

5 CAPITAL FINANCING WITHOUT RESORT TO SAVINGS

Our analysis so far leaves no room for doubt that the traditional financing methods of the West are by no means the only ones possible in an economy in which capital is privately owned. Business has developed many methods for spreading the incidence of losses over large numbers of persons through insurance, in order that individual losses can be held to easily bearable proportions. It is singular, then, that we have not to any significant degree employed an insurance system *as such* in dealing with the risk of entrepreneurial error.

In fact, this failure is no less than remarkable when we have before us the comparable experience of Federal Housing Authority insurance in the field of consumer-goods financing. This insurance protects a lending bank that extends credit to a home buyer. Such a purchaser is generally *not personally liable* on home-purchase money mortgage notes. A failure to pay such a purchase money mortgage note enables the creditor to resort only to the buyer's equity in the residence, but not to obtain a personal judgment against the de-

fault. Consequently, there exists for the lender a risk that a home buyer may default on the purchase price and that the market value of the mortgaged house may be less than the balance due on the note at the time of default. FHA insurance covers this risk.

There are no insuperable obstacles to the establishment either through private or governmental means, or through a combination of both, of a system of credit-financing the purchase of newly issued capital stock and of insuring, through either a mutual or funded insurance plan, the risk of entrepreneurial error, which might cause the newly formed capital represented by such stocks to fail to produce sufficient wealth to defray the buyer's cost of acquiring them. We have called attention to this in *The Capitalist Manifesto*, where we suggested that an FHA-type corporation to provide such insurance might be called the Capital Diffusion Insurance Corporation (CDIC).¹⁹ Conventional financing methods, now and heretofore used, restrict new capital formation to those who, through their ownership of savings or existing capital, are in a position to self-insure against the entrepreneurial risks of new capital formation. The proposed CDIC system would simply substitute for the existing self-insurance method a system of mutual or funded insurance to protect banks which finance capital acquisition loans against an excessive coincidence of entrepreneurial errors affecting a financed portfolio of stocks. The essential difference between these alternative systems of financing new capital formation is that the traditional system limits the acquisition of newly formed capital to the owners of existing capital, whereas the CDIC method eliminates savings or the ownership of existing capital as an indispensable factor.²⁰

¹⁹ See *The Capitalist Manifesto*, p. 253-254.

²⁰ Credit policy considerations might, of course, require a small down payment on the purchase of a financed portfolio, thus still employing savings to this limited extent.

A. FINANCED-CAPITALIST PLAN

We will outline the possible features of a method of simultaneously financing new capital formation and—at the same time—increasing the proportion of households owning viable capital estates (*i.e.*, capital estates of sufficient magnitude that when their financing costs are paid off, they can support, or materially contribute to the support of, a household enjoying a reasonable standard of living). We are fully aware that many, if not all aspects of the plan may be refined and improved.

In general, no new institutions other than the insuring agency itself would be involved, and this would in many ways be similar to the FHA insurance system.

In all probability, the most satisfactory agency for performing the insurance function would be a public corporation, established and financed initially by Congressional appropriation or by the sale of stock or bonds to the public, and thereafter deriving its income and reserves through fees collected on a proportionate basis from borrowers. The fund would thus provide mutual insurance against the risk that newly formed capital may not produce the wealth expected of it within the predetermined loan period used for financing the purchase of securities representing it.

Already existing financial institutions would make CDIC-insured loans only to *individuals* seeking to acquire equity securities.²¹ These would include commercial banks where general indus-

²¹ Although Harold G. Moulton in 1935 pointed out that increased capital formation could come about in spite of a decline in savings through the use of commercial bank credit, his study was not concerned with the diffusion of capital ownership. See Note 8 above. In principle, the financed-capital plan is not unlike a recent suggestion by the Senate Select Committee on Small Business. The Committee proposed that the Small Business Administration be authorized to insure lease bonds (written by private surety companies) for small retailers, to qualify them to rent space in shopping centers. At the present time, developers cannot finance new shopping-center developments without first leasing most of the space to triple-A tenants (those with net worth of 1 million dollars or more).

trial trade or professional-service businesses are being established and farm credit banks where agricultural borrowers are involved. Each loan would be made in accordance with policies established by Congress and administered by the Federal Reserve System or by the Capital Diffusion Insurance Corporation, as Congress might determine. The possible contents of these controlling policies we will mention later. Such CDIC-insured loans would be made *only* to finance the purchase of newly issued corporate equities, never to finance purchases of outstanding stocks in the secondary market. Since the very function of such a system is to bring into existence a growing number of individual owners of viable capital estates, CDIC loans should not be available to facilitate the purchase of stocks either by corporations or by financial intermediaries of any kind.

Maximum limits upon such loans would be necessary, but these would be subject to uniform change from time to time as the conditions of the economy might require. The entire portfolio of securities purchased pursuant to such loans should be pledged to the lending bank to secure the repayment of the purchase price of the capital estate and payments of interest and insurance on the loan. It would seem desirable, however, under certain conditions, for only part of the income to be withheld for application on the loan obligation of the purchaser of securities. The portion of portfolio income applied through the escrow to payment of the purchase price of the shares in the portfolio might vary with the extent to which the loan has been repaid, or with the extent to which the portfolio has yielded more than the expected return at the time of the loan.

Loans could be, and probably should be, non-recourse loans, that is, they should not involve the personal liability of the borrower. *The assumption of the risk of failure of the newly formed capital, repre-*

See the 11th Annual Report, Senate Select Committee on Small Business, January 1960, p. 47.

sented by the various securities in the portfolio, to produce the wealth expected of it at the time the financed-capitalist loan is made, would be the function of the insuring agency, CDIC. To use personal liability loans for this purpose would be to employ the self-insurance feature which has been responsible for the failure of the existing financing system to promote capital diffusion.

The loan paper received by banks which made CDIC-insured loans to financed capitalists would be made rediscountable by the Federal Reserve Banks, and legislative authority would be granted to Federal Reserve Banks, under proper controls, for the issuance of Federal Reserve Notes against the discounted capital-acquisition loan paper. This system is illustrated by Chart 1, page 43.

Similar arrangements, within the Federal Farm Credit System, could be made for financed-capitalist loans to primarily rural borrowers. It would seem that the same policies should prevail, including the requirement of proper diversification of portfolios.

In *The Capitalist Manifesto*, it was pointed out that both the political and economic essence of private property in productive capital is the right to receive all the wealth produced by that capital. This is impossible unless mature corporations, after setting aside only necessary operating reserves (not reserves for expansion of any kind) pay out 100 percent of their net income to the stockholders.²² By a "mature corporation" we mean a corporation that has effective access to market sources of capital funds for new capital formation, including funds available for new capital formation through the financed-capitalist program. Thus corporations as a whole would compete in the market for new capital, and the judgments concerning where, when, and how much of the wealth produced by capital to invest and how much to spend on con-

²² See *op. cit.*, Chapter 5 and pp. 222-226. The necessity for tax reforms leading to the eventual repeal of the corporate income tax and the scaling down of personal income taxes is discussed on pp. 181 and 220.

CHART 1

FINANCING ARRANGEMENTS

OF THE FINANCED-CAPITALIST PLAN

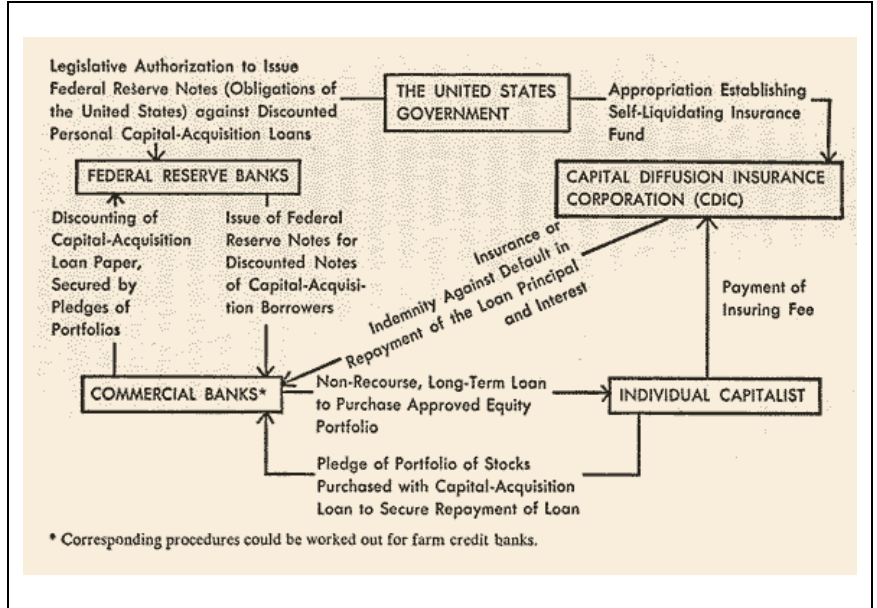
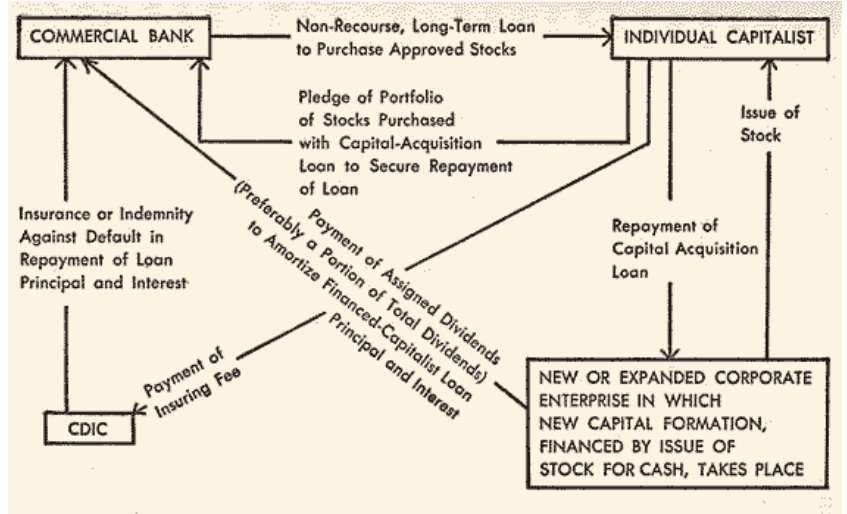


CHART 2

HOW CAPITAL INSTRUMENTS PAY FOR THEMSELVES UNDER THE FINANCED-CAPITALIST PLAN



sumption would be left to the property owner—the investor.

The arrangements under which newly formed capital would pay the costs of the new owners in acquiring their portfolios of securities, and would thereafter enable such owners to participate in the production of wealth through capital ownership, is illustrated by Chart 2, page 44.

When capital-acquisition loans have been paid off in full, including principal, interest and insurance fees, the equity portfolio pledged to secure the loan would be released to its owner. During the loan period, a substantial opportunity would be afforded the new capitalist, through his contact with the lending bank and its loan advisers, to obtain the elements of an “investor education.”

Such questions as how many such loans may be made to a particular household or a particular borrower, the size of capital estate that one could hold before the financed-capitalist facilities would no longer be available, etc., are questions of policy. The correct answers to these questions depend on the rate of technological change, the rate at which households must be withdrawn from the labor market and enter production through capital ownership in order not to have excessive unemployment of non-owners of viable capital estates, and on many other circumstances which we need not state in detail here.

B. CAPITAL DIFFUSION INSURANCE

It is important here to understand the nature of our proposal of capital diffusion insurance. *It does not insure management or shareholders against the risks of business failure.* It only insures a commercial bank, which lends funds to a qualified investor to buy a portfolio of newly issued stocks, against the risk that the yield on the portfolio will not, within the loan term, defray its costs of acquisition. Since the entire portfolio acquired through one or more financed-

capitalist loans would be held in escrow until the purchase loan had been paid off, the CDIC insurance would actually provide only ultimate protection against a *concurrence* of entrepreneurial error in several of the corporations whose stocks are represented in a well-diversified portfolio.

So far as the financed capitalist is concerned, shares of stocks that become worthless continue to be *his* worthless shares. The management of a business which has issued stock for the purchase of which CDIC-insured loans have been made is even more directly affected by the risk of failure. If the dividends are insufficient, during the financing period, to pay off the financed-capitalist loans on the corporation's stock, such management must correct its mistakes and convince "the public" that its errors have been corrected, or it will not fare well thereafter in the competitive market for funds to continue growth. Today, earnings in successful years can be arbitrarily diverted from the shareholder to offset mistakes that have caused unsuccessful years.

C. FINANCED-CAPITALIST PLAN AND POWER DIFFUSION FOR A FREE SOCIETY

There is no doubt that government, in the administration of the financed-capitalist program, would exercise considerable power. Is such power reconcilable with the contention that a capitalist economy joined with a political democracy is the ideal power-diffused society? We believe that it is.²³

²³ The nature of political power is such that it must, particularly in a modern mass-production and mass-communication state, be reasonably centralized to be efficient and effective. American political history has been characterized by legislative, judicial and administrative changes required to increase its efficiency in the face of its large-scale tasks by eliminating much of its original decentralization. Such centralization of political power, however, rather than being offset through

In exercising policy-making power through the financed-capitalist program, government employs *only political power*. The economic power created through the simultaneous promotion of capital formation and the diffusion of private ownership of capital is privately held and individually exercised economic power—all of it. Through this program, only privately owned capital is created. The power of government is limited to umpiring the rules of the economy, without becoming one of the players.

The protection of private property, without any kind of discrimination, is the first economic rule of a capitalist society. The prime corollary of this first economic rule is the principle that government should never engage in production, nor in the distribution or redistribution of wealth, except such distribution as is involved in protecting the owner of capital or the owner of labor power in the wealth his capital or labor produces.

Under the financed-capitalist plan, the exercise of political power, under constitutional requirements of uniform laws, is accompanied by the creation of private economic power in the form of new capital-owning households, or households in which private ownership of capital is increased and strengthened. The power of government is neither total (*i.e.*, it does not include both political and economic power) nor is there any tendency for it to become total.

It will be seen at once that many policies already long recognized as indispensable to a free-enterprise economy (for example, our anti-trust or anti-monopoly policies) can be made much more

the diffusion of economic power in accordance with capitalist principles, has in fact been aggravated by the concentration of economic power in large corporations and in their relatively small group of stockholders and the relentless transfer of economic power to government through the weakening of the private property of individuals in the assets of the great corporations.

effective under the financed-capitalist program than under our present mixed economy.²⁴

²⁴ We do not here suggest that the CDIC system of capital formation should eliminate savings altogether as a means of insuring the risk of entrepreneurial error, but only that an alternative means should be concurrently available which is free of the inherent tendency toward concentration of ownership of capital found in the prevailing system of business and corporate finance. As we suggest in *The Capitalist Manifesto*, such an arrangement, to be effective, might have to be combined with investment preferences for new financed capitalist estates. See pp. 230-232.