr. Kelso—if I may, Mr. Chairman—really is that the emphasis that we have had in our tax system on priorities of the artificial stimulation of mass buying—you are suggesting that rather than do that, we really switch that and put the emphasis upon the expanding of production and the expanding of capital ownership which will expand production in two ways; is that correct? First, by spreading it out more and giving it to the individual worker and, second, by allowing that capital to again be placed into production?

Mr. KELSO. Senators and Congressman, I would say that the alternative contemplated by two-factor financing in general is to simultaneously expand production and consumption. You expand

[1] See diagram on p. 158 of Mr. Kelso's prepared statement.

production, represented by equity stock. You build the stock ownership on a broad worker basis, and then you pay out the wages of capital fully, both to the new owners of newly formed capital and to the old stockholders as well.

Representative LONG. If you expand production in this way, with people making more and more money, all of us living up to the Joneses, you are automatically going to expand consumption.

Mr. KELSO. That is exactly the point of the story. That is what we should do. You need to expand consumption if you are going to expand production.

Representative LONG. Let me ask you another question, if I may. As Senator Humphrey knows, I was in the investment banking business for a period of time when I was out of public life.

Chairman HUMPHREY. It pays better, too.

Representative LONG. It pays better.

Mr. Fay raised two very serious questions; one you discussed, the other you have not.

The first was, what do you do about giving someone diversification in their holdings so that their whole life savings, which it might represent, are not in just one company? Possibly, the failure of that company could wipe out their life savings.

Mr. KELSO. H.R. 462 would do that.

Representative LONG. You responded to that. Let me ask you the other end of it.

If you do get a bailout of a privately owned company—and the use of this type of a system as a bailout where ownership is beginning to get old and there is nobody left really to take it over—what could you structure into this to prevent such a bailout occurring? That concerns me.

Mr. KELSO. Congressman, the word "bailout" is a pejorative word.

Representative LONG. It may be pejorative, but it is pretty right, too. I have seen some of them.

Mr. KELSO. Let me say first what the safeguards are that now exist. Then let me call attention to the fact that close-holding owners of businesses do die, none of them are immortal and when they die, there is a question of succession.

One of the finest uses of the ESOP is to enable the employees to succeed to ownership of the business. The alternatives are to merge into a conglomerate which comes in and kicks the thing all apart and promotes the people to places where they did not want to move, and substitutes management and often disorganizes the whole community, or to sell the business to the faceless public, that gambling casino called Wall Street where, again, it loses its character and becomes bounced around.

Representative LONG. That is what happened to the railroads, did it not?

Mr. KELSO. That is part of what happened to the railroads.

The only question is whether the employees are paying more than the business is worth. Keep in mind, they buy it on terms so it pays for itself. The danger of overpayment in this situation is really terribly small. Why? Because it has to be paid for. One way it may make such payment is by the ESOP to go to the bank and borrow the purchase price. What is behind the loan? It is the general credit of the business. Once you have survived the icy eye of the lender, there is a high probability that the price is not excessive.

Second, the sellers may carry the loan, and often do—taking back a note from the ESOP. The note is guaranteed by the corporation, but the sellers do not get paid unless the business is successful and pays out. If the business pays for itself, it is, again, unlikely that the price was excessive.

The first one of these ESOP's that I did, which was in 1956, if anyone thinks this is a recent invention, was the case of a newspaper owner in California, George Morell, who founded Peninsula Newspapers, Inc., publishers of the Palo Alto Times and several other newspapers.

George Morell had been offered cash by the Ritter chain in St. Paul, as I recall, and he went to his employees and said, "this really puts me in a tight spot." I am nearing 80 years old. I think that I should reduce my responsibility in the business. I have been offered cash. It is most of my total fortune. I have a lot of children and a lot of grandchildren, so it is my duty to pass on to them what I can after taxes. But you people helped me build this. I would like to have you get it.

They tried every other technique in the world. The banks told them it could not be done. I put together an ESOP and the employees paid for it in 7½ years through an ESOP. The plan never took a cent out of their pockets or wages. They have gone on to use their ESOP to buy new presses, new plants, and so forth.

I would like to tell you one more story.

In H.R. 462, there is another provision. The really rich man—I am now talking about, say, an H. L. Hunt or John Paul Getty or a Mellon or a Rockefeller—paints himself into a dreadful corner in our private-property, free-market economy. He gets so rich, that at the end of the line he is forced to socialize his fortune. He cannot give it to individuals because he gets into such a bracket that the gift and estate taxes, State and Federal, become confiscatory. He cannot take it with him—if he could, he probably would.

Now, the ESOP offers an alternative. The ESOP, under H.R. 462, would offer an alternative, because that bill would give the ESOP the status of a 501(C)(3) foundation.

Henry Ford, instead of socializing his gigantic fortune in the Ford Foundation, could have set up an ESOP for the employees of the Ford Motor Co., its distributors, its dealers, and either in increments during his life, because it is free of gift tax, or at his death, or in some combination of the two, he could have raised the incomes of all the employees without raising costs to the company. That is terribly important. I believe that we would have flooded Japan with Ford cars rather than the other way around if we had mastered that technique then.

Second, Mr. Ford could have put every employee of the Ford Motor Co., and its distributors and dealers, where they would know, if they worked diligently during their working lifetimes, that they would retire rich—again, not rich in the Henry Ford sense of the word, but rich in the sense of having several hundred thousand dollars of dividend—paying stock that would make them self-sufficient. In terms of their motivation, I think they would have worked like tigers.

A very, very terribly wealthy druggist in California—he owns the finest drug chain in California and Hawaii—has written to a number of Senators and Congressmen. He said, I have painted myself into

this corner. If you will pass H.R. 462, I pledge to you that I will put into an ESOP for my employees dozens of millions of dollars, and my brother will do likewise.

Between them, by the way, they own—it is estimated—the better part of $2 billion worth of productive capital. That would make a lot of employees very prosperous.

Chairman HUMPHREY. Is that Mr. Dart?

Mr. KELSO. No, that is Mr. Long.

Chairman HUMPHREY. There are a few rich druggists.

We are going to have to move along here. We have kept you all too long. We could be at this forever.

I wanted to ask just a question here, if I may. Let me very quickly put it to Mr. Brems and Mr. Brannon. Whatever may be the pluses or minuses of this so-called Kelso idea, his point is that his plan attacks the cause of poverty. The modern economist is constantly showing us ways to redistribute income, along with ways to stimulate the economy, to be sure. But, what is your evaluation of Mr. Kelso's plan to get at the cause of poverty; namely, by letting people share in private property? I always said, if private property is good, then it is good enough for everybody. I have always believed in a large amount of disbursement of property. I do not believe in just chopping up what other people have and cutting up the pie and saying that is it.

What do you have to say, in just a moment, on that?

Mr. BREMS. Of course, this is a value judgment that has to do with the ends that a policy should be serving.

Let me put it this way. Capitalism is the most productive economic machine ever devised. It is much like freedom and good health: You do not notice it while you have it, but once you have lost it, you realize what you have lost.

Capitalism is worth preserving, I personally believe, and the best way to preserve it is to give far more people a stake of ownership in it. I am speaking here as a citizen, I am not speaking as an economist. My colleagues may or may not share my views about capitalism.

However, if you wish to preserve capitalism by giving more people a stake in it, then there are many ways of doing that. ESOT is one way, but I think others deserve consideration.

What I said about diversification is not satisified by H.R. 462. That diversifies only at the moment before you retire—after the party is over. That is not what I was thinking of. I was thinking of the ESOT funds running unnecessary risks during the entire membership period by not being allowed to diversify.

I may have misunderstood Mr. Kelso, and I think that he misunderstands me. If I do not understand what pure credit is, I am in the good company of Mr. Burns.

There are two things to keep straight. You should distinguish between countercyclical economic policies and structural reform. The economy is in bad shape, partly of our own doing; I would say mostly of our own doing. We have a lot of slack that we should not have had.

You can stimulate the economy as long as you have slack. Because of the slack, you can have both more consumption and more investment. You can have more growth. In fact, you can have more of everything by adopting a suitable expansionary monetary and fiscal policy. That is one thing.

The question of reform is something else. Now, you want to reform the economy in such a way to spread ownership. Let us keep issues straight by assuming that all of that slack has been handled by other means. Let us not mix ESOT up with the greatly expansionary effects of liberal monetary and fiscal policies.

Chairman HUMPHREY. I have to cast a vote. There are problems here. You can see our retention problem here.

We do have a number of questions that have been prepared. I must confess that we only tried to touch the surface here today. We wanted to get Mr. Kelso here, hear what he had to say, and get some of the critics of this plan and hear what they had to say.

We have looked over the statements today that have been brought to our attention, and we would like to formulate a number of questions. If it is possible within the time frame that you gentlemen have—I know that you are very busy—we would like to send you some questions to fill out this record, because the so-called Kelso approach needs to be carefully analyzed.

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF HANS BREMS TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN HUMPHREY

I. CONCENTRATED OWNERSHIP OF WEALTH

Question 1. Kelso has made the statement, "If a minority of families and individuals are permitted to monopolize the means of producing wealth through capital ownership, the economy will slowly, or not so slowly grind to a halt." Relatedly, he said in another context, "the present concentration of corporate wealth in the hands of a very small percentage of the population jeopardizes the future operation of the capitalist system, especially when this concentration co-exists with large-scale poverty in the U.S. economy." How would economists respond to such a dire prognosis? To what extent are these statements valid?

Answer. Mr. Kelso's description of both the state and the trend of the concentration of wealth ownership is inept and inaccurate.

In his testimony before this committee [14], Mr. Kelso repeatedly describes the ownership of "capital" by the top five per cent of consumer units. As his testimony proceeds, the description becomes increasingly dramatic. In his Sec. III, 9, these units own "virtually all" capital. In Sec. V they own "all" the productive capital. The climax is Mr. Kelso's answer to the Chairman's fifth question: Here "only 5 per cent of our consumer units own *any* capital *whatsoever*"!

Mr. Kelso uses the terms "capital" and "productive capital" loosely. But in no sense of the word "capital" is it true that five per cent of the consumer units own all of it.

This committee needs and deserves accurate data to start from, so I must search for such data. They are not difficult to find. Most of them are published by the United States government in readily accessible places. I begin with capital in the narrowest sense of direct ownership of corporate stock.

(1) *Individual Family Ownership of Corporate Stock*

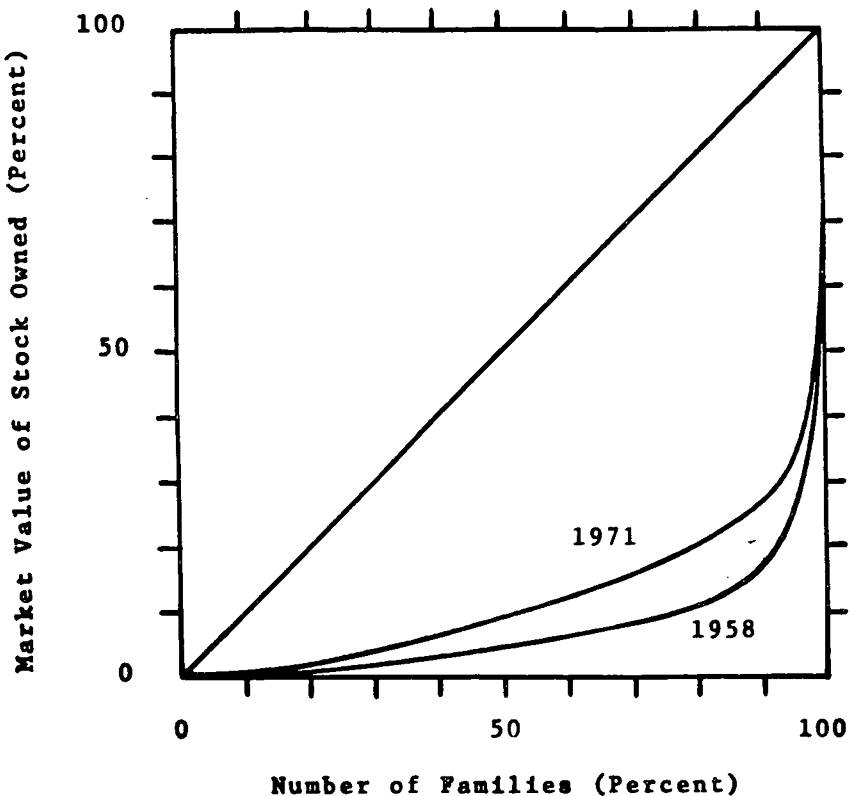
The percentage of the market value of stock owned by the richest five per cent of United States families is not 100 per cent or anywhere near it, and the percentage is declining:

	Percent
1958	73.7
1960	71.3
1964	70.5
1969	66.6
1970	68.0
1971	67.1

as shown by Blume, Crocket, and Friend [2], using Internal Revenue Service data. In other words, from 1958 to 1971 the percentage of the market value of stock owned by the richest five per cent declined from slightly less than ¾ to slightly above ⅔.

But why confine ourselves to the richest five per cent, as Mr. Kelso does? Why not look at the whole distribution? That is what a Lorenz Curve does, and Blume, Crocket, and Friend offer one, which I have reproduced in my Figure 1. The curve reads as follows. Arrange all families according to their adjusted gross income, beginning at the origin to the left with the poorest ones. The 1958 Lorenz Curve then shows that the poorest 50 per cent of the families owned 4.5 per cent of the market value of stock; the poorest 90 per cent owned 16.8 per cent; and the poorest 95 per cent owned 26.3 per cent. In the next 13 years the distribution became more equal: The 1971 Lorenz Curve shows that the poorest 50 per cent of the families owned 8.0 per cent of the market value of stock; the poorest 90 per cent owned 24.9 per cent, and the poorest 95 per cent owned 32.9 per cent.

FIGURE 1.—Trends in the distribution of stock ownership, Lorenz curves, 1958–71



Source: U.S. Department of Commerce.

So much for direct ownership of corporate stock. I turn to institutional ownership.

(2) *Institutional Ownership of Corporate Stock*

In the past quarter century, financial institutions other than bank-administered personal trusts have more than trebled their share of the market value of all noninvestment-company stock:

	Percent
1950	7.6
1960	16.5
1969	19.8
1971	22.5
1973	24.0

as cited by Blume, Crocket, and Friend [2], 25.

Pension funds accounted for the largest growth in institutional stockholding. The pension-fund wave began with the 1949 steel settlement. In 1950 private pension funds had $6.7 billion of financial assets of which 1/6 was in corporate stock. In 1970 they had $100 billion of which perhaps 2/3 were in corporate stock [20], 133.

How important are pension funds to families? In the appendix to his testimony before this committee, Mr. Walker [24], 13 answered:

> For families as a whole, pension fund reserves are a significant proportion of total wealth. Currently, private pension fund reserves comprise approximately 8.3 percent of the total financial assets of families, while the current annual flow of funds into private pension reserves comprises approximately 13.6 percent of the net acquisition of financial assets by families.

How important are pension funds to *lower-income* families? Mr. Walker continued:

> In summary, there is substantial savings for retirement in the form of pension plans. For lower income families, then, stock may be *indirectly* saved through ownership of pension reserves, but the demand for more *direct* ownership has been quite small.

In the growth of institutional stockholding, mutual funds and life insurance companies ran second and third, respectively, to pension funds. All are roundly dismissed by Mr. Kelso [14], 38n., on the astonishing grounds that

> As to indirect ownership, through financial intermediaries such as insurance companies and mutual funds, investment of this kind are almost never acquired on a self-liquidating basis, so they do not make a net increase in the buyer's standard of living.

To Mr. Kelso, then, security is no part of standard of living! So much for indirect ownership of corporate stock. I turn to ownership of noncorporate business.

(3) *Ownership of Noncorporate Business*

In the United States corporations own perhaps 3/4 of all physical capital stock owned by business. The rest is owned by noncorporations, i.e., partnerships and proprietorships. As most of us know, partnerships and proprietorships are small business. But I shall cite the facts just the same—they seem to have escaped Mr. Kelso.

Of all active corporations in 1970, 85.5 per cent had receipts of $ 1,000,000 or over. Of all active partnerships in the same year, merely 32.9 per cent had such receipts, and of all proprietorships in the same year, merely 5.9 per cent had such receipts [22], 472.

Admittedly, receipts are not a perfect measure of size. We should have preferred assets or value added. But since corporations are probably more vertically integrated than are noncorporations, assets or value added would probably have displayed even more dramatic differences in size distribution between corporations and noncorporations. I may safely conclude, then, that the ownership of corporate business is far more heavily concentrated than that of noncorporate business.

Capital in the form of ownership of noncorporate business is roundly ignored by Mr. Kelso. I turn to human capital.

(4) *Human Capital*

Unlike the national income accounts, which define investment as the production of *physical* income-earning assets only, some economists would like to define it as the production of *any* income-earning asset. The foremost example of production of a *nonphysical* income-earning asset is education. Education is knowledge embodied in a human being rather than in a machine.

I am pleased to report two things about education. First, education by its very nature is education of individuals. Consequently, mass education produces a *nonconcentrated* form of ownership of income-earning assets. Second, the United States has carried mass education *much farther* than any other nation. In 1940, 15.6 per cent of the population aged 18–21 was enrolled in higher education. In 1970, 51.4 per cent were enrolled [21], 45, 219. In 30 years we have more than trebled the percentage!

Capital in the form of human capital is roundly excluded by Mr. Kelso [14], 84, on the astonishing grounds that "technology in general is embodied only in capital instruments, *not in human beings*."

I invite Mr. Kelso to consider the following two cases. First, imagine an advanced economy like the United States donating plant, equipment, transportation, and communications systems to a country like Bangladesh, raising the latter's physical capital stock per capita to United Stats standards. So all the physical capital is there, but the human capital is still missing.

Second, imagine the United States destroying all plant, equipment, transportation, and communications systems in an advanced country like Germany—as we nearly did in 1942–45, leaving all larger German cities as smoking piles of debris! So all the physical capital is gone, but the human capital is still there.

Now which of the two, Bangladesh without human capital or Germany without physical capital, would first reach United States per capita income? As we know, West Germany did so in 30 years. As we suspect, Bangladesh wouldn't do it in a century. Does that comparison tell Mr. Kelso if technology can be embodied in human beings?

(5) *Conclusion*

Even for capital in the narrowest sense, i.e. direct ownership of corporate stock—the only sense admitted by Mr. Kelso—the percentage of it owned by the richest five per cent is not 100 per cent or anywhere near that. As I consider capital in wider senses, I find it less heavily concentrated.

As for "large-scale poverty" in the United States, that term is not well-defined. Poor in the United States may be rich in Greece, not to mention Bangladesh. In my answer to Question Three I shall demonstrate that what may safely be said is that normal economic growth steadily erodes absolute poverty.

Exposed to the double fact that, first, wealth ownership is less concentrated than Mr. Kelso believes it to be and, second, normal economic growth steadily erodes absolute poverty, Mr. Kelso's underconsumptionist prognosis of pending disaster will begin to melt away—just as the Marxian one has done.

Needless to say, not even the accurate data dismissed or ignored by Mr. Kelso can settle the question of whether or not reform is desirable. Although wealth distribution is not as inequal as Mr. Kelso believes it to be, I personally should like to see it becoming more equal. I should like to see that, not because of any belief that the economy would otherwise "grind to a halt," but simply because I happen to believe that a more equal wealth distribution would make our democracy a healthier and more smooth-working one.

Question 2. Have economists been quite neglectful of the issue of wealth ownership which is at the root of our poverty problem? Can you point to any plan devised by any economist which really attacks the root of the poverty problem but does not involve the redistribution of income. Wouldn't the wider distribution of *newly created* wealth accomplish this objective?

Answer. In my answer to question 4 I shall demonstrate ways of "attacking the root of the poverty problem" that do not directly involve wealth distribution.

But here in question 2, never mind such ways. With or without them there remains ample room for ways directly involving wealth distribution—accomplishing what Keynes in his preface to [16] called "the accumulation of working-class wealth under working-class control".

What plans have been devised to accomplish this? Few economists are as clever as Keynes, who could devise his own plan. Most economists merely analyze plans devised by others. Both here and in Western Europe plans have been devised as well as carried out. Yes, they share the belief that spreading newly created wealth will do: No plan calls for the expropriation of existing wealth.

At the risk of repeating some of what I said in my recent book [5] and in my prepared statement before this committee, I briefly put together and survey a catalogue of existing specific plans. I arrange them according to decreasing decentralization:

(1) *Single-Firm Funds Without Diversification*

In the United States, four forms of single-firm funds without diversification enjoy preferential tax treatment, i.e., profit-sharing plans, thrift plans, stock-bonus plans, and ESOTs.

(a) A straight *profit-sharing plan* is a wage earners' investment fund set up voluntarily by an individual firm with the purpose of giving its employees a funded share of its profits. Employer contributions must depend upon profits. The portfolio of the fund need not be diversified: More than 10 per cent of the assets of the fund may consist of the stock of the employer. Benefits may well be paid before retirement, for example after a fixed number of years, upon layoff, illness, disability, or reaching a certain age, etc.

(b) A *thrift plan* is a wage earners' investment fund set up voluntarily by an individual firm with the purpose of encouraging the thriftiness of its employees. Employer contributions must be a fixed proportion of employee contributions. The latter are optional. If opted for, they must be a fixed proportion of the compensation of the employee. Otherwise the thrift plan is like the profit-sharing plan: The portfolio of the fund need not be diversified, and benefits may well be paid before retirement.

In the appendix to his testimony before this committee, Mr. Walker [24], 8, informed us that roughly 310,000 profit-sharing and thrift plans exist covering approximately 9 million employees.

(c) A *stock-bonus plan* is a wage earners' investment fund set up voluntarily by an individual firm with the purpose of establishing employee ownership of the stock of the employer. Employer contributions need not depend upon profits but must be in the form of the stock of the employer. The portfolio of the fund need not be diversified. Benefits may well be paid before retirement but must be distributed in the form of the stock of the employer.

Mr. Walker [24], 8, informed us that roughly 7,250 stock-bonus plans exist covering approximately 400,000 employees.

(d) An *ESOT* is a wage earners' investment fund set up voluntarily by an individual firm with the dual purpose of establishing employee ownership of the stock of the employer and enabling the latter to borrow *via* ESOT on favorable terms. Employer contributions need not depend upon profits but must be in the form of either the stock of the employer or cash. The portfolio of the fund need not be diversified. Benefits may well be paid before retirement but must be distributed in the form of the stock of the employer.

Mr. Walker [24], 9, estimated that 300 ESOTs exist.

Profit-sharing plans, thrift plans, stock-bonus plans, and ESOTs are all confined to a single firm. Consequently, according to his job, an individual wage earner will automatically belong to one fund only. He has no freedom of choice, so there can be no competition among funds.

But the lack of competition matters little, for the funds have little scope to maximize their rate of return. The portfolio of none of the four funds needs to be diversified. If it isn't, funds cannot spread their risk among firms, industries, and geographical regions. Lack of diversification reduces the mobility of capital and prevents funds from helping to raise labor productivity in the sophisticated economy-wide way described in Sec. 23 of my prepared statement.

(2) *Single-Firm Funds With Diversification*

In the United States, one form of single-firm funds with diversification does enjoy preferential tax treatment, i.e., the pension plan.

A *pension plan* is a wage earners' investment fund set up voluntarily by an individual firm with the purpose of providing definitely determinable benefits to its employees after retirement. Employer contributions cannot depend upon profits. The portfolio of the fund must be diversified: No more than 10 percent of the assets of the fund may consist of the stock of the employer. Benefits cannot be paid before retirement and cannot depend upon profits.

Mr. Walker [24], 7, informed us that roughly 420,000 pension plans exist covering approximately 27 million employees.

The pension plan, too, is a single-firm fund. According to his job, an individual wage earner will still automatically belong to one fund only. He has no freedom of choice; there is no competition among funds.

But with diversification, the fund now has some scope to maximize its rate of return. It can spread its risk among firms, industries, and regions. In its own small way the diversifying fund may help increasing the mobility of capital and thus help raising labor productivity in the sohpisticated economy-wide way described in Sec. 23 of my prepared statement.

(3) *Suprafirm Funds*

In Western Europe some suprafirm funds enjoy preferential tax treatment. A suprafirm fund is neither set up by nor confined to any single firm. At most it might be confined to a single industry or a single geographical region. The fund is set up by law or by collective agreement between employers and employees. The fund serves the dual purpose of giving labor a share of, first, the capital gains accruing to stockholders in an inflationary economy and, perhaps second, the co-determination rights inherent in voting-stock ownership. Employers contribute a fraction of either their wage bill ("investment wage") or their profits bill ("profit sharing"). The fund is free to diversify its portfolio. The fund issues non-negotiable fund certificates to the employees. A specified number of years after its issue a fund certificate becomes redeemable.

Suprafirm wage earners' investment funds have been enacted in West Germany and France. The West German system is a voluntary investment wage subsidized by the government and now so appealing that ⅔ of West German wage earners are participating. The French system is a compulsory profit-sharing scheme with full tax credit for employer contributions. All corporations with more than 100 employees must contribute. In 1973, 9,300 corporations and more than four million wage earners were covered by the system.

Plans for new suprafirm funds are being debated in several Western European countries. It is important to distinguish between two different forms, i.e., those confined and those not confined to an industry or a region.

(a) *Suprafirm Funds Confined to an Industry or Region.* Consider a fund confined to an industry or geographical region. According to his industry or his residence, an individual wage earner would automatically belong to one fund only. He has no freedom of choice; there is no competition among funds. A genuine industry or regional fund would only be allowed to buy shares of firms within that industry or region, so the fund could not spread its risks among industries or regions. As a result, it would be of limited help in raising labor productivity in the economy-wide way described in Sec. 23 of my prepared statement.

(b) *Suprafirm Funds Not Confined to an Industry or Region.* Next consider a fund confined to neither an industry nor a region. Let there be a number of such funds among which the individual wage earner would be free to choose—as the 1974 German coalition-government agreement proposed [9]. Each fund would be free to diversify its portfolio, thus spreading its risks among firms, industries, and regions. There would not only be plenty of scope for funds to maximize their rate of return; they would be under powerful competitive pressure to do so: Funds would very likely compete on rates of return offered. If some of them did, the rest would have to follow suit. Such funds would be of maximum help in raising labor productivity in the economy-wide way described in Sec. 23 of my prepared statement.

II. ECONOMIC GOALS OF THE UNITED STATES

Question 3. Kelso has stated that the nations' two most important economic goals are full employment and a steady increase in the GNP. Would you agree? He also states that these goals are highly deficient and perhaps damaging and that broadening the ownership of capital should be a primary goal. Would you as an economist support Kelso in amending the Employment Act to expand U.S. economic goals to include policies favoring broadening the ownership of capital?

Answer. Neither I nor any other economist sets the goals of this nation. To those who do, full employment and steady growth of the gross national product enjoy high priority.

When Mr. Kelso thinks of such goals as "damaging," he has in mind full-employment policies such as the 1848 policy of digging holes in the *Champ de Mars* and then filling them again. Our 1946 Employment Act had something else in mind; namely, the full exploitation of the economic potential of the United States. My best way to answer question 3 is to declare myself in complete agreement with Mr. Walker [24], 1, when he said:

> Preliminarily it should be emphasized that broadened stock ownership is not a panacea. The future well being of the American public is primarily related to the long-run economic growth of this country which in turn requires a continuation of high rates of capital formation, continued technical progress, and continual improvement in the skills of the labor force.

I agree and wish to exemplify.

First, careful modern work by Phelps Brown [19] shows that in the period 1890–1960 the real wage rate was growing at an average annual rate of 2.08, 1.61, and 1.91 per cent in such advanced economies as the United States, Germany, and Sweden, respectively.

Second, let me be specific with respect to poverty and define a "poor" American family as one whose income in 1971 dollars was 3,000 or less per annum. Then [23], 218, in 1955 17.6 per cent of all families were poor. In 1971 merely 8.3 per cent were poor. The percentage of poor families was halved in 16 years or—which is the same thing—poverty was being eroded at an average annual rate of 4.2 per cent. This is perhaps faster than the average American realizes and certainly faster than Mr. Kelso realizes.

The halving of poverty in the period 1955–71 was a gratifying fact, and I see no reason why we can't go on halving poverty every 16 years—ESOT or no ESOT. Personally I would favor broadening the ownership of capital, although not necessarily in the form of ESOT. I see no conflict between such broadening on the one hand, and a full-employment steady-growth policy on the other. That carries me to question 4.

Question 4. Should our economic goal be "general affluence" rather than full employment as suggested by Kelso? How can general affluence be achieved?

Answer. If like Mr. Kelso one thinks of full-employment policies as the 1848 policy of digging holes in the *Champ de Mars* and then filling them again, then full employment and affluence may be alternatives—otherwise not. So I dismiss the question of general affluence *versus* full employment as uninteresting and turn to the more interesting question of how to achieve general affluence.

Normal economic growth does generate affluence, but normal economic growth doesn't just happen. It takes a minimum of gentle nurturing. Such nuturing has two parts to it.

The first part is *expanding* the growth potential. To do this one must first know what the sources of economic growth are. In my answer to question 5 I shall report on some modern mapping of those sources. Here I shall merely say that advances in knowledge have contributed 1.8 times as much to United States growth as has physical capital formation. Education and advances in knowledge combined have contributed 2.7 times as much.

The second part is *exploiting* the growth potential. Here, countercyclical policies are helpful. In applying such policies we have been less successful than certain Western European countries. I have taken a look at the smoothness of growth in five leading countries [17] and [18] and would crudely characterize their growth 1951–71 as follows:

France: Fast, rising, and smooth.
The Netherlands; Fast, rising, and bumpy.
Sweden: Slow, rising, and smooth.
United States: Slow, rising, and bumpy.
West Germany: Fast, falling, and bumpy.

Perhaps we should borrow a leaf from the countercyclical-policy books of France and Sweden. In a forthcoming article [6] I show how the Swedes managed.

III. SPECIFIC POINTS IN KELSO'S NEW ECONOMIC SYSTEM

Question 5. Kelso claims that widespread adoption of ESOP's will provide for extremely rapid rates of economic growth accompanied by full employment for 2–3 decades, at which time a true "leisure society" will be possible. Considering his grandiose economic system, is there any economic basis for such optimistic projections? What do you see as the major difficulties with the Kelso plan from and economist's perspective?

Answer. No one looking at long-term economic growth can help being impressed by its convergence to *steady-state* growth, i.e., growth at a constant proportionate annual rate. For the one hundred years 1870–1969 the gross national products of the two leading capitalist economies, the United States and West Germany have been growing at average annual rates of 3.7 and 3.0 per cent, respectively [21], 99. My Figure 2, reproduced from [21], 97, shows how. The West German case is the more revealing of the two: In 1945 the German economy lay in ruins, nothing stirred. But in a beautiful arc of history's largest and most perfect convergence, the 1948–69 West German curve swings right back into an extrapolated 1870–1913 path.

Before and after such things as
the electromagnetic revolution,
the chemical revolution,
the internal combustion engine,

the automobile,
two world wars,
the unionization of labor,
the computer revolution, and
the mass-education revolution
capitalist economic growth is so regular, so resilient, so irresistible! Before and after ESOT?

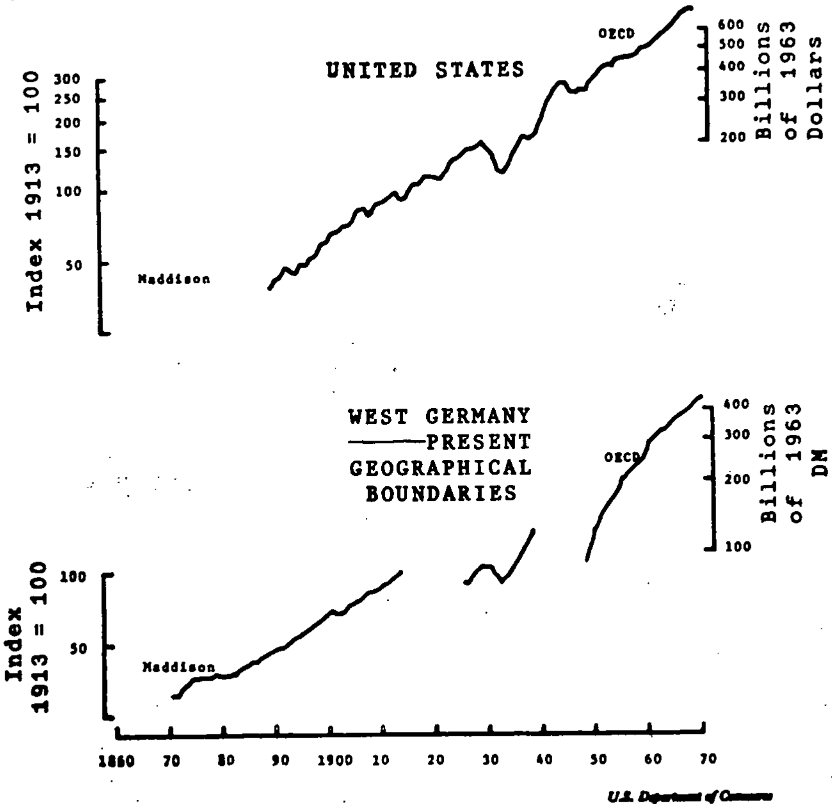


FIGURE 2.—Gross national products of the United States and West Germany

What are the sources of capitalist economic growth? During the past quarter century, theoretical and econometric work on the subject has greatly expanded. Such work has left us with the impression that technological progress is the most important single source. A survey of econometric work on technological progress was offered by Kennedy and Thirlwall [15], and a much shorter one was offered by myself [4], 73–80.

All I can do here is to reproduce the main conclusion of the most recent work on the sources of United States growth. Potential national income of the United States in constant dollars was growing at an average annual rate of 3.41 per cent from 1929 to 1969. Denison [8] used six factors to explain this growth and measured the percentage contributions of each of the six [8], 128:

	Percent
Advances in knowledge and not elsewhere classified	27.0
Labor, except education	26.7
Capital	14.7
Education	12.0
Economies of scale [1]	10.9
Improved resource allocation	8.8
Total	100.0

[1] Includes the very insignificant contributions of housing occupancy ratio and irregular factors.

In other words, advances in knowledge contributed 1.8 times as much to growth as did physical capital formation. Education and advances in knoweldge combined contributed 2.7 times as much.

Could a wage earners' investment fund accelerate growth? Parts V and VI of my comprehensive statement examined whether or not it could accelerate capital formation. It could. If it did, that would accelerate growth. But the acceleration might turn out to be modest, for empirical production functions often show the elasticity of output with respect to physical capital stock to be around ¼. That means that a one per cent increase in physical capital stock will increase output by ¼ of one per cent—everything else remaining equal.

Would ESOT produce a "leisure society" after 2–3 decades? Without ESOT the "leisure society" is already here: For his period 1929–69 Dension [8], 127, found average hours *falling* at an average annual rate of ½ of one per cent!

One of "the major difficulties with the Kelso plan from an economist's perspective" are Mr. Kelso's own claims for it. No claim of his is based on serious economic analysis. Mr. Kelso, who quotes mostly himself, claims to have pioneered the insight that there are two factors of production, not just one. Perhaps that particular claim is the most eloquent proof of Mr. Kelso's lack of familiarity with professional economic analysis. Economists have used two-factor production functions for more than a century. Almost half a century ago, Paul H. Douglas, later a distinguished United States Senator, pioneered econometric estimates of the parameters of such functions, and we have been at it ever since. Neither in his testimony before the Senate Finance Committee [13] or this committee [14] nor in his book [12] does Mr. Kelso betray any sign of having ever seen a production function, much less estimated one himself and put it into a specified model of economic growth.

Question 6. Speaking of the new monetary arrangements he proposes, Kelso has said: "Such a system would solve the major monetary problems of the U.S. economy both internally and internationally." This would be deflationary, for the value of net goods and services vastly exceeds the cost of new capital formation." Will monetizing new capital formation accomplish all of these worthy goals claimed by Kelso?

Answer. Unwittingly Mr. Kelso reopens the famous early-nineteenth-century issues between the Currency Principle and the Banking Principle. Ricardo advocated the former, according to which self-liquidating productive bank credit may or may not be inflationary. Tooke and Fullarton advocated the Banking Principle, according to which such bank credit can *never* be inflationary: The credit creates physical output, and once that output has been sold the credit is liquidated. Mr. Kelso sides with Tooke and Fullarton but goes them one better: Such bank credit is outright deflationary!

The issue was settled—I should have thought for good—in the early twentieth century by Wicksell. Very briefly Wicksell's arugment [26], 190–208, especially 194–95, was this. The demand for bank credit is a function of the bank's rate of interest: A lower rate of interest will attract more borrowers. Wicksell now distinguished clearly between unemployment and full employment—exactly 30 years before Keynes.

First, let the rate of interest be such that planned saving and planned investment are equal at unemployment and idle capacity. Lowering the rate of interest from such an unemployment equilibrium will enable newly attracted borrowers to demand inputs hitherto unused. No other output will therefore have to be curtailed. Since the extra income generated by the mobilization of inputs hitherto unused is matched by a net increase in output, output prices will not rise.

Second, let the rate of interest be such that planned saving and planned investment are equal at full employment and fully utilized capacity. Lowering the rate of interest from such a full-employment equilibrium will enable newly attracted borrowers to demand only inputs hitherto used elsewhere. New borrowers compete with old ones, and in the scramble for inputs, input prices rise. Old output will have to be curtailed to make room for new output. Since the extra income generated by the higher input prices is matched by no net increase in output, output prices will rise.

Wicksell concluded that Ricardo had been right and Tooke and Fullarton wrong.

The Tooke-Fullarton Banking Principle is only one strand—the demand-pull strand—of Mr. Kelso's claim that his plan is deflationary. The other strand—the cost-push strand—is that labor will stop asking for money wage rate increases beyond productivity increase once labor becomes a co-owner of business *via* ESOT.

Is this really to be expected? Under decentralized bargaining like ours, local labor can always gain an edge on the rest of the economy by asking for, and getting, such increases. They don't perceptibly hurt the employer as long as he can shift them to the price of output. Such shifting, in turn, doesn't perceptibly hurt local labor in whose overall consumption budget the employer's product is a drop in the bucket. All this holds, ESOT or no ESOT.

Neither of Mr. Kelso's two strands is convincing.

In Sec. 22 of my prepared statement I briefly discussed Mr. Kelso's request that the Federal Reserve System should "monetize" new capital formation by rediscounting notes issued by ESOT and already discounted by its lender. I said that such rediscounting would expand the money supply and reduce the rate of interest.

I stand by what I said. I add two things. First, such rediscounting would not be deflationary and could easily be inflationary. Second, like any two-price system, an ESOT 3-per-cent-interest shelter in the midst of a 10-per-cent economy could possibly be an invitation to deceit. It would certainly make Dr. Burns' job even more difficult. One can understand why, in his letter to the Chairman of this this committee, Dr. Burns does not consider such a shelter desirable.

I conclude that Mr. Kelso's "monetization" would solve the major monetary problems of the United States economy neither internally nor internationally. It would aggravate them.

Question 7. Kelso claims that the public stock markets currently are relatively insignificant with respect to financing the growth of the economy. Do you feel this is true, and if so, is it a serious matter that needs remedying through such measures as Kelso proposes?

Answer. In countries like the United States and West Germany it is true that stock financing takes, and always has taken, third place to self-financing and borrowing. Relating long-run sources of funds to long-run uses, I took a look at the ratio between stock issue and purchase of physical assets in recent years. In Footnote 9 of my prepared statement I found that ratio for 1969–72 to be 8.4 per cent for nonfarm nonfinancial corporations. That is four times higher than the 2 per cent repeatedly cited by Mr. Kelso. Even so it is still small.

Why is it so small? Sec. 19 of my prepared statement examined the cost of capital to a firm and mentioned that issuing stock, borrowing, and self-financing carry different price tags. Of the three ways of financing new investment, issuing stock is usually the most expensive one, the one to be used as a last resort, the one to be used to finance marginal investment.

Does its smallness make it unimportant? Far from it. Economists know that some of the most important things we deal with are determined on the margin. The margin may be small but it is often very important.

Being small but possibly very important, why is issuing stock such an expensive way of financing new investment? The answer is that to its owner, stock ownership is not all that attractive. Owning stock means owning firms whose undistributed profits are taxed at 48 per cent by the Federal Government, and whose distributed profits are taxed twice. Does the double taxation reduce the attractiveness of stock ownership equally to rich and poor? It does not: In the appendix to his testimony before this committee [24], 10, Mr. Walker compared a taxpayer in the 20 per cent marginal income tax bracket to one in the 70 per cent bracket. Mr. Walker found that double taxation increases the tax burden of the low-income taxpayer from 20 to 58.4 per cent or by a factor of 2.92 but increases that of the high-income taxpayer from 70 to 84.4 per cent or by a factor of merely 1.21. So double taxation is not neutral as between rich and poor, it penalizes the poor far more. Could this be one reason why low-income taxpayers shy away from corporate stock ownership?

But even the 48 per cent Federal corporate income tax rate is not the whole story. Inflation overstates the very tax base of the 48 per cent. First, the law permits depreciation allowances based on historical cost only. Second, the entire return on invested depreciation allowances is considered profits—taxable profits—including that part of the return which is merely a compensation for inflation. As a result, the law overstates corporate profits. By how much? Bach [1], 7, quotes a Terborgh estimate to the effect that over the past quarter century, 19 per cent of reported corporate profits were fictitious profits reflecting under-depreciation. Friedman [10], 94, quotes a recent Terborgh estimate to the effect that currently as much as one-third of reported profits are fictitious. Could one reason for those low price-earnings ratios be that one-third of the earnings are fictitious?

The tax treatment of corporations is in effect a special punishment of the most productive sector of our private economy. Is this a serious matter? The punishment may be what Congress wants and may be justified by what Congress considers to be social justice. But if the left hand of Congress doesn't always know what the right hand is doing—as Mr. Brannon [3] hints in his testimony before this committee—then Congress might take another look at double taxation and overstatement of corporate profits.

If the matter is serious, does it need remedying through "such measures as Kelso proposes"? ESOT would be a most special remedy and far from the only conceivable one. But I must hurry on to Question Eight.

Question 8. Kelso claims as one of the real virtues of his plan the leveraging aspect involved or as he puts it, stimulating capital formation now through future savings. Is this sound from an economist's perspective, or should ESOPs be denied their current exemption status from the IRS law prohibiting such leveraging techniques for any other type of pension or deferred compensation plan?

Answer. As I understand it, the Employee Retirement Income Security Act of 1974 permitted an ESOT to borrow from an otherwise nonqualified lender or borrow with the guarantee of an otherwise nonqualified guarantor.

An ESOT comes into existence by an act of borrowing cash from the outside. Through this act of borrowing ESOT and its parent firm submit to normal capital-market screening. Consequently the borrowing activity of ESOT in no way reduces the mobility of capital—as I pointed out in Sec. 23 of my prepared statement.

Borrowing is a normal and important way of financng new investment. Borrowing by an ESOT guaranteed by the parent firm is no less sound than direct borrowing by the parent firm. Whether or not that, in turn, is sound enough is precisely the kind of question normal capital-market screening will answer. How severe the capital-market screening standards should be is precisely the kind of question normal Federal Reserve routine will answer.

With such checks and balances operating in our economy, I personally see no reason to deny ESOT its ability to borrow.

IV. SHORTCOMINGS OF ECONOMIC ANALYSIS

Question 9. Do you agree with Kelso's statement that: "Keynesian doctrine forces labor to demand more pay for less work" and also "that labor *receives* 75% of the economy's income does not mean that labor produced it." "Not a trace of criticism is due labor unions or individual wage earners for this development. The responsibility rests squarely on Keynesian "scientific economics" which lie, misrepresent, or equivocate about technology's logic and function."

Answer. How can Keynesian doctrine force an employer to keep anybody on the payroll who receives more than he produces? This is a free country, and employers are still free to fire employees not earning their keep. Would any employer let Keynesian doctrine stand in the way?

That Keynesian doctrine should lie, misrepresent, or equivocate about technology's logic and function is unlikely for the simple reason that Keynesian doctrine has very little to say about those things. Keynesian doctrine is short-run analysis. Long-run analysis, dealing with technology, is neoclassical, not Keynesian. For example, the two-factor production function $X = ML^{\alpha}S^{\beta}$, where

α = elasticity of output with respect to L
β = elasticity of output with respect to S
L = Labor
M = factor representing technology
S = physical capital stock
X = output

used to explain the distributive shares in a competitive profit-maximizing economy, is neoclassical, not Keynesian. The function was first written by Wicksell [25], 198, in 1901—35 years before Keynes. Its parameters were first estimated empirically by Paul H. Douglas [7] in 1928—8 years before Keynes.

So Mr. Kelso has misdelivered his accusations. So what if he can't tell one addressee from another. But what does Mr. Kelso himself have to offer?

Against neoclassical production functions Mr. Kelso pits diagrams like the one reproduced in [14], Sec. III, 6–7. The diagram is supposed to tell us what happened to labor input and capital input from 3,000 B.C. to 2,000 A.D. Mercifully both inputs remain undefined and unmeasured—"mercifully" because if you are saying nothing you can't be lying! Mr. Kelso might claim that the diagram is purely impressionistic. But even Mr. Kelso's impressionism is provincial:

He clearly sees things from the factory floor of a single firm, is impressed with all the expensive plant and equipment he sees around him, and counts it all as "capital input". He fails to see the economy-wide picture. He fails to see that all that plant and equipment, in turn, was built in other plants. There, labor went into the designing and construction of the plant and equipment. And as Gordon [11] has shown, the capital goods sector is more labor-intensive than the consumers' goods sector.

Question 10. Have economists perhaps had a two factor theory, but only a one factor policy, namely focusing on labor and employment?

Answer. I dare say we have had a two-factor theory—for more than a century! Economists don't *make* policy—Congress does. Economists merely *analyze* policy. If much of our analysis runs in terms of labor and employment, the simple reason is that to policymakers it is important that nobody who is willing and able to work should be unable to find it. Needless to say, in our analysis of a two-factor world we use our two-factor theory.

V. ESOT VERSUS MR. KELSO

When I wrote my prepared statement I was determined to let neither Mr. Kelso's inept use of data nor his lack of training in economic theory keep me from analyzing ESOT on its own merits. I hope I succeeded.

When answering the Chairman's ten questions I find many of them forcing me to pass professional judgment on the quality of Mr. Kelso's arguments. Nothing personal is meant. I can only hope that to advocates and opponents of ESOT alike, such professional judgment is useful. Whether ESOT is encouraged or discouraged, Congress must know what it is doing. Least of all those who favor some kind of wage earners' investment fund would like to see it sold to Congress by untenable arguments.

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Response of Hans Brems to Additional Written Questions Posed by Senator Javits

Question 1. You have written that under the Kelso Plan the employee is assigned the role of "innocent bystander" because he "will eventually own something for nothing." Do you think this lack of employee initiative or active involvement is detrimental to the achievement of greater labor productivity?

Answer. It may be. But it may also be that rank and file feelings may differ from those of the union leadership. French experience in this respect may be worth reporting. The French wage earners' investment funds were introduced by statute in 1967 without union support. The system is a compulsory profit-sharing system with full tax credit for employer contributions to the funds. Details such as placement of funds are left to employer-employee agreement. The labor unions rarely wanted to be a party to such agreements. Consequently the employees are typically represented by their local *comité d'entreprise* rather than by their union. According to Cars, *Andel i vinst* (Stockholm 1975), p. 43, union attitude is still "critical, passive, and noninvolved". But the first distributions, beginning in 1974, "were experienced as something positive" by a large part of the rank and file. As a result, union leadership is not likely to try to kill the system now.

Question 2. In your prepared statement you emphasize that an important difference between the Kelso Plan and Western European plans is that Western European plans rely on the initiative of the employees and their unions rather than on that of the employer. That is that Western European plans are *voluntarily negotiated* by labor and management in *collective bargaining.* Do you think this is a weakness of the Kelso Plan? Why?

Answer. To the extent that Western European systems are voluntary at all—as are the West German and Dutch investment-wage systems—they are indeed thus negotiated. But even in the compulsory French profit-sharing system details such as placement of funds are left to employer-employee agreement.

The Kelso system envisages no active labor participation at all in setting up an ESOT. As an economist I don't pretend to know social psychology. But I suspect that a person would be left cold if something concerning his financial interests were set up without asking him, without involving him actively, without inviting his representation in running it. At least that could be his initial reaction. Later, when the system begins working and passing out money to him, he may warm up to it.

Question 3. It is true that the effect of ESOP financing is to fix, at the time of the loan and stock purchase the price at which annual employer contributions, will be converted into stock. Thus, while the ESOP debt is being retired, if the value of the stock decreases this appears to me to magnify the disadvantages to employees of this leveraging effect. Please comment.

Answer. Yes, according to Mr. Kelso's testimony to the Financial Markets Subcommittee of the Senate Finance Committee on September 24, 1973, "employees . . . acquire stock in increments over a period of years at a price fixed at the time the block of stock is first purchased."

Does this "magnify the disadvantages to employees"?

Well, the value of stock may go up or it may go down.

In the long run and for the stock market at large, it does go up—stock ownership *is* a hedge against inflation! But short run-ups and downs are violent. And if the stock of one firm goes up, that of another may go down. That is why a risk-averting stockholder diversifies his portfolio—or sticks to mutuals! Now the law discourages diversification of ESOT portfolios: To qualify for preferential tax treatment employer contributions to an ESOT must be in the form of either the stock of the employer or cash. The portfolio of the fund need not be diversified. Benefits must be distributed in the form of the stock of the employer.

I would say that if this arrangement does not magnify the disadvantages to employees, it does magnify their risks—compared to those run by risk-averting individual stockholders or by risk-averting mutuals.

Question 4. In your opinion are the income redistribution claims of Kelso Plan advocates exaggerated when they are examined in light of conventional macroeconomic analysis?

Answer. Mr. Kelso prefers to talk in terms of income creation rather than in terms of income redistribution. Let me separate the two.

First income redistribution. Any wage earners' investment fund will redistribute disposable income in favor of the wage earners. In Sec. 14 of my prepared statement I show graphical results of computer simulation of such income redistribution. The graph refers to the Western European concept. In Sec. 11 of the prepared statement I discuss the size of an ESOT system. I imagine an ESOT system would be smaller than a Western European one, both because ESOT freezes merely the original contribution, and because it redeems more permissively. Be that as it may, both a Western European system and an ESOT system would accomplish a significant redistribution of income in favor of the wage earners.

Second income creation. This is what Mr. Kelso talks about, and his projections are highly optimistic. The fifth question of the Honorable Hubert H. Humphrey in his letter of December 19, 1975, was this: "Is there any economic basis for such optimistic projections?" In my answer to that question I try to demonstrate that no claim of Mr. Kelso's is based on professional macroeconomic analysis. I also discuss the nature and sources of growth as well as ESOT's possible acceleration of growth. I refer to that answer and to Parts V and VI of my prepared statement.

Question 5. In your prepared statement you estimate that the revenue loss that would result from universal adoption of ESOT would amount to some $21 billion. Do you believe that benefits from ESOTs are sufficient to offset these revenue costs?

Answer. My $21 billion estimate applied to "the unlikely event that all non-financial corporations had set up ESOTs and contributed, say, 10 percent of the wage bill to them." The estimate served the purpose of showing how large the preferential tax treatment already is under existing statutes. But the event is "unlikely," and my estimate was no prediction.

Still, would the benefits of such an unlikely event offset the revenue loss? Let me distinguish between a depressed and a fully employed economy. In a depressed economy the benefits of accelerating capital formation and expanding employment could be very large—and the net revenue loss smaller, because of expanded tax revenue from sources other than the corporate profits tax. But countercyclical stimuli may just as well be provided in non-ESOT forms such as by reducing the overall corporate profits tax rate, by raising the overall investment tax credit, by reducing the rate of interest, etc.

So let us keep our issues straight and discuss ESOT in the context of a fully employed economy—assuming that the countercyclical policies are doing their job properly. *Then* would the benefits offset the revenue loss? Benefits to whom? The supposed beneficiary, labor, has so far shown little interest. The benefit-revenue trade-off is obviously political. Economics as a science must pass the buck to Congress.

Question 6. In your opinion, and based on the analysis of ESOT's that you have undertaken, do you think the Kelso Plan provides any of the co-determination rights characteristic of European plans?

Answer. The Kelso Plan does envisage possible co-determination anchored in in voting stock. To be true, in return for granting tax *deductibility* the law does not require the parent firm to issue voting stock to ESOT. But in return for granting tax *credit* it does.

A nondiversified ESOT may provide more co-determination than does a diversified one. Congress should be warned that in single-firm wage earners' investment funds, local co-determination and diversification are logical alternatives. A nondiversified ESOT owns nothing but the stock of the employer. Provided that stock is voting stock, co-determination in employer affairs is at its maximum. A diversifying ESOT is selling the stock of the employer—and with it go the voting rights. To be true, the diversifying ESOT is buying the stock of other firms. But the accompanying voting rights may be of less interest to its members. A fully diversified ESOT owns practically no employer stock, and co-determination in employer affairs is at its minimum. So much for single-firm ESOT.

The same could be true of the large diversified suprafirm funds of the Western European type. The only proposal known to me which tried to cope with the problem was the Danish one: Here, voting rights inherent in stock ownership would be exercised not by the central fund but by the individual fund members employed by the stock-issuing firm.

There is a growing inclination, most articulate in West Germany and Sweden, to separate the codetermination issue from a wage earners' investment fund. Codetermination should be anchored, it is felt, not in stock ownership but simply in the employee status. West Germany has gone very far in putting employee representatives on the board of directors. In the coal and steel industry there has been equal representation of employees and stockholders since the fifties. The present West German coalition government is now trying to extend this parity principle to the rest of industry. A 1973 Swedish statute entitles employees to two seats on the board of corporations employing 100 employees or more. In 80 per cent of such firms employees have exercised that right. On the whole, West German and Swedish employers seem happy with employee representation on the board of directors. Such representation seems to be enhancing the already enviable record of industrial peace in the two countries.

Question 7. One of the claims of ESOT advocates is that this technique is a useful capital formation device. You point out in your statement that any acceleration of capital formation that occurs should *not* be attributed *directly* to the ESOT scheme. Would you explain this view?

Answer. Indeed! I did not say "*any* acceleration of capital formation that occurs," I distinguished between the effect of ESOT upon the propensity to save and upon the inducement to invest.

As for the propensity to save, I said that a wage earners' investment fund reducing the national disposable-income fraction of national output could raise the propensity to save national output. Any resulting acceleration of capital formation *should* be attributed directly to the ESOT scheme.

As for the inducement to invest, I said that tax deductibility and tax credit to an ESOT as well as rediscounting by the Federal Reserve System of notes issued by ESOT would dramatically reduce the cost of capital to the parent firm. But the resulting acceleration of capital formation *should not* be attributed directly to the ESOT scheme, for it could just as well have been produced by applying the same liberal fiscal and monetary policies to all firms—ESOT or no ESOT. The ESOT scheme is merely an incidental vehicle for such liberal policies—and not a necessary one.

Question 8. How well do you think the leveraged approach (Kelso Plan) to employee stock ownership compares with the Western European counterparts, with specific reference to (a) genuine worker participation in company affairs, and (b) security of employees financial interests?

Answer. The leveraged approach is uniquely American and is unique to ESOT. The leveraged approach means that an ESOT may be set up instantly, borrowing cash from the outside; employer cash contributions will slowly pay off the debt of ESOT. Western European schemes rely on no outside borrowing, hence cannot set up an instant fund. The instant birth of a full-grown ESOT may strike Western Europeans as typical of American impatience, but the full-grown ESOT does have appeal: With luck it will at once begin to make capital gains later to be passed on to its members.

How does the instant full-grown ESOT compare with Western European counterparts with respect to (a) worker participation and (b) financial security? Well, financial security is a matter of diversification. And in single-firm wage earners' investment funds, local codetermination and diversification are mutually exclusive, as pointed out under Question Six. A nondiversified ESOT owns nothing but the stock of the employer. If that stock is voting stock, codetermination in

employer affairs is at its maximum. A diversifying ESOT is selling the stock of the employer—and with it go the voting rights. The same could be true of the large diversified suprafirm funds of the Western European type.

It could well be, therefore, that the ESOT concept offers more codetermination, and the Western European concept more financial security. You take your pick. For other ideas on codetermination, see my answer to the sixth question above.

KELSO BANGERT & CO.
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SAN FRANCISCO INVESTMENT BANKERS NEW YORK

January 13, 1976

The Honorable Hubert H. Humphrey
Chairman
Joint Economic Committee
Congress of the United States
Washington, D.C. 20510

Dear Senator Humphrey:

Enclosed herewith is my letter of response both to the questions contained in your letter of December 18, 1975, and to the questions asked by Senator Russell Long, as forwarded to me with Mr. Hamrin's letter of December 19, 1975. To the best of my ability I have answered the questions fully. I believe that these questions and my responses will materially round out the presentation on ESOP financing, two-factor economics, and other business and government applications of two-factor theory.

In response to your letter of January 5, 1976, I am in an extremely difficult position to provide the information requested.

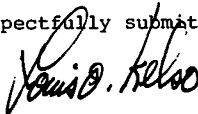
Kelso Bangert & Co. Incorporated believes itself to be, and represents to its clients that it is, a fiduciary with respect to the information it receives from them. Thus we would be unable to provide the information requested on each of our clients without expressly requesting their permission and this, I am afraid, could injure our relations with those clients.

We are engaged in innovating in the world of finance -- perhaps the most conservative part of our society and certainly a milieu in which innovation is difficult to sell and to implement. The additional information which we would have to obtain on each firm, in order to answer various of the questions, and to make our answers current, would be burdensome for the client and would involve a mountain of both professional (including computer projections) and clerical work for our own staff if done with the care we would want to apply in order to responsibly meet the Committee's request.

I would very much appreciate your advice as to whether we may be relieved of the burden of responding to the Committee's questions transmitted with your letter of January 5, 1976, both on the grounds of the potential impairment of our relationships with our clients and on the grounds of the expense and time involved in such a formidable undertaking.

We will be guided by your suggestions.

Respectfully submitted,



Louis O. Kelso

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Enclosures

KELSO BANGERT & CO.
INCORPORATED
SAN FRANCISCO INVESTMENT BANKERS NEW YORK

January 12, 1976

The Honorable Hubert H. Humphrey, Chairman
Joint Economic Committee
Congress of the United States
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Joint Economic Committee ESOP Hearings
December 11th and 12th, 1975

Dear Senator Humphrey:

In this letter, I will undertake to respond to the questions set forth in your letter to me of December 18th, 1975 and to the questions asked in writing by Senator Russell Long, as transmitted to me in the letter of December 19th, 1975 from Mr. Robert D. Hamrin, Staff Economist to the Joint Economic Committee.

For simplicity, I will restate each question in capital letters, or such portions thereof as may seem necessary, and will follow such restatement with my response.

QUESTIONS ASKED BY SENATOR HUBERT H. HUMPHREY, CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE

"1. YOU CLAIM THAT IF YOUR FORM OF ESOPS WERE WIDELY ADOPTED, OUTPUT COULD EXPAND BY 20-30% A YEAR. TWO VERY SERIOUS QUESTIONS RELATED TO THIS CLAIM ARE: A) WHAT ABOUT PHYSICAL LIMITS TO GROWTH? AND B) WOULDN'T THIS RAPID AND GREATLY INCREASED GROWTH REALLY BE AT THE EXPENSE OF OTHER COUNTRIES AS THE U.S. BOTH ABSORBS THE RESOURCES AND BIDS UP THE PRICES OF RAW MATERIALS FROM ITS GREATLY INCREASED DEMAND? DOESN'T IT SEEM HIGHLY QUESTIONABLE THAT MOST INDUSTRIES CAN EXPAND THEIR OUTPUT BY 20-30% PER YEAR? FOR EXAMPLE, MANY SERVICE-ORIENTED INSTITUTIONS SUCH AS LIFE INSURANCE COMPANIES AND COLLEGES, HAVE NO POTENTIAL FOR SUCH RAPID EXPANSION."

RESPONSE:

(1) Some error has crept into our communications concerning the rate of growth which I would anticipate if the United States adopted a two-factor economic policy and began implementing that policy along the lines I have recommended. I believe that economic growth rates would begin to accelerate within one year from serious

implemention of a two-factor policy and that within four or five years annual growth rates of 10% or better could be achieved. I have never suggested that our growth rate could be stimulated beyond that achieved by Japan in its best years--about 15% per year. I have estimated that it would take between 25 and 30 years to build a capital structure for the U.S. economy of such capacity that it would be capable, with an intermediately fully-employed labor force, of producing a high general standard of living. Perhaps these numbers have been transposed in the discussions.

(2) I accept as sound the views of those scientists who believe that technology will always outpace resource depletion if the United States and other countries of the world will but significantly control their population growth rates. See for example The Next Hundred Years, by Harrison Brown and others (The Viking Press, New York, 1957). A revised edition of this book was published about 1967.

I do not subscribe to the views of scientific "Henny Pennies" who insist that the sky is falling. Even if we were to assume that at some point the U.S. growth rate, or the world economic growth rate, would be limited by physical factors, the changes in economic policy and corporate financing techniques which I have recommended are, I am convinced, critically necessary to achieve a better distribution of whatever levels of affluence we can achieve.

(3) In general, most of the underdeveloped economies are resource rich, as is the United States. I believe that the model which the United States economy can provide in demonstrating how a private property, free market economy can be operated for the benefit of all its inhabitants, rather than primarily for the benefit of a few, will be imitated by every free society on earth. I would estimate that the resources saved by solving these internal economic problems alone (through providing a working model within our own economy that others can follow) would begin to eliminate the world's poverty at a rate that would in turn reduce the prevalence of wars. Resources we squander in war would contribute greatly to the world's peaceful affluence.

(4) If the United States does not establish, by correcting the errors in its own economy, a successful working model of a private property, free market economy that functions well for all its inhabitants, giving them high standards of income,

high quality goods and services, constantly hardening money supply (i.e., progressive deflatation), expanding leisure and diminishing toil, the rest of the uncommitted nations will fall to socialism, as vast areas of the world already have. Nothing could more effectively diminish our opportunities for foreign trade in resources as well as in fabricated goods and in services. We must stop trying, as we did in Korea and Vietnam, to kill ideas with bullets. Bad ideas can only be killed with good ideas--and the only convincing good ideas are the ones that have proven superior in practice. The time for our actually fulfilling the world's expectations of us, and to demonstrate how a private property, free market economy within a political democracy, is the best form of economic system and best society for all peoples, is at hand. We have no time to waste.

(5) There can be no assurance that every industry or every business can achieve growth rates of 10-15% per year in the course of our building a sufficiently large capital structure to produce a high standard of living for all the American people. Growth is, and should be, responsive to economic demand. But service industries, like manufacturing industries, do expand in response to the demand of consumers with the economic power to buy goods and services to satisfy their needs and wants. Millions of people do not purchase insurance because they cannot afford to. And so with most industries, service and non-service.

"2. WHEN LEVERAGED ESOPS ARE USED AS NEW TECHNIQUES OF CORPORATE FINANCE, ALL OF THE ADDITIONAL CAPITAL INPUTS MUST BE PROFITABLE FOR THE SUCCESS OF THESE PLANS. HOW CAN YOU ASSUME THAT ALL COMPANIES WILL BE ABLE TO SIMULTANEOUSLY UNDERTAKE SUCH RAPID EXPANSION OF OUTPUT? WHAT ABOUT THE PROBLEM OF SATURATED MARKETS OR DO YOU FEEL THAT THIS WILL SOMEHOW NOT BE A LIMITING FACTOR?"

RESPONSE:

(1) All of my proposals assume the basic responsiblity of business, on a company-by-company basis, to carefully determine the feasibility of each expansion, including the power of the market to absorb the added goods and services. Limiting factors on the expansion of business today are the lack of consumer dollars, inflation, and high interest rates. Through pursuit of a two-factor economic policy, we learn how to build productive power and its attendant purchasing power into those with unsatisfied needs and wants--something we have never before been effectively

able to do. The growth of the economy and of the businesses within it would simply be in response to the increased incomes resulting both from the expansion itself, from the operations of the expanded economy, and from the fact that a rapidly expanding proportion of the population would begin receiving incomes--higher incomes--from two sources: their labor and their capital.

(2) I do not believe that it is true that "all of the additional capital inputs must be profitable for the success of these plans." Business failures are lower in periods of prosperity than in periods of recession, economic strangulation, and frustration, as at present. Nevertheless, errors will be made and failures will occur. The purpose of the suggested Capital Diffusion Insurance Corporation (CDIC) is to spread the risk of this failure over the broadest possible base of the economy.

(3) "Saturated markets" can only really exist when all consumer units achieve a high standard of living. At that point, and I estimate it will take 25 to 30 years under a fully implemented two-factor economic policy to achieve this, we will, as to all such "saturated" markets, have achieved the steady-state affluent economy. No further expansion is needed for all to live well. Then we need only to continue production at that level and make certain that all consumer units can adequately participate in production so as to enjoy a high standard of living.

"3. WHY SHOULD THERE BE SUCH A GREAT EXPANSION OF PRIVATE GOODS WHEN SO MANY PEOPLE TODAY FEEL THAT INCREASES IN THE QUALITY OF LIFE DEPEND ON BETTER GOVERNMENT SERVICES--FOR EXAMPLE, MORE PARKS, BETTER HEALTH CARE, MORE AND BETTER MASS TRANSIT, ETC.?"

RESPONSE:

(1) My proposals are intended to make the overwhelming majority of our consumer units who are poor significantly more affluent. Affluent societies can afford, and do normally insist upon and achieve, improved quality in their social amenities: more and better parks, better health care, more and better rapid transit. Many of these, like health care and mass transit, would indeed be part of the expansion of the private sector financed as we have proposed, and broadly owned as we have proposed. Many such "government services" become government services only when the private sector institutions that originally provided them fail. Most such failures are the result of our defective economic policy and our resulting defective business financial practices.

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"4. HOW IS YOUR PLAN AN ATTACK ON THE "CAUSE" OF POVERTY WHEN SO MANY PEOPLE IN POVERTY ARE NOT, AND NEVER WILL BE, MEMBERS OF THE LABOR FORCE? WHEN YOU SPEAK OF GENERAL AFFLUENCE, DO YOU REALLY BELIEVE THAT YOUR PROGRAM WOULD SOMEHOW LIFT EVERYONE OUT OF POVERTY? IF SO, HOW?"

RESPONSE:

(1) Here again the question is one of the proper priorities. In The New Capitalists, which Mortimer J. Adler and I published in 1961, Mr. Adler and I demonstrated that using the basic logic of corporate finance, capital ownership could be built into every consumer unit in the United States, in the course of expanding the economy to a level where it would be capable of producing a high general standard of living. But Congress would have to lay down priorities as to which groups of individuals would be the first to acquire viable capital estates, which groups second, etc. Simply because we would not enjoy a high general standard of living until we can produce it by expanding our capital structure by, I estimate, a factor of somewhere between 7 and 12 magnitudes, on a per capita basis, it is my recommendation that the first priorities should be given to the workers in private enterprise where most of the goods and services in the U.S. economy are produced. Since I believe that this will provide us with somewhere between 25 and 30 years of intense full employment, most families can acquire capital estates through their participation in the labor force. There would be a serious risk of failing to motivate people to work if it became as easy to acquire a viable capital estate without working, as by working. Perhaps 15 years into the expansion of our economy under a two-factor policy, we could begin to experiment with using the techniques outlined in The New Capitalists and in my testimony before the President's Commission on Income Maintenance Programs (Exhibit 3 to my written statement before the Committee).

"5. YOU HAVE STATED THAT THIS TYPE OF PLAN WOULD BE EXTENDED TO THE WORKERS IN SOCIETY FIRST. THEREFORE, AREN'T YOU DELIBERATELY INCREASING THE GAP BETWEEN THOSE WITH JOBS AND THE POOR, SICK AND DISABLED IN OUR SOCIETY WHO MUST SURVIVE ON VARIOUS TRANSFER PAYMENTS?"

RESPONSE:

(1) I believe this question is substantially answered in the response to the previous question. By itself, giving priority in

the acquisition of capital estates to employees in the private sector, the gap between workers in such jobs and the poor, sick and disabled in our society might well be widened unless increased welfare is used to close this gap. As the economic demand of consumers for goods and services, resulting from increasing incomes, reducing prices and fuller employment, diminishes the economic load on taxpayers of the unemployed and the capital-less, the economy can afford improved welfare for those who are incapable of entering the labor force, even though there is a demand for their participation.

"6. YOU HAVE SAID THAT YOUR THREE BOOKS MAKE IT EMPHATICALLY CLEAR THAT THE SECOND INCOME PLAN IS DESIGNED TO MAKE ALL POOR PEOPLE STOCKHOLDER CONSTITUENTS OF THE MAJOR CORPORATIONS. HOW WOULD THIS BE ACCOMPLISHED? WHY DO YOU SAY THE MAJOR CORPORATIONS?"

RESPONSE:

(1) More accurately, I should say that the objective of a two-factor economic policy and implementation is to make all consumers holders of viable capital estates, that is, capital estates which will materially increase their incomes, and upon retirement, provide them high level incomes upon which to live comfortably. The size of the corporation is not important.

"YOU'VE SAID ALSO THAT GHETTO RESIDENTS MUST BECOME OWNERS OF EQUITY IN CORPORATIONS LOCATED OUTSIDE THE GHETTO. WHAT IS THE MECHANISM FOR THIS AND THE REASONING BEHIND THIS?"

(2) These discussions grew out of the so-called "Community Development Act" of the early Nixon administration which was designed to assist ghetto residents in obtaining ownership of ghetto industries and only ghetto industries. It appeared to me that the law would have built an economic barbed wire fence around each ghetto that incorporated itself as a Community Development Corporation. In general, it would make sense to help the economically weakest members of society to become holders of equities in the most powerful corporations. This is exactly what ESOPs would do for the great industrial populations. Two-factor financing techniques in general are capable of accomplishing this objective.

"7. IN PROVIDING FOR GOVERNMENT EMPLOYEES, YOU HAVE CALLED FOR THE 'PRIVATIZATION OF ALL PUBLICLY-OWNED ASSETS.' IS THIS REALLY FEASIBLE AND HOW DOES THE OWNERSHIP OF SUCH ASSETS PRODUCE A SECOND INCOME FOR THE PUBLIC EMPLOYEES?"

RESPONSE:

(1) There are a variety of two-factor financing tools for accomplishing the privatization of publicly-owned income producing assets, or assets that are capable of becoming income producing. For example, the privatization of the Tennessee Valley Authority, by a combination of ESOP financing and two-factor, consumer-ownership public utility financing, would enable the employees and the consumers of TVA to purchase that enterprise, to pay for it out of what it produces, and thereafter derive incomes from their capital ownership. The same would be true of the Post Office, of the public utility facilities that revert to the Federal government upon the expiration of forty year leases of power sites on government lands, of government owned ship building facilities, uranium purification facilities, and so forth.

(2) In the case of certain governmental operations that are capital intensive in the sense of requiring expensive capital structures, "facilities corporations" could be organized, either to finance the building of such facilities in the future, or to acquire existing facilities, or both. The facilities corporations would employ the governmental employees, would lease the facilities to the proper governmental agencies at fair market value, and would lease the employees to the governmental agency at cost. The adoption of an ESOP by the facilities corporation to accomplish the financing would thus build ownership of these income producing facilities into governmental employees, which ownership would take the place of the illogical and unbelievably wasteful and expensive pension systems which are bankrupting state and local governments and absorbing incredible amounts of federal revenues today. Under such arrangements, the same dollar that finances construction of a government building would finance the ownership of these income producing facilities by government employees. The overall tax saving to taxpayers would be enormous.

"8. DOESN'T AN ESOP, BY ALLOCATING SHARES IN THE ESOT ACCORDING TO COMPENSATION LEVELS, ACCENTUATE THE MALDISTRIBUTION WHICH CURRENTLY EXISTS BETWEEN THE HIGH AND LOW PAID WORKERS IN THE U.S. ECONOMY? DO YOU FEEL THAT ON EQUITY GROUNDS, THE LOWER PAID

EMPLOYEES SHOULD BE GIVEN A DISPROPORTIONATELY LARGE SHARE IN THE ALLOCATION? COULD CRITERIA OTHER THAN COMPENSATION BE USED?"

RESPONSE:

(1) This question is substantially identical to Question 8 answered at Pages 58-59 of my written submission.

"9. HOW ARE NEW EMPLOYEES HANDLED? DO THEY DILUTE THE EQUITY OF WORKERS ALREADY IN THE ESOT OR DO THEY JUST 'SIT BY' UNTIL THE NEXT COMPANY CONTRIBUTION OR LOAN FOR EXPANSION OCCURS?"

RESPONSE:

(1) The ESOP, if properly designed, is an incredibly flexible device for accomplishing its goals. In the case of the so-called "leveraged ESOP," allocations of stock to employee accounts are made on an annual basis as the debt is retired. As new employees come in, they normally automatically become participants. As employees leave, they automatically cease to be participants. Since virtually every business has a continuous need for capital formation year after year, a long term employee will be receiving in his ESOP account allocations resulting from the amortization of numerous financings, in addition to such allocations as may result from investment tax credit ESOP stock allocations, or from gifts or bequests if H.R. 462 should become law. (See Appendix IV and Pages 71-72 of my written statement.)

"10. HOW DOES YOUR PLAN BENEFIT OLDER WORKERS, WHO MAY BE RETIRING BEFORE FULL VESTING OF THEIR STOCK OWNERSHIP? AREN'T THEY MORE INTERESTED IN A SECURE RETIREMENT INCOME?"

RESPONSE:

(1) Obviously it is not possible to turn back the clock. Once an ESOP is installed, it operates prospectively only. Where an ESOP is substituted for an existing pension plan, the substitution is often limited to people who have at least ten years or so to work before retiring. As to the older workers, an existing pension or profit sharing plan may be continued in operation until they retire.

"11. SHOULD A SCHEME SUCH AS YOURS TO EXPAND EQUITY OWNERSHIP COERCE OR FORCE PEOPLE WHO HAVE HIGH RISK AVERSION INTO HIGHER RISK SITUATIONS WHERE THEIR RETURN OR BENEFIT LEVEL IS NOT GUARANTEED?"

RESPONSE:

(1) No "coercion" in the pejorative sense is involved in any ESOP. In the first place, employees are free to seek employment elsewhere if they do not like the employer company, or do not wish to own the employer's stock. Secondly, risk is a part of life, and so-called "fixed benefit" pension plans merely create the illusion that risk is eliminated. Actually they transfer the risk from the employee to the employer (and many employers are threatened with retirement system cost bankruptcy today). They accelerate the inflation that assures that the workers' pensions will be inadequate when they get it.

(2) Furthermore, it would be a simple matter in setting up a Capital Diffusion Insurance Corporation to insure lenders that make ESOP loans, just as the FHA program insures lenders that make FHA housing loans, to add an additional insurance program which would insure each ESOP participant, for a premium to be paid by the employer or by the ESOP trust, that he will receive at retirement in dollars not less then the dollar equivalent of the stock allocated by the employer to his account during his working lifetime. Indeed, a private insurance group is already studying the possibility of organizing a firm in California to sell just such insurance. This would simply spread the relatively rare risk of business failure over the economy as a whole. Significant business failures, once a rational economic policy is adopted and implemented, should be substantially reduced.

"12. OVER TWO YEARS AGO, YOU PREDICTED THAT 'UNIONS WILL BECOME THE CHIEF AGENTS IN SPREADING AND ACCELERATING THE ACCEPTANCE OF TWO-FACTOR ECONOMICS AND OF FINANCING TECHNIQUES BASED UPON THESE CONCEPTS.' WHY HASN'T THIS COME TO PASS?"

RESPONSE:

(1) There is evidence, which it would be premature to discuss here, that this prediction will be fulfilled. Nothing more is involved than each labor union expanding its concerns and jurisdiction to comprehend both factors of production. Several

wise labor leaders are already moving in this direction. One local of a national union has made the establishment of an ESOP its principal demand in its collective bargaining negotiations which are underway as this writing is taking place. The opportunity of unions to increase their constructive contribution to the American economy, to decrease their destructive contributions to it, and to increase their sources of revenue by receiving a check-off on capital ownership built into members--each suggests this change will come to pass.

"13. RELATED TO THIS IS THE PROBLEM THAT WORKERS USUALLY STAY AT THEIR JOB ON THE AVERAGE ONLY 5-6 YEARS. THEREFORE, MANY WORKERS WILL NEVER HAVE THEIR LOAN SHARE PAID UP UNLESS CONTINUITY MECHANISMS ARE PRODUCED. THIS WOULD SEEM TO HAVE LITTLE MOTIVATING EFFECT. DO YOU FORESEE ANY TYPE OF CONTINUITY MECHANISMS TO ALLEVIATE THIS PROBLEM?"

RESPONSE:

(1) The "individual retirement account" (IRA) established under ERISA may well become the "continuity vehicle" by which workers, without adverse tax impact, can move their ESOP accounts from one company to another. The end result may be the holding of a diversified portfolio of stock by the time the worker reaches retirement age.

"14. THERE IS ALSO THE PROBLEM THAT IN A LARGE CORPORATION, THE WORKER IS ONLY ONE OUT [OF] A VERY LARGE POOL OF WORKERS. SO, THERE WOULD NOT BE THAT MUCH CONCERN FOR HOW YOUR WORK EFFORT WOULD INFLUENCE YOUR DIVIDEND LEVEL. CERTAINLY, THERE IS NOWHERE NEAR THE MOTIVATION TO THE WORKER THAT THERE WAS TO THE INDIVIDUAL FARMER GRANTED LAND UNDER THE HOMESTEAD ACT, AN ANALOGY YOU OFTEN RAISE. HOW DO YOU RESPOND TO THIS PROBLEM?"

RESPONSE:

(1) Irrespective of the size of an enterprise, if a worker owns a substantial block of shares in it, and the wages of his capital are paid out fully like the wages of labor, so that his dividends on his beneficially owned stock form a significant part of his income, the common sense of the American worker will leave no doubt in his mind as to where his best interest lies: in doing the best job possible for his employer, in saving costs, and in promoting the profitability of the company. I believe that, motivationally, as much is gained through size under these circumstances

as is lost in getting away from the high risks and frustrating vulnerability to the vicissitudes of nature on the "family farm."

"15. WILL WORKER ALIENATION REALLY BE SIGNIFICANTLY DIMINISHED THROUGH ADOPTION OF AN ESOP? AREN'T THERE OTHER BASIC CAUSES, SUCH AS THE ORGANIZATION OF WORK AND WHAT THE EMPLOYEE HAS TO DO DAY-IN AND DAY-OUT, WHICH ARE MORE FUNDAMENTAL TO THEIR ALIENATION?"

RESPONSE:

(1) It seems to me that the chief source of worker alienation is the erosion of the adequacy of the worker's labor power to support him, resulting from technological advance, and his awareness that he increasingly relies upon coercion rather than performance for his income--the morally unfortunate position that a one-factor economic policy has put each worker in. As his growing capital ownership not only restores, but indeed enormously enhances his productive power, he will gain pride and interest in his employer and in his work. I doubt that most workers, in jobs providing them with good incomes and the prospect of retiring economically self-sufficient, are as much concerned about the "monotony" of industrial work as it now appears. Work of every kind, with the rarest exceptions, invariably involves monotony, and it always has. Common sense tells the worker that monotony is a reasonable price to pay for being economically secure throughout his lifetime. This is not to say that the work place should not be made as pleasant as is reasonable, and as interesting as is reasonable. But where monotony on the job produces a good income and the purchasing power of the dollar is growing year by year, as it will when inflation is reversed, the employee will look to the time he spends off the job for his diversions, his excitements, his amenities, and most of the things that make up the quality of life. His job will not be his whole life, and it should not be.

"16. IF ESOPS ARE SO INHERENTLY ATTRACTIVE, BOTH FOR THE CORPORATION'S FUTURE GROWTH AND FOR THE BENEFIT OF THE EMPLOYEES, WHY ARE THERE ONLY ABOUT TWO HUNDRED COMPANIES WHICH HAVE ADOPTED THEM AND WHY ARE ALL OF THESE COMPANIES QUITE SMALL?"

RESPONSE:

(1) It is no secret that smaller companies are more innovative than larger ones. Nevertheless, this Committee has seen the

most serious and intensive sort of study of the possibility of adopting an ESOP by American Telephone and Telegraph Company, whose controller, Mr. Robert Flint, testified at these hearings. Other major public utilities and manufacturing corporations are giving the most serious consideration to the adoption of ESOPs.

(2) I believe that the one missing link to a great expansion in the number of ESOPs is Congressional guidance both through a change in the National Economic Policy along the lines urged in my written statement, and through Congressional adoption of the minor reforms that would make ESOP financing far more efficient and attractive, both to businesses and to employees, and to their unions.

"17. SINCE YOU HAVE PROMOTED ESOPS AS A MEANS TO SPUR FUTURE GROWTH THROUGH NEW CAPITAL FORMATION, DOES IT BOTHER YOU THAT MOST ESOPS CURRENTLY IN EXISTENCE AND THOSE BEING DISCUSSED FOR POSSIBLE ADOPTION DO NOT INVOLVE NEW CAPITAL FORMATION? RATHER, THEY ARE USED FOR TRANSFERS OF OWNERSHIP, FOR RE-FINANCING EXISTING DEBT, AS ALTERNATIVES TO SELLING STOCK TO THE PUBLIC, FOR PUBLIC-OWNED CORPORATIONS GOING PRIVATE, FOR THE FINANCING OF ACQUISTIONS AND FOR DIVESTITURES, AND FOR SOLVING ESTATE LIQUIDITY PROBLEMS."

RESPONSE:

(1) Achieving the goal of broad capital ownership, ultimately by all consumer units in the U.S. economy, is as much dependant upon assuring that as generations of capital owners die, the method of succession used advances this goal, as it is upon broadening ownership in the course of financing expansion. The ESOP is the most ideal device ever designed for converting closely held ownership into broadly owned enterprise under these circumstances.

(2) At current interest rates, the financing of new capital formation is in trouble, no matter how it is done. A southern power company recently issued 14% bonds! The moment that low interest credit is made accessible to basic, well managed businesses to finance their growth, as outlined on pages 16-25 of my written statement, I predict that the rate of new capital formation through ESOP financing and other types of two-factor corporate finance will accelerate spectacularly.

"18. ISN'T IT TRUE THAT FOR SUCH COMPANIES AS BROOKS CAMERA, MULACH STEEL AND HALLMARK, THE OWNERS WERE SIMPLY CREATING MARKETS FOR THEIR SHARES UPON RETIREMENT? WOULD YOU SUPPORT LEGISLATION TO LIMIT ESOPS TO ISSUANCE OF NEW STOCK SO THAT THEY TRULY WOULD PROMOTE NEW CAPITAL FORMATION IN THIS COUNTRY?"

RESPONSE:

(1) In each of the cases mentioned above, there were conglomerates and competitors standing by to purchase the companies. The owners, in each case, simply chose to sell to their employees out of a belief that they owed this opportunity to their employees, once the ESOP technique had been perfected for their use.

(2) Because it is just as important to broaden the ownership of existing capital as it is to broaden the ownership of future newly formed capital, I would hope that Congress would see the wisdom of not adopting legislation that would cripple the use of ESOPs to enable close-holding owners to sell to their employees. In most cases, if close-holding owners were selfish, they would merge their enterprises into a conglomerate and further concentrate the ownership of capital in U.S. enterprise. Only the most enlightened close-holding owners have used ESOPs to date. Congressional guidance encouraging this is desperately needed by the economy. Similarly, the enactment of H.R. 462, with its provision which would permit a close-holding owner to achieve the same tax advantages by transferring great blocks of stock to an ESOP trust that he would otherwise gain by socializing his fortune through placing it in a general purpose charitable foundation, would also help to broaden the ownership of existing capital.

"19. IS IT POSSIBLE THAT WORKERS ACQUIRING EQUITY IN A DECLINING OR FAILING COMPANY MAY NOT BE SUCCESSFUL IN TURNING THE COMPANY AROUND? SHOULD THE GOVERNMENT, THROUGH THE CDIC, BE PUT INTO THE POSITION OF AIDING WORKERS TO BUY UNSOUND STOCK AND 'HOLD THE BAG' FOR THEM? YOU MAKE A BIG POINT OF ELIMINATING GOVERNMENT SUBSIDIES WHICH YOU TERM 'BOONDOGGLES.' YET, ON THE OTHER HAND, YOU CREATE THIS NEW POWERFUL GOVERNMENT ENTITY, THE CDIC. HOW DO YOU RECONCILE THESE TWO POINTS?"

RESPONSE:

(1) CDIC, if government organized (it could be a group of private insurers) would be as fastidious as any insurance company

in not insuring unsound risks. Similarly, the Federal Reserve Bank, should ESOP financing be made discountable therewith, would certainly adopt administrative procedures to prevent the making of loans to failing or unsound companies. The freedom to fail has to be a part of any free society, and the freedom of financial institutions not to make loans to unsound enterprises is equally important. It would be a misunderstanding to assume that I have ever recommended ESOP financing for failing companies or that I believe such to be a proper use of it.

"20. IS THERE A PROBLEM FOR A COMPANY WHICH MUST RETRACT ITS WORK FORCE SINCE IT THEN MUST PAY OUT SUBSTANTIAL AMOUNTS OF CASH TO THE ESOP PARTICIPANTS WHICH ARE NON-DEDUCTIBLE."

RESPONSE:

(1) A properly designed and operated ESOP is subjected to periodic liquidity analyses to enable it to meet such contingencies. Distributions from the ESOPs are in stock, not in cash. The rate at which, in a non-public corporation, the ESOP repurchases stock from retirees can normally be adjusted to accomodate the facts.

"21. AREN'T THE OFFICERS AND DIRECTORS OF THE CORPORATION WHICH IS IN POOR FINANCIAL CONDITION LEAVING THEMSELVES OPEN TO PERSONAL LIABILITY FOR UTILIZING AN ESOP TO DISPOSE OF SHARES THAT COULD NOT BE MARKETED IN ANY OTHER WAY? HOW CAN IT BE SAID THAT THIS KIND OF ARRANGEMENT IS FOR THE 'EXCLUSIVE BENEFIT OF THE EMPLOYEES'?"

RESPONSE:

(1) The answer to the first question is "yes." Selling shares in a failing company to an ESOP by insiders would violate the Internal Revenue Code provisions against selling at more than "fair market value" or "fair value" if there is no public market. ESOPs are not recommended for failing companies, but rather for healthy companies that wish to grow in a healthy way, to contribute to the health of the economy.

"22. WOULD YOU AGREE THAT THE 'TAX STATUS OF ANY CORPORATION CONSIDERING AN ESOP IS OF FUNDAMENTAL INPORTANCE?' THEN, WHAT ABOUT THE MANY CORPORATIONS, USUALLY AMONG THE GIANTS, THAT PAY LITTLE OR NO TAX? FOR EXAMPLE FORD, LOCKHEED, HONEYWELL, AMERICAN ELECTRIC POWER, CONSOLIDATED EDISON, LTV, AND CHASE MANHATTAN CORPORATION, TEXACO AND MOBIL. OF WHAT REAL BENEFIT IS AN ESOP TO THEM?"

RESPONSE:

(1) Many corporations, including giant corporations, fail to make profits because we have a floundering economy. It lies within the power of Congress to put the U.S. economy back on the road to prosperity, accelerating growth and profitability by expanding the National Economic Policy in the manner urged in my testimony. Only a defective economic policy and a defective corporate financial strategy built on that policy could explain the non-profitability of the giant corporations cited in the question--and of many others. In short, the reforms proposed in this testimony should return our corporations, great and small, to profitability and to the status of high taxpayers.

"23. IF CONTRIBUTIONS ARE LIMITED TO 15% OF PAYROLL, HOW CAN THIS POSSIBLY HELP A HIGHLY CAPITAL-INTENSIVE FIRM SUCH AS THE OIL COMPANIES? WOULDN'T THE VALUE OF NEW EQUITY SHARES BE QUITE SMALL RELATIVE TO THEIR NET WORTH?"

RESPONSE:

(1) The answer is "yes," although the actual limit under present law is 25%, rather than 15%. H.R. 462 would remove this limit and thus go a long way towards helping to solve this problem. Similarly, corporations whose employees would become excessively affluent should naturally be among the first considered for application of the broader financed capitalist plan which can be used to build capital ownership into any group within the economy, under priorities determined by Congress.

"24. TO THE EXTENT THAT ESOP FINANCING IS CATEGORIZED AS DEBT, DOESN'T IT LIMIT THE BORROWING CAPACITY OF A CORPORATION SINCE A LENDING INSTITUTION WILL CONSIDER THE FIXED NATURE OF THE CORPORATE OBLIGATION TO THE ESOP BEFORE LENDING IT ADDITIONAL FUNDS?"

RESPONSE:

(1) Setting aside for the moment the fact that an obligation to pay beneficial owners of stock the full wages of their capital is improperly categorized as "debt"--a problem yet to be worked out with accountants unfamiliar with two-factor economics--my experience with lending institutions is that they are far more ready to make loans repayable in pre-tax dollars than loans repayable in after-tax dollars. Again, carefully considered legislation clarifying the fact that a corporation's obligation to

pay out earnings relatively fully is not a debt would be extremely helpful. Congress should take steps to invest the stockholders in U.S. corporations with true private property in the capital represented by their stock.

"25. MR. KELSO, YOU SPEAK HIGHLY OF THE 'SECOND INCOME' RESULTING FROM THE DISTRIBUTION OF DIVIDENDS. WON'T THIS ADVERSELY AFFECT THE CORPORATE CASH FLOW AFTER THIS DISTRIBUTION, MAKING IT LOWER THAN IT WOULD BE UNDER TRADITIONAL DEBT FINANCING WHERE NO DIVIDEND BURDEN IS PRESENT?"

RESPONSE:

(1) Technically, a corporation's "cash flow" is improved when it finances its growth on pre-tax dollars rather than after-tax dollars. Giving corporations access to vastly greater financing sources through the Federal Reserve discount procedure would far more than offset any disadvantage resulting from vesting corporate stock with the attributes of private property, i.e., requiring corporations to pay out the wages of capital to their owners (the stockholders) regularly as an aspect of their rights of ownership in the corporation. From the standpoint of the corporation, its sole concern should be that it has adequate financing. I think that I have demonstrated such adequate financing can be obtained through the use of the ESOP technique or of other techniques built upon two-factor principles, provided the financing paper is made discountable with the Federal Reserve Bank and the effective interest rate comprehends only actual administrative costs, and reasonable profits of the immediate lenders.

"26. IF ESOPS BECAME WIDESPREAD, THE BANK CREDIT USED WOULD RESULT IN A MUCH GREATER INCREASE IN THE MONEY SUPPLY THAN AT PRESENT WHICH WOULD BE FED INTO A DEMAND FOR GOODS AND SERVICES IMMEDIATELY. THEREFORE, ISN'T THIS PROGRAM AN ENGINE OF INFLATION?"

RESPONSE:

(1) It is of central importance in considering this question to remember that ESOP financing, and indeed all financing built upon two-factor principles, is aimed solely at providing credit to enterprises that will, in the judgment of experienced lenders, and in conformity with such precautionary rules as may be laid down by the Federal Reserve Bank, pay off their financing out of their operations within an acceptable period of years. At the outset, and until considerable experience is gained, I believe that such credit

should be used exclusively for financing new capital formation, although, as I have noted above, capital in well-managed businesses pays for itself not just once, but over and over again in cycles, its productiveness being renewed by reserves set aside for depreciation, before net income is computed. It is my belief that the immediate reduction in monetized welfare caused by the payment of unemployment compensation, pumping government funds into the support of boondoggle jobs, the distribution of food stamps, and the providing of welfare in general, will, under proper financial surveillance, more than offset the increase in the money supply resulting from the monetization of self-liquidating newly formed capital.

(2) Billions upon billions of dollars, actually constituting monetized welfare, are spent by the Federal government and, through "matching participation" by state and local governments, in the support of wholly synthetic jobs pursuant to the National Economic Policy of attempting to solve the income distribution problem solely through full employment. As we begin to accelerate economic growth by making feasible the construction of the enormous quantity of new capital formation that must take place to maintain the American economy as the world's leading economy, and to eliminate poverty, need and want, this too will result in a reduction of the present monetization of welfare (concealed as employment) to further offset the temporary growth in the money supply resulting from monetizing newly formed capital. The end result, I estimate, would be no net increase in the money supply, unless, in the judgment of the Federal Reserve Board of Governors, such increase is necessary for reasons independent of an accelerating economic growth rate.

(3) Since the credit used to finance self-liquidating newly formed capital normally will be reversed within the short period of years contemplated by the feasibility study which precedes each increase in new capital formation, and since the capital instruments will continue virtually indefinitely to produce goods and services for the economy after the credit is totally reversed, their productiveness being restored by depreciation funds set aside out of gross income before net income is computed, the overall effect of the sustained new economic policy must inevitably be deflationary.

"27. YOU HAVE SAID, 'THE DIRECT DISCOUNTING OF ESOP NOTES WITH THE FEDERAL RESERVE BANK SHOULD BE STRICTLY LIMITED TO BASIC FINANCING OF HIGH PRIORITY, SELF-LIQUIDATING NEW CAPITAL FORMATION.' DOESN'T THIS PLACE A LARGE RESPONSIBILITY AND INCREASED DEGREE OF CONTROL BY THE GOVERNMENT IN JUDGING WHAT CONSTITUTES 'HIGH PRIORITY' ITEMS?"

RESPONSE:

(1) The simple facts of life are that under our present money and banking system, there is "credit allocation." As I have shown, most credit is allocated in such manner as to make the rich richer, and to perpetuate the capital-lessness of the majority of consumer units. I am only suggesting that these priorities are the wrong priorities, and that the techniques are basically the wrong techniques. Abraham Lincoln once remarked that it is the function of government to do for the people what they cannot do for themselves. Since pure credit, by its very nature, is a "social" thing, it is, in my opinion, a necessary and proper function of government to determine the overall priorities relating to its use. It is elementary that where pure credit is used to build economic productive power into consumers, a more wholesome result is achieved than by trying to give consumers with inadequate incomes consumer credit in order to enable them to buy the goods and services they want and need, but cannot afford. Consumer credit only diminishes their consuming power--their actual power to enjoy goods and services. The interest they pay provides no enjoyment whatsoever, except to the receivers of interest.

(2) I believe that the way to get government out of the lives of most citizens is for it to forthrightly assume the responsibility for an economic policy that will enable people to individually produce a high standard of living, each for himself. This diminishes the need for welfare, for governmental health care, for governmental subsidies for education, for governmental subsidies to business, for governmental imposition of higher and higher taxes to support income redistribution and boondoggle. The net effect of the transition from a one-factor economic policy to an effective two-factor economic policy should be to eliminate most of the role of government in the private lives of its citizens, yet to keep government in the position of doing for citizens that which they cannot do for themselves.

"28. YOU HAVE CLAIMED THAT INTEREST RATES, REFLECTING ONLY ADMINISTRATIVE AND RISK-COSTS WOULD FALL TO 2-3%. WHAT ABOUT INFLATIONARY PREMIUMS? DO YOU ENVISION ABSOLUTELY NO INCREASE IN PRICES UNDER YOUR PLAN?"

RESPONSE:

(1) My thinking on this subject begins with the basic proposition, that under conditions of redundancy of labor (and these

have prevailed during the last three-quarters of a century, except during wars and immediately following wars), it is fundamentally dishonest for people to demand progressively more pay for progressively less work input. The principle of distribution of a communist economy is "from each according to his ability, to each according to his need." The principle of distribution in a private property, free market economy is "from each according to what he produces, to each according to what he produces." Communist economies, with their principle of distribution based on need and the government the only possible arbiter of "need," lead to totalitarian societies. Private property, free market economies, in which the government economic policy is such that every consumer unit is enabled to produce a high level of income, and therefore enjoy automatically a decent level of consumption, are free economies, because the proper economic foundation supports the structure of political democracy. I believe that it is distasteful to working people to demand progressively more pay for progressively less work input, and that they do so only because, under our defective economic policy today, they have no choice. In the mid-Thirties, because we saw no alternative solution to the problem of raising consumer incomes to where employees could afford a decent standard of living, we passed a series of laws granting to organized labor the power to use physical coercion--in reality raw, brute force--for the personal gain of the individuals involved. Rule by law and rule by brute force are opposites. One is the characteristic of a government of laws, the other is a characteristic of an anarchy or of a totalitarian society. We have adopted and are pursuing an anarchistic economic policy. (Please see the statement by historian Arnold Toynbee attached hereto as Attachment 1, and the article by Mr. A. H. Raskin, for many years labor editor of the New York Times, attached as Appendix II to my written statement.)

(2) Clearly, this coercive power cannot, and should not, be eliminated until consumers are offered true economic opportunity to produce the level of income they wish to enjoy without such coercion. I believe this can come about only through the expansion of our existing National Economic Policy into a two-factor economic policy, and through our setting about to implement that policy in the manner contemplated in my testimony before this Committee. At this point, I believe that "inflationary premiums" will disappear, and competition will arise to drive prices down to their reasonable level. The combination of capital protecting itself against extinction by not being brought into existence except on terms where it will pay for itself, and labor, as the result of the technological shift in the burden of production off

labor and onto capital, being forced to demand progressively more pay for progressively less work, is the real engine of inflation. I urge Congress to remodel this engine, and give national guidance to the citizens of the country in order that they may stop engaging in inflationary activities (because they are no longer necessary, and, indeed because they are now self-defeating), and we will reverse inflation and substitute for it long, gentle deflation.

(3) There is yet one other aspect of the power of government, using the tools implicit in a two-factor economic policy, to assure that "inflationary premiums" cannot be demanded by anyone. This is a renovation of our anti-trust policy in conformity with achieving the goals of a two-factor economy. Some of the steps that Congress and the Administration could take in this direction are:

(a) Recognize that the most dangerous monopoly in a private property, free market economy is the monopolization of the personal (family) power to produce wealth in excess of the individual's or family's desire to consume. The structural changes in financing that I have recommended will go far in correcting this evil, but Congress should study and seek other possible corrective measures.

(b) Where corporations are required to divest themselves because of "market monopolies" under existing anti-trust laws, in the course of accomplishing such divestitures every effort should be made to broaden the proprietary base and to build capital ownership into consumers who do not now own capital. Perhaps, through amendment of the anti-trust laws, more severe definitions of the percentage of market held by the top producers (the number would undoubtedly vary from industry to industry) should be adopted as a definition of the existence of market monopoly power.

(c) Since it is the inability to finance the entry of a new competitor into monopolistic or oligopolistic markets that preserves the power to administer prices and represses competition, government should make pure credit accessible to establish new companies in a monopolized or oligopolized field, making certain that such financing uses ESOP techniques or other techniques built upon two-factor principles, in order to broaden the proprietary base and widen the opportunities of all consumer

units to participate in production through capital ownership. This was in essence what the U.S. government did during World War II, to bring into existence more shipbuilders, more aluminum manufacturers, etc. But in those cases, no steps were taken to assure that the ownership of the new industries would not become highly concentrated in the pinnacle capital ownership class. Similarly, the government of Japan made pure credit accessible before and after World War II in order to increase the industrial power of that nation. But again, lacking an awareness of two-factor economics, the credit was used in such manner as to incredibly concentrate the ownership of wealth in that economy.

(d) Keep in mind that approximately 98% of new capital formation in the past 15 years has been financed out of internal cash flow or borrowings repaid from internal cash flow, resulting in simply making the rich richer and keeping the poor capital-less. Present monopolistic power and size is inevitably the result, primarily, of defective financing techniques, and of failing to invest the corporate shareowner with private property in his equity capital, so that the wages of capital would be paid out fully and regularly, like the wages of labor. Obviously, this was not possible until alternative methods of financing growth were advanced. But I believe that the financing techniques which I have defined, and many additional ones that can be developed using the same principles, provide that alternative. In the tools constructed upon the principles of two-factor economics, government has, and should exercise, the power to prevent either business or labor from exacting "inflationary premiums" from the consumers.

QUESTIONS SUBMITTED BY SENATOR RUSSELL LONG

"1. THE ISSUE OF OWNERSHIP V. CONTROL IS A DELICATE ONE, ESPECIALLY WHERE UNIONS ARE INVOLVED. WHAT ARE YOUR VIEWS ON THIS SUBJECT, ESPECIALLY ON WHETHER THERE SHOULD BE A MANDATORY PASS-THROUGH OF THE VOTING POWER TO EMPLOYEES ON STOCK HELD BY AN ESOP?"

RESPONSE:

(1) I should say that the question of ownership versus control of the corporation is not only a delicate one, but one about which there has been much confused thinking, and, in Europe, much confused action.

Firstly, it should be recognized that the government of a corporation is a republican form of government, rather than a democratic form. Thus, the shareholders--the electors, or corporate electorate--elect a legislative body, the Board of Directors of the corporation. The Board of Directors, in turn, appoint management, including the chief executive officer, and such operating committees of the Board as it feels may be necessary to the proper governance of the corporation. The ultimate power, as in the case of a direct democracy, is held, under the laws of most states, by the stockholders. Thus at a stockholders' meeting, either special or general, the stockholders by majority of a quorum can override the selection of management made by the Board of Directors, and could, of course, absent restrictions in the by-laws or charter, replace the Board of Directors.

(2) "The question of control" of a corporation cannot be considered independently of the additional questions of "competence to control," and "control for whom, or for what?" Management is perhaps the most sophisticated and difficult art in the entire economic world. Thoroughly competent managers are as rare as perfection in any field of human endeavor. While much can be discerned about the ability of an individual to manage or control the activities of a corporation, or some part of them, from his education, his experience, his personal presence and rapport with other human beings, the ultimate test of a good manager is, of course, performance. The proper response to the question of "management of the corporation for whom? or for what?" should, it seems to me, be answered by saying that for those who take a long-range point of view (and I believe that this enormously important social policy question requires taking the long-range point of

view), the proper object of management is the profitability of the corporation for its stockholders. Implicit in this answer are many things. The corporation that pollutes the environment will sooner or later be brought to heel by government's exercise of its police power, and perhaps made to pay dearly as the result of adverse public opinion of its potential customers. This can impair profitability. The corporation that does not treat its employees well will not obtain maximum performance from them; nor may it be able to employ the kind of employees it would wish. Thus, long-range thinking requires some identification of the self-interest of profit to the stockholders with a social concern for others, and a concern for the public interest and the environment.

(3) Two-factor theory assumes that any human being is qualified, merely by being a member of the human race, to own productive capital, and that ideally, all human beings would own viable holdings of productive capital in order that they may be economically self-sufficient, free of any dependence upon the charity of others or of the government, and that they may enjoy the dignity which goes with economic self-sufficiency. But, two-factor economics does not assume that every human being is qualified to hold a corporate management position. Management is, as I have noted above, a rare and difficult art. Good management is crucial to maximize the success of a corporation. It is neither in the interest of employees, as such, nor of stockholders, as such, nor of employee-stockholders, as such, that corporations be managed by inexperienced managers, incompetent managers, or amateur managers.

(4) Two-factor theory recognizes that there is a long history in modern law of separating management, or control, from ownership, and that these two things, control and ownership, are functionally distinct and different. The entire law of trusts is built upon the implied desirability, in certain situations, from the point of view of those having the decision making power, to separate the right to the economic benefits of capital ownership from the management of that capital. Unfortunately, while the model of the law of trusts is essentially that followed by the modern corporation, the failure of one-factor economic theories, of National Economic Policy, and of corporate strategy and managerial science in general to recognize that trustees who are not responsible are not under restraint to be good trustees has been overlooked. The Board of Directors and management who conceptually and, in U.S. corporations at least, in fact control the corporations (subject, again, to the ultimate power of stockholders to substitute new directors and new managers

should they elect to exercise that power), are not required to deliver over the net economic product of the corporation to its owners, as the trustees of a private trust normally would be. Lacking this responsibility, there is undoubtedly much more to be desired on the part of modern corporate management than it, in most cases, delivers. If a managerial mistake causes a loss of millions of dollars to the corporation, but, having no right to the payment of the full wages of his capital ownership, the stockholder cannot establish (in most cases) that such loss adversely affected his dividends, he is unlikely to take offense or to be unified with his fellow stockholders in demanding better managerial performance or perhaps a new management.

(5) All this is radically changed in the corporation where all employees, managers as well as sub-management employees, are stockholders; where their interests as stockholders (once their stock is paid for) is identical with that of public stockholders or even close-holding private stockholders. When our development of two-factor financing techniques has provided wholly adequate alternative sources of financing, so that the corporation can, and if necessary can be required, to respect the full rights of private property of its stockholders in their equity ownership, by paying out the wages of capital fully and regularly (though at longer intervals) like the wages of labor, virtually all of the control shortcomings of the modern business corporation will be eliminated. Stockholders can quickly ascertain what errors or incompetence on the part of management cost each of them individually; under such circumstances, stockholders could be depended upon to call management to account and to bring about improvement or change. At the same time, the interest of managers as stockholders in assuring the long-range profitability of the corporation is precisely the same as the interest of employee-stockholders who are below the management level, and of stockholders of the corporation who are not employees. The absurd conflicts that have risen repeatedly in the past, where management engages in activities designed to artificially elevate the price of the stock, in order to benefit them personally through the exercise of their stock options, and all similar practices based upon the interest of management, or the interest of employees, being different than that of stockholders in general, would cease. Similarly, as employees acquired significant stock ownership in the corporation for which they work, their interest in making excessive pay demands, in return for no increase in work input, must of necessity be tempered by their interest in avoiding impairment of the value of their stock in the corporation.

(6) It appears to me that employees in general who, either by nature or by demonstrated self-improvement, have not shown themselves qualified for managerial positions, have no place in the management of corporations. This is not to say that the corporation should not be an open institution, within which ambitious sub-management employees, by dint of achievement and self-development, can rise through the ranks to top management levels. This is most desirable, and most corporations abound with instances of such opportunity. But it is not in the interest of the employee as stockholder, nor even in the interest of the employee who does not own stock, and certainly not in the interest of stockholders in general nor of the economy itself in general, for a business enterprise to be subjected to amateur or incompetent management. Broad participation in the ownership of the corporation and broad receipt of the wages of capital are necessary in order that non-inflationary mass consumption can support mass production, and so that the economy can operate to achieve optimum advantages for the society. But broad participation in management can only be a prelude to incompetent management and deficient performance by the corporation itself.

(7) In line with the foregoing discussion, I believe that the voting of employee-owned stock held by an ESOP trust can be either by a committee appointed by the Board of Directors, or passed through the trust to the employees, through the operation of a proxy machinery by the trust committee for the benefit of the employee participants, as those in power may determine for the design of the ESOP. It should be remembered that the establishment of an ESOP is a collectively bargainable objective under existing law, and that if the voting of company stock by employee-participants, rather than by a committee appointed by the corporation's Board of Directors, is determined by employees to be a desirable thing, it lies within their power to achieve it. I do not, however, believe that the pass-though of the voting power to employees should be made mandatory. In the first place, such pass-through of voting power is not necessary where management is made responsible and where it discharges that responsibility well. Secondly, it will be difficult enough to achieve the broadening of the proprietary base of the U.S. economy sufficiently to prevent its decline to a second or a third rate economy within the short time span I believe available to us to achieve this goal (five to seven years at most), without erecting any barriers to such necessary economic change. The imposition of mandatory pass-through of the voting, when pass-through can be achieved by labor

itself if it deems it ultimately desirable, would be the imposition of an unnecessary and, I believe, undesirable barrier to the acquisition of capital ownership by many, perhaps most, employees.

"2. HOW DO YOU DISTINGUISH BETWEEN THE ESOP AND THE CO-MANAGEMENT PROGRAM IN GERMANY WHERE UNION LEADERS SIT ON A MANAGEMENT BOARD? IS THE GERMAN MODEL A POTENTIAL LONG-RANGE THREAT TO THE UNION'S NATURAL ADVERSARY POSITION?"

RESPONSE:

(1) I believe that most of the basic distinctions between the use of ESOP financing to broaden capital ownership so as to include all employees, and the participation by union leaders in the management of a corporation, are essentially covered in my answers to the previous question. The European co-determination or co-management program, in my opinion, fails to solve the economic problem--the purchasing power distribution problem--which is of absolutely prime importance. It fails to add to the limited productive power of the worker the potentially much greater productive power of capital ownership. Thus it leaves the worker in a position where he must still continue to demand progressively more pay for progressively less work, except that he will be in a better position to achieve this destructive goal. Thus inflation, under co-determination or co-management, should rage on until it destroys the economies that employ it, or until government, in the interest of saving the society from total anarchy, becomes itself totalitarian and terminates political democracy, as well as any possibility of achieving economic democracy. In other words, it appears to me that the co-determination or co-management movement in the European economic communities and in the Scandinavian countries and in Great Britain manages to achieve the worst of both possible worlds: (a) it fails to solve the economic question of enabling economies to reverse inflation, accelerate growth, and enable citizens to be self-sufficient and taxpayers to be free of tax burdens to achieve income redistribution, while (b) it bedevils the businesses of the economy with amateur, incompetent management.

(2) On the question of whether the German co-determination or co-management model is a potential long-range threat "to the union's natural adversary position," I would say that it is not necessarily so. Different unions can fight among themselves to take over the management of a corporation, as can different factions within a single union. U.S. business today is being subjected to a constantly increasing number of "take-over raids"

where one management is taking an adversary position against another. I would think that the co-determination or co-management movement, as such, would not reduce the opportunity, or even the reason, for civil strife within business.

(3) But an assumption is involved in the question just discussed as to whether a labor union has a "natural" adversary position, and if so, adverse to whom? The class-warfare school of labor relations is a direct outgrowth of a defective economic policy that began, so far as we can tell, with man's origin, and has continued down to today. Man has not yet made an accomodation with technology or with the machine. Man's morality is built upon the idea that outtake should be related to input. So long as those concerned with the economic order of society and with the business world fail to recognize that a shift through technology of the burden of production off labor onto the non-human factor of production implies and requires a reverse shift in the financing of economic growth and changes in the ownership of capital from generation to generation that would provide opportunity for employees (and ultimately all consumers) to legitimately acquire the ownership of a growing capital holding, the "adversary" position of unions to management and to stockholders was indeed inevitable, though I think totally unnatural. It forced men to violate their moral nature by demanding progressively more pay for progressively less work. Aristotle pointed out that the nature of a thing should be judged by its tendency. The tendency of this defective economic policy, and of the defective corporate strategy following from it, is to cause everyone to stop producing and live by stealing--obviously a ticket to extermination of the society as a whole.

(4) I believe that under a two-factor economic policy, implemented in the ways that I have suggested in this testimony, and in other ways that Congress, economists, businessmen, bankers, accountants, and others may find possible, the class-warfare school of labor relations will disappear, and the adversary aspect of the labor union versus either management or stockholders or the corporation itself will also disappear. Management and employees become co-workers and co-owners, and their interests as owners, of management employees, sub-management employees, and of non-employee stockholders become unified. This is the chief attraction, in my opinion, of a change to a two-factor economic policy: to eliminate the game of each segment of the economy taking its turn holding the society at whole at ransom in order to get what he wants, as Mr. Toynbee so well pointed out.

"3. WHAT IS YOUR TAX PHILOSOPHY ON THE WISDOM OF CORPORATION INCOME TAXES COMPARED TO INDIVIDUAL INCOME TAXES FOR PAYING THE COST OF GOVERNMENT?"

RESPONSE:

(1) I am very firmly convinced that the burden of taxes imposed by government should fall upon individuals, not upon corporations at all. The corporate income tax is a double tax on one of the two factors of production--capital. When the government taxes the income of corporations, it is merely weakening the property rights of the stockholder in his corporation. If the state and federal governments together take over 50% of the corporate net income, they have destroyed over 50% of the private property of the individual in his corporate equity. Perhaps even more important is the fact that, if we are to function as a democratic society, it is critical that individuals understand, and feel directly and personally, the burdens which government imposes on them, or perhaps more accurately, the burdens which they force government to impose upon themselves. Thus only when taxes are personal can the individual know through their impact what is going on between government and individuals in the economy. The mere elimination of corporate income taxes, however, would only be part of the measures required to fully invest the corporate stockholder with private property in his corporate equity. The ultimate restoration of that power would also require limiting corporate management to setting aside only operating reserves, and paying out the net income of the corporation (the wages of capital) fully and periodically, like the wages of labor.

(2) The question of timing is another matter. I would not urge the repeal of the corporate income tax while all of the capital in the U.S. economy is owned by a tiny minority of shareholders. I believe that to get from where we are to where it would be desirable to be--an economy in which every consumer unit produces the income that it desires for living, either through employment, or through capital ownership, or (preferably for the next two or three decades) both--the little-by-little repeal of the corporate income tax through the payment of the wages of capital fully to individuals who are building their first viable holdings of capital is the least disturbing and most productive way to eventually accomplish the total elimination of the corporate income tax. This would mean encouraging ESOP financing for corporate employees in all types of enterprise, ESOP financing

and consumer ownership financing for all types of public utilities, and eventually, once it is certain that the task of building an economy with a capital structure many times larger than our present capital structure is well advanced, the use of the financed-capitalist plan, as outlined by Mr. Adler and myself in The New Capitalists. This is the most workable and practicable method of correcting our past mistakes and approaching so close to the full elimination of the corporate income tax that it could then be formally repealed.

"4. WHAT IS A GOOD APPROACH FOR INTEGRATING CORPORATE AND PERSONAL INCOME TAXES IN WAYS THAT WILL SIMPLIFY AND MAKE THE TAX SYSTEM MORE EQUITABLE?"

RESPONSE:

(1) I believe that the broadest possible use of the two-factor financing techniques which I have outlined, and the development of additional two-factor techniques to meet special needs, is the best way of integrating the corporate and personal income taxes to simplify and make the tax system more equitable. These techniques would raise the economic productiveness of tens of millions of economically unproductive or economically under-productive people. They constitute a little-by-little repeal of the corporate income tax; they assure the elimination of future economic non-self-sufficiency for an enormous part of the population; and they would raise the tax base for income taxes, property taxes, gift taxes, and estate taxes, so as to diminish the tax burden upon all. It is the combination of eliminating the major portion of the Federal budget that finances welfare and boondoggle, and the building of the tax base itself, that will pave the way for any fine-tuning of the tax system necessary to achieve ultimate justice.

"5. WHAT KIND OF FINANCING DESIGNS MIGHT BE DEVELOPED FOR CUTTING THE COSTS OF BUILDING MASS TRANSIT SYSTEMS, LIKE THE D.C. METRO, AND NEW ENERGY PRODUCTION SYSTEMS?"

RESPONSE:

(1) Assuming, for the purposes of this question, that all of the enterprises involved are or could be made public utilities, I would suggest that a financing design be employed that would build a small portion of the ownership of these enormously capital-intensive enterprises into employees, and the remainder of the ownership of such enterprises into the public utility consumers. The technique may be outlined as follows:

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 commited, 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.

"6. WON'T YOUR PROPOSED MONETARY REFORMS PUT THE FEDERAL RESERVE IN THE POSITION WHERE IT WILL BE DIRECTLY ALLOCATING CREDIT TO INDIVIDUAL BORROWERS?"

RESPONSE:

(1) I believe not. The financing of new capital formation in basic, well managed businesses, through ESOP financing and public utility consumer capital ownership financing and similar techniques, involve the borrowing by the ESOP, or by the consumer escrows (in the case of public utilities) from existing commercial banks, insurance companies, or, if they should be qualified to make such loans, from savings and loan associations. Only the broad general rules would be laid down by the Board of Governors

of the Federal Reserve Bank, pursuant to a Congressionally-determined policy of ceasing, so far as possible consistent with the laws of private property, making the rich richer, and, in the alternative, making owners of viable capital estates of the 95% of consumers who do not own such capital estates today. I believe that this process, as discussed in my written and oral testimony, should begin with building capital ownership into employees in the case of non-public utility corporations, and partially into employees and partially into consumers in the case of public utilities. Within the broad policies and limitations laid down by Federal Reserve rules and regulations, the borrowers would be selected by the lenders in the conventional way.

(2) There would be, under the proposed two-factor monetary reforms, vastly less "allocation of credit" than has existed for decades in the past, since all of the evidence points to the fact that credit has been allocated to the rich and denied to those who do not own capital. It is through access to credit that the poor can legitimately become owners of capital, and yet, all of the qualitative studies show that 95% of the consumer units in the American economy own no productive capital of more than token significance.

"7. HOW WOULD YOUR PROPOSAL FOSTER COMPETITION ON [IN] OVER-CONCENTRATED INDUSTRIES?"

RESPONSE:

(1) Please see the answer to Question 28 in the series of questions submitted by Senator Hubert H. Humphrey with his letter of December 18, 1975.

"8. ISN'T IT TRUE THAT EARNINGS PER SHARE WOULD DECLINE, AT LEAST INITIALLY, UNDER AN ESOP? WHY DON'T YOU FEEL THAT THIS IS A VALID YARDSTICK FOR DECIDING WHETHER TO ADOPT AN ESOP?"

RESPONSE:

(1) If the ESOP financing plan is properly designed, there is no possible reduction in "earnings per share" under the principles of two-factor economics. The guarantee by the corporation to the lender is simply a guarantee to make a high payout (ideally a full payout) of the wages of capital to the new beneficial owners

of stock representing that capital, in pre-tax dollars (because it is the policy of Congress to encourage broader capital ownership by this means). There is invariably a close relationship between the period of time that newly-formed capital is shown by the feasibility study to be necessary to earn its costs for the corporation and the term of the loan made to the ESOP. Thus to properly compute the per share earnings of the corporation, consistently with two-factor economic principles, one should add the after-tax earnings of the corporation (without deduction for the payment by the corporation either of dividends or of so-called "contributions" into the ESOP) to the aggregate of the payments made into the ESOP. Payments of the wages of capital to the owners of capital are not corporate expenses, and should not be considered a reduction of corporate earnings, but rather the very essence of corporate earnings themselves. Obviously, accountants, and the Accounting Division of the Securities and Exchange Commission, must be convinced of the soundness of two-factor economics before they will concur in this view, but I believe the theory to be unimpeachable.

(2) Even accepting the erroneous view that payments by the corporation into the ESOP are "expenses," there is in many instances no decline in earnings per share as the result of using ESOP financing, or a temporary decline in earnings per share, followed by a long-term increase in earnings per share. Much has been written in recent years to the effect that "earnings per share" is a measure that emphasizes the present, but frequently disregards the long term (Wall Street Journal Editorial, March 7, 1973, p. 12). The implications of ESOP financing, like those of two-factor economics in general, should be appraised in the light of long-term effects. Shrewd financial analysts have urged abandonment of earnings per share "altogether as a measure of corporate performance" ("Let's Abandon Earnings Per Share," by Joel M. Stern, Wall Street Journal, December 18, 1972, and related editorial). The factors involved here are:

(a) the tax savings to the corporation;

(b) the shifting (which may be gradual) from an irrational retirement system (pension or profit sharing plan) that involves investing in the securities of other companies (usually purchased in the secondary market where they do not finance economic growth, but only brokerage churning) which are 100% pure cost to the corporation,

to ESOP financing under which the same dollar that finances corporate growth, finances employee stock ownership;

(c) the restraint that the gradual acquisition of capital ownership by employees will naturally impose upon their demands in the future for progressively more pay in return for progressively less work; and

(d) the fact that the corporation, through its ESOP, can finance its expansion on pre-tax dollars while simultaneously building retirement security into employees.

(3) There is clearly an awareness today, on the part of union members and leaders, as well as by non-union employees and the public at large, that demands for increased pay in return for decreased labor input (or in any event without any increase in labor input) are bringing about a reduction in the standard of living of all American consumers. Until there is a tradeoff that is sufficiently attractive and valuable to restrain this practice, the evidence is that it will continue. The one tradeoff that, if properly communicated and if properly supported by public policy declared by Congress and supported by the Administration, will be sufficient, is the tradeoff involved in an opportunity, over a reasonable working lifetime, to acquire a viable capital estate capable of enabling one to produce a decent standard of living beyond retirement or in the event of illness or technological unemployment. When these costs are added together, and some quantification given to the improved motivation that all evidence shows to exist where employees are aware that they are acquiring a growing ownership in their employer, the per share earnings decline should either be non-existent or brief. If it does exist, its brief existence will be followed by improved earnings to all shareholders over the long term.

"9. CAN YOU SUGGEST WAYS OF PROTECTING WORKERS AGAINST THE DOWNSIDE RISK THAT THEIR STOCK VALUES MAY DECLINE FROM THEIR ORIGINAL PURCHASE PRICE?"

RESPONSE:

(1) I have been told by insurance actuaries that insuring ESOP participants that the stock they ultimately receive on distribution, either upon separation from employment, or disability or death or retirement, will have a value not less than the value at which it was purchased by the ESOP or the value which was used for tax purposes in the event it was contributed to the ESOP, is

an economically and safely insurable risk. Such insurance is now under study by at least one group in California. Clearly, such insurance would have to be written over a substantial number of companies to be sound and profitable. However, it is obvious that, decade in and decade out, the productive power of the American economy has grown, and that if we could eliminate institutional barriers, it would grow much more rapidly. I believe that such insurance should be explored by Congress, as well as by private insurers. Clearly, the writing of such insurance could be a function undertaken by the Capital Diffusion Insurance Corporation, which I discussed in my written statement and in my oral testimony.

"10. WHAT WOULD BE THE TAX IMPACT OF GIVING ESOPS THE TAX-STATUS OF A CHARITABLE CORPORATION? HOW CAN YOU JUSTIFY TREATING THE ESOP AS A 'CHARITABLE' ENTITY?"

RESPONSE:

(1) I believe that the government would gain revenue from giving ESOPs the tax status of a general purpose charitable foundation. Once funds are put in a foundation, precious little tax revenue is collected from that capital or from its income thereafter at any level of government. Giving the ESOP the status of a general charitable corporation would return the gigantic concentrations of wealth in the U.S. economy, in my opinion, to the tax base: income tax, property tax, gift tax, and estate tax. I have asked many rich men whether, if they could achieve the same tax result, they would prefer giving part of their fortunes to an ESOP over giving it to a charitable entity, and they have uniformly answered "yes." Thus the government would gain, these holdings of capital would become connected with individuals who need such capital ownership in order to be self-sufficient and to avoid becoming wards of governmental or private charity, and the motivational effect, in giving hope to the 95% of people who now cannot realize the American economic dream--the dream of acquiring a viable capital estate--would be enormous.

(2) I believe that the ancient Jewish historian-philosopher Maimonides himself gave the proper justification for treating the ESOP as a "charitable" entity. He said that "The most meritorious of all [methods of giving] is to anticipate charity, by preventing poverty***this is the highest step and the summit of charity's golden ladder." (Translation from Matnot Aniyim 10,7 by Moses Maimonides, in The Union Prayerbook for Jewish Worship, Part II,

The Central Conference of Jewish Rabbis, New York, 1962, pp. 117-118.) To the same effect is the following: "Greater is he who gives, and greater still is he who lends, and with the loan, helps the poor man to help himself."--from Shabbat 63a. (See There Shall Be No Poor, Richard G. Hirsch, Union of American Congregations, Commission on Social Action of Reform Judaism, New York, 1965, p. 21.)

"11. HOW DO YOU JUSTIFY TREATING DIVIDEND INCOMES AS TAX-DEDUCTIBLE EXPENSES?"

RESPONSE:

(1) Modifying the tax laws so as to make dividend payments into ESOP trusts, public utility consumer-ownership financing escrows, and the like, would simply be one cautious, but necessary, step in assuring that the owner of capital stock gets a full payout of the wages of the capital underlying his stock during the period that he is paying for that stock. See the discussion and answer to Question 3 above.

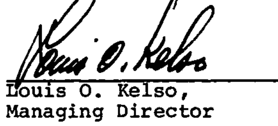
"12. CORPORATION INCOME TAXES AMOUNT TO ABOUT 14% OF THE TOTAL FEDERAL REVENUE INTAKE. IF EVERY CORPORATION TAKES ADVANTAGE OF YOUR TAX PROPOSALS, HOW WILL THE GOVERNMENT PAY ITS BILLS?"

RESPONSE:

(1) I estimate that through the acceleration of corporate growth, through bringing to life industries that have almost gone to sleep, like the building of new cities, the housing industry, the building of rapid transit systems, the rehabilitation of the railroads, the building of the hundreds of energy-generation plants that have been cancelled in the last two years, etc., etc.; the increase in employment; the decrease in unemployment compensation and in all forms of welfare; and the increase in government income taxes as the result of growing and eventually full employment; would far more than offset the government revenue lost, even with all corporations taking the fullest advantage of two-factor financing proposals.

(2) Again, the object of the plan is to build self-sufficiency into every consumer unit, eliminate the need for most welfare in the future, and to build up a tax base of such magnitude that taxation will be a negligible burden upon every taxpayer.

Respectfully submitted,



Louis O. Kelso,
Managing Director

LOK:mf

ATTACHMENT 1

Social Order Changing

Technological Leaps of Industrial Revolution Shift Balance of Political, Economic Power

By ARNOLD TOYNBEE
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The industrial revolution is a revolutionary change in the nature of the agent who does the world's work. It is a replacement of people by machinery. In Britain, where this revolution broke out first, it has been going on for 200 years and it is continuing everywhere at an accelerating speed.

It its first phase, its human victims were mostly manual workers. Asian as well as British manual spinners and weavers were put out of business by British machines.

In our own lifetime, the invention of computers has begun to victimize mental workers as well. Computers, doing sums in binary arithmetic at lightning speed, can do better than human minds in keeping accounts and perhaps even in making at least minor executive decisions.

Automation--a new name for mechanization raised to the nth degree--threatens to make most people economically superfluous. In other words, it threatens to turn the majority of us into unemployed persons, living on a dole, or--if you prefer to state the same fact in nicer words--it promises to turn the majority of us into rentiers living on unearned incomes.

This social consequence of automation was foreseen as soon as automation itself. Today we have traveled far enough along the road to be able to begin to discern how this social revolution is working out.

POWER POLITICS

The process is the play of power politics: the result is an inequitable distribution of society's aggregate product, income, and wealth. In the aggregate society will be richer than in the past, since machines are more potent than people or oxen for producing material goods and services. But this increase in aggregate wealth is not going to reduce the age-old inequity of its distribution.

In the affluent automated society the poorest people will be still poorer than before--poorer relatively, and perhaps poorer even absolutely. The distribution of wealth will change because this is determined by the balance of power, and the balance has been changed drastically by the industrial revolution's progress. Power politics do not make for justice.

In the use and abuse of power, man is the same old Adam today as he has always been.

FOUR MAJOR CHANGES

The current change in the balance of power is the result of four changes in the technological and the social situation.

First, society has become dependent on public service for the supply of daily necessities of life which people were formerly able to provide for themselves independently.

Secondly, the cost of making and operating machines has increased as the machines themselves have become more high-powered. Costly machines are not profitable if, once installed, they are not kept working uninterruptedly.

Thirdly, automation cannot eliminate human agents completely. Unlike a living organism, a machine cannot look after itself and cannot reproduce itself. The "man-power" required for making and operating machinery may be reduced to a minimum by automation, but there will be a minimum that will be irreducible and indispensable.

Fourthly, the human agents who are still needed for making an automatic world work increased their power over society by unionization. Their solidarity gives them a monopoly, and this monopoly gives them a stranglehold.

STRIKE WINS

These four new facts, in conjunction, enable indispensable unionized workers to exert extreme pressure on society by striking. Strikes in public services that supply the daily necessities of life can paralyze society instantly. Strikes in industries whose products are not daily necessities can ruin these industries by putting their costly plant out of action.

Being human, the unionized workers in high industrialized countries are using their power to extract from society the lion's share of society's aggregate income. They cannot, of course, extract more than the total amount of society's real income.

If their demands, in terms of money, exceed this amount, the result is inflation, and the victorious strikers' real gains fall short of their nominal gains in a currency that is being depreciated by their action. Meanwhile, the strikers' fellow citizens who do not share the strikers' power of paralyzing society are not making even any nominal gains, while the inflation is inflicting real losses on them.

In this situation, the distribution of society's aggregate real income is determined, not by the social value of people's work, but by their ability to paralyze society quickly.

People who are able to cut off light, heat, and power, or to put the sewers out of action are in a stronger bargaining position than surgeons, doctors, hospital nurses, educators, researchers and inventors.

If the medical profession strikes, some people whose lives could have been prolonged will die immediately, but not the majority of the population. If teachers strike the damage to society through illiteracy will not begin to be felt for years. If researchers and inventors strike, the penalty will be paid mostly by people still unborn, and consequently the living generation will not take a researchers' strike seriously.

IMMEDIATE IMPACT

Thus the present situation puts a premium on ability to damage society immediately, while it does not reward ability to benefit society eventually.

The redistribution of society's aggregate income on this basis augurs ill for society's prospects. Yet this is the basis for redistribution that is being dictated by the new balance of power.

The consequence is an aggravation of the struggle for shares in society's aggregate income. On the one hand, the "white-collar" workers in the industrially advanced countries, and the governments of the industrially backward countries that produce indispensable raw materials, are copying the industrial workers' strategy. They are fortifying their bargaining power by unionization.

On the other hand, the owners of industrial plant and the authorities who have to provide public services are reducing the number of human employees to a minimum by carrying the process of automation farther and farther.

A unionized human employee is as costly as a machine, but, unlike machines, human beings are troublesome, and their behavior is unpredictable. They are mulishly wilful, whereas a machine, being inanimate, is more docile even than an ox. The incentive for replacing people by machines is strong.

GRIM MUSICAL CHAIRS

What, then, is the outlook, supposing that the consequences or our present behavior do not move us to behave differently?

Today we are playing, in deadly earnest, the children's game of musical chairs. Each time the music starts, one more chair is removed from the row. Each time the music stops, one more player fails to find a seat and has to go to the wall. If we play this game to its conclusion, the last seat left will be occupied by a minority consisting of the most effective saboteurs.

This victorious minority will be extracting enormous salaries. Because it cannot extract from society more than society's total real income, the minority will have to leave some fraction of this for providing a dole for the unemployed majority.

This majority will consist of the "under-thirties" and the "over-forties." The "under-thirties" will not be allowed to compete for remunerated employment unless they have obtained a Ph.D. degree. The "over fifties" will be retired compulsorily, and the doctors will be allowed to keep them alive until they have reached the maximum permissable age (this will probably be eighty).

ULTIMATE LOSERS

Is this the kind of society that we want? If it is not, we shall have to change our tune. At present we are behaving like blind cut-throats.

Is this civilized? Is it human? On a long view, is it even in the interests of the eventual winners in this sinister game of musical chairs? They, too, in their turn, will reach retirement age. This will overtake them swiftly, and then they will have rejoined the wretched majority. Do they relish this prospect?

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VIEWS on the NEWS

Chairman HUMPHREY. I am going to ask our professional staff to make an indepth study of the ESOT plan. We have some obligation to do so. We will want to be back in touch with you, Mr. Kelso, Professor Brannon, Professor Brems, Mr. Fay, and others, to fill out this record.

With that, I am going to have to recess the committee.

[Whereupon, at 1:20 p.m., the committee recessed, to reconvene at 10 a.m., Friday, December 12, 1975.]