AFTERWORD II
WHAT LOUIS KELSO KNEW

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The ancient Greek poet Archilochus observed: "The fox knows many things, but the hedgehog knows one big thing." Although the meaning of this enigmatic fragment has been lost in time, the late British philosopher Isaiah Berlin, in a celebrated essay,[1] made the fox and the hedgehog symbols of a deep temperamental divide between thinkers and writers, and perhaps human beings in general.

Berlin thought that a great chasm exists between "those, on one side, who relate everything to a single central vision, one system … a single, universal organizing principle … and, on the other side, those who pursue many ends, often unrelated and even contradictory, connected, if at all, only in some de facto way … related by no moral or aesthetic principle."

The hedgehog, then, is holistic, the fox pragmatic. In Berlin's taxonomy, Plato is a hedgehog, Aristotle a fox, and Tolstoi a fox who wants to be a hedgehog. As the author of an important biography of Karl Marx, an arch-hedgehog if ever there was one, Berlin might well have extended his analysis to economists. Their thinking reflects the same temperamental split.

Louis Kelso was a hedgehog. As a political economist and visionary social thinker, he knew one big thing—an overarchingly momentous thing that illuminates the social landscape like flashes of summer lightning, a transformational big thing that generations of economists, with one possible exception, Jean Baptiste Say, had inexplicably overlooked. He knew that capital is an input factor on the production side of the free market equation, and thus performs work and earns income just as human labor does. And he knew the momentous social implications of this revolutionary discovery.

But Kelso was also a fox who knew many things about the world. He was a corporate and financial lawyer; he was also an investment banker. He knew how institutions were put together and how they worked—and for whose benefit. He particularly understood the corporate form of organization. He designed corporations, served as corporate counsel, and sat on corporate boards. His favorite law clients were inventors and entrepreneurs. He understood politics and how Congress worked. He could draft the legislation that would translate his ideas into law. He could write the floor speech that explained why Congress should pass that law.

Above all, Kelso understood corporate finance. He knew that capital was self-financing, that it could be financed from credit as well as from savings. He knew that despite their virtuous claims of sacrifice and belt-tightening, it was through capital credit that the truly rich amassed their wealth. He knew the exact mechanisms by which ownership of capital was concentrated, deliberately and "with surgical precision," as he used to put it, in a tiny fraction of the population. He knew all the subtle ways that law and finance reinforce each other to create "the invisible structure" of the economic order, a structure that controls the earning power of individuals and families and the nature and extent of economic opportunity in the society.

In Louis Kelso's case, the hedgehog and the fox complemented each other. The one knew why and the other knew how. They consulted on a regular basis. Their collaboration produced a large and remarkable body of theory and practice, including the Employee Stock Ownership Plan (ESOP), for which Kelso is mainly remembered after his death. It was his vulpine abilities that enabled Kelso to devise from an obscure provision of the Internal Revenue Code a way to connect working people with capital credit, so that they could buy and pay for company stock out of its earnings, and to persuade,

[1] *The Fox and the Hedgehog: An Essay on Tolstoi's View of History*, Isaiah Berlin, 1953, revised 1978, reprinted Elephant Paperbacks, Ivan R. Dee, Publisher, Chicago, 1993, p. 3.

as he did in 1956, Isidore Goodman, then head of the Pension Trust Division of the Internal Revenue Service, to qualify the first ESOP. But this innovation could never have taken place without the hedgehog's vision.

Americans are generally not much interested in abstract ideas. Indeed, we instinctively distrust general theories and paradigms that purport to "explain it all." We think their advocates arrogant and out of touch; we dismiss them as ideologues, Johnny one-notes or fanatics. They bore us. We are more at home with foxes, even when they are wrong. We prefer information and data to seamless webs.

Ever since the Great Depression, economics has been the uncontested preserve of the foxes. Although John Maynard Keynes wrote a general theory, an act which would seem to qualify him as a hedgehog, he was really a super-fox in search of a quick-fix to the Great Depression. Despite his professed disdain for *"rentiers"* and the "functionless investor" his intention was not to destroy the capitalist system, but to save it from being repudiated by the desperate millions who could no longer earn a living. As Robert Heilbroner, the prose laureate of Keynesian economics, explained: "But no one could gainsay his aim: the creation of a capitalist economy in which unemployment—the single greatest and gravest threat to its continuance—would be forever eliminated."[3]

Louis Kelso was also drawn to the study of economics by the Great Depression. Like Keynes, he sought to understand the cause of a catastrophe both men regarded as not only tragic, but unnecessary and absurd. But the two seekers organized their search around different questions, belonging to different orders of thought. Keynes the pragmatic fox asked: How can employment be restored and maintained? Kelso the philosophical hedgehog asked: What is the logic of this system people call "capitalism"?

Kelso's question took him back to the first principles of classical economics identified by Adam Smith—supply and demand, competition, and private property in labor and capital. These were the working parts of a macro-construct identified in 1803 by a French disciple of Adam Smith, Jean Baptiste Say. Its essence was distilled in the famous aphorism: "Supply creates its own demand."

Until the Great Depression, Say's Law of Markets was the linchpin of classical theory. Say and his followers interpreted it to mean that if government adopted a hands-off policy—*laissez-faire*—the market economy would automatically correct its periodic imbalances between production and consumption, returning to "equilibrium," a state which they believed synonymous with full employment. Depressions could therefore not occur.

In the real world, however, some unknown factor was working to undermine Say's elegant and irrefutable logic. Depressions not only occurred, they did so with increasing frequency and deepening severity. Two years into the Great Depression of the Thirties, President Hoover reminded the American people that "depressions are not new experiences, though none hitherto has been so widespread. We have passed through no less than fifteen major depressions in the last century."[4]

In the physical sciences, a phenomenon which is theoretically not supposed to happen but which does happen and which the dominant paradigm cannot fully explain, is called an "anomaly." It signals that the established paradigm is in trouble. The Great Depression was the anomaly that ended the classical reign. Only World War II brought the economy out of its decade-long coma—a sinister lesson not lost on either political leaders or economists. With a new employment crisis looming when the munitions plants shut down and the veterans returned home, the post-war world's most urgent need was an economic alternative to war.

As an outsider and amateur, Louis Kelso had no personal stake in any economic theory. Having determined that goods and services were produced and consumed in the physical world, he decided to investigate this process in the spirit of a physical scientist studying the behavior of matter.

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[3] Robert Heilbroner, *The Worldly Philosophers*, Time, Inc., New York, 1961, p. 295.

[4] Charles A. Beard and Mary R. Beard, *America in Midpassage*, The Macmillan Company, N.Y., 1939, p. 69.

For him economics was not, as to Joseph Schumpeter and other theoretical economists, "a fascinating intellectual game,"[5] but the matrix of fate. The grandson of pioneers who had migrated west by wagon train, he was not quite 16 years old when the Great Depression struck. His family's standard of living hovered just above subsistence for the entire decade. To pay for his education at parochial school and at the University of Colorado, he did any sort of work he could get—stonemasonry, "sticking" newspapers at the Denver Post, driving a dynamite truck.

His own direct experience with privation and hardship, inflicted by an event which he attributed to human incompetence and mismanagement rather than God or necessity, made Kelso think about economic arrangements in a way that Keynes could not. Born in the year Marx died, Keynes was thirty years older than Kelso. He was an Englishman of the gracious late Victorian-Edwardian age, a second-generation, Cambridge-educated classical economist, and, not least, the possessor of a comfortable fortune from currency and commodity speculation which gave him what Louis Kelso regarded as the highest prize of the Industrial Revolution: the leisure which enabled him to live a vigorously creative life.

Thomas S. Kuhn observes that men destined to change the paradigm of their profession either come from outside that profession or enter it very young. Kelso met both of these specifications.[6]

Kelso's search for logic inevitably led to that conundrum of classical economics, Say's Law. On its face, it seemed as unassailable to him as to the classical economists and even Keynes. Although modern economists claim that Keynes "disproved" Say's Law, the fact is that he never so much as questioned it. Instead, he acknowledged as "indubitable" the proposition that "the income derived in the aggregate by all the elements in the community concerned in a productive activity necessarily has a value exactly equal to the value of the output."[7]

How could such an indubitable proposition go wrong? One of Louis Kelso's most basic and original contributions to economic thought is his solution to this puzzle. Say's Law of Markets describes a system where productive input on one side, measured in costs, translates into distributive out-take on the other, measured in earnings. It is an accounting equation—in Louis Kelso's words, "double-entry bookkeeping writ large." The costs of production become income paid to those who have contributed to production. Governing this process is a moral and legal construct called Private Property—the true "invisible hand"—which enforces the distributive rule, "to each according to his production."

Say's Law indicates that supply and demand is a self-regulating process—a feedback system. It is conceptually sound. Its apparent unworkability is due to the attempt of economists from Adam Smith on to interpret it as if only one factor were "at work," when in fact there are two. By failing to recognize that capital instruments also perform work and earn income, thereby constituting a second factor of production, traditional economists simply could not account for the changes industrialization was making on the supply side of the market equation, and their corresponding effects on the demand side.

Their traditional fixation on labor kept economists oblivious to the most important economic fact about technological change. It does not make labor more productive. It makes capital more productive. And since technological innovation is the force that drives the ongoing Industrial Revolution, they missed the meaning of that, too.

Kelso defines technological change or innovation as "a process by which the ideas flowing from science are applied to the development of capital instruments and the land, thus harnessing nature and making her work for people." Thus technology is a process by which human ingenuity and invention

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[5] Bernard D. Nossiter, in a review of Gunnar Myrdal's *The Challenge of World Poverty*, *The Washington Post,* September 10, 1970.

[6] Thomas S. Kuhn, *The Structure of Scientific Revolutions*, University of Chicago Press, 1962; 2nd ed., 1970, p. 90.

[7] J. M. Keynes, *The General Theory of Employment, Interest and Money*, Harcourt, Brace and Company, N.Y., 1935, p. 20.

shifts ever more of the burden of production from labor to capital, from the human factor to the non-human factor.

In other words, technological change methodically replaces labor input with capital input, changing the input mix from labor intensive to capital intensive. It is a process which increases the productive power not of those who *work* with capital but of those who *own* capital. And to the extent that the private property rule of distribution is respected, it proportionately increases the flow of market-sourced income to capital owners, and proportionately decreases the flow to labor. Technological change, in other words, is the mysterious agent responsible for creating a bottleneck in the supply/demand pipeline.

Louis Kelso reaffirmed Say's Law as the fundamental logic of a private property, free market economy as first described by Adam Smith, but with this proviso: Supply creates its own demand only when those who produce goods and services also want and need to consume the goods and services produced. Thus Say's Law of Markets assumes a *democratic distribution of productive power* to balance *democratic consumption.* (Italics mine.)

Louis Kelso occasionally speculated on why the independent productiveness of capital, a fact so obvious to him, had not been discovered earlier. Marx had come very close, and so had Keynes. Kelso considered it possible that had Keynes lived longer, he would have seen his error and corrected it.

What caused the brilliant Keynes to miss the central meaning of the Industrial Revolution? He himself answers this question in his introduction to the *General Theory*.

Here Keynes rather sententiously cautions his fellow classical economists about the importance of assumptions. He writes: "The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds."[8]

Ironically, Keynes was completely unaware that his own mind was in thrall to an idea already ancient in 1776, when Adam Smith formalized it in the opening paragraph of *The Wealth of Nations*. It was adopted by the early English socialist philosophers. Karl Marx made it the rallying cry of the labor-dependent proletariat: "All wealth is produced by labor." Only one classical economist went on record to question whether in fact the labor theory of value was true He was, as we might expect, the prescient M. Say.

It was this idea that caused Keynes to dismiss Say's Law as irrelevant, and to build his theoretical structure on a false premise.

We need look no further than the *General Theory* for proof that Keynes had indeed been blind-sided by the assumption that labor is the only active factor of production, and that capital is merely a passive adjunct of labor. Keynes freely acknowledges his bias:

> "It is much preferable to speak of capital as having a yield over the course of its life in excess of its original cost, than as being *productive…*
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> I sympathize, therefore, with the pre-classical doctrine that everything is *produced* by *labour* (italics his), aided by what used to be called art and is now called technique … and by the results of past labour, embodied in assets. … It is preferable to regard labour, including, of course, the personal services of the entrepreneur and his assistants, as the *sole factor of production* (italics mine), operating in a given environment of technique, natural resources, capital equipment and effective demand."[9]

Capital is simply not as "real" to Keynes as labor. Capital has no life of its own; it is an abstraction. Technology, too, is reduced to "technique"; like capital instruments, it is an inert part of the environment, functionally indistinguishable from land and other natural resources.

Modern economists will deny that they treat labor as the sole input factor. They claim to theorize about many inputs. That is true, but they persist in attributing increases in output to "labor productiv-

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[8] *Ibid.*, p. xiii.

[9] J.M. Keynes, *Op. Cit.*, pp. 213-14.

ity." If this formula were deliberately invented to deceive the general public about the nature of the productive process, it could hardly be more effective. Assigning the output of two input factors, capital and labor, to only one of them, labor, is simply a statistical rendition of the neo-classical doctrine, reaffirmed by Keynes, that capital is not productive in itself but aids and assists labor to produce more.

Is it true, as Keynes preferred to assume, that labor is the sole factor of production? That capital is not inherently "productive"? Or is Louis Kelso right when he asserts that capital is a second factor of production, which performs work and earns income in all the senses that labor does?

If Keynes is right, it really does not matter who owns the economy's productive capital, or how much of it anyone owns, as long as there are lots of jobs and employment. And if capital ownership is not important, then neither is the fact that most of the economy's productive power is monopolized by a tiny fraction of the population.

But if Kelso is right and there really are two factors of production, and if technological change is making the one owned by the many less productive and the one owned by a few ever more productive, then the question of who owns the capital is a momentous question.

If the Keynesian view is right, the gradual erosion of private property rights in both capital and labor is just the price we have to pay to stave off the next depression. The fact that private property also happens to be the foundation of our political freedom is just our misfortune.

But if Kelso is right, private property free market principles can be used to correct the faults of the market economy so that it distributes income as efficiently as it produces it, while expanding economic growth, creating new markets and better customers for business without redistribution, and without sacrificing our constitutional freedoms.

Louis Kelso sometimes mentioned a psychological quirk he had observed in human nature. People refuse to recognize a problem, he said, until they see its solution. First the solution, then the problem! He had identified an important form of social denial which may throw some light on why we still cling to a pre-industrial view of production.

Perhaps the reason Keynes and the classical economists, including Karl Marx, could not see beyond labor employment was that until Louis Kelso invented them, there were no techniques to finance capital ownership for those without savings. Ownership was the prerogative of those who financed new capital or bought existing capital out of personal income withheld from consumption. Since working people had to spend every last penny on subsistence, capital ownership was not an option for them.

In the early seventies, this revealing exchange took place between reporter Mike Wallace and Professor Paul Samuelson on national television:

Wallace: "All right. My understanding of Kelsoism is that it's designed to enable men who are born without capital to buy it, to pay for it out of the income it produces, to own it and therefore to receive income from that capital. Devoutly to be wished?"

Prof. Samuelson: "Oh, yes. And it would be nice to have lollipops grow on trees for the picking … It really has a Marie Antoinetteish ring to it. 'Let them own capital.'"[10]

This is a beautiful example of the scarcity mentality that characterizes conventional economics. Capital ownership is "cake," a scarce luxury product before bakeries were mechanized to produce it in volume. Louis Kelso used to say that the Industrial Revolution was a revolt launched by the human race against scarcity. But until we understand the impact of technology and technological change on the distributive dynamics of the free market, we will not understand either the necessity for universal capital ownership or the advanced financing technology Louis Kelso invented to make this possible.

Now that the solution is at hand, isn't it time to acknowledge the problem?

One great virtue of Louis Kelso's binary economics is that it returns economics to fundamental ideas—to Aristotle, St. Thomas Aquinas, Adam Smith, J. B. Say, John Stuart Mill, Karl Marx, and

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[10] "60 Minutes," CBS Television Network, March 16, 1975; copyright 1975 by CBS, Inc.

the American founding fathers. It brings political-economics back to first principles, as enunciated in the British and American common law, the U. S. Constitution, and the Bill of Rights.

But the overwhelming virtue of Kelso's binary economic paradigm is that it restores truth to economics. Truth enables us to understand our mistakes and to correct them, not overnight, but gradually, in the light of our new understanding.

All the economic issues of our time undergo a fundamental transformation when subjected to the pragmatic truth test of whether capital is a factor of production. They are seen from a new, higher perspective. New solutions present themselves to the oldest and most intractable economic problems.

The practical implication of Kelso's insights is that we cannot efficiently produce goods and services through two factors while distributing income through just one. Free market logic simply will not permit it. And if we jettison the free market, as Marx did entirely and Keynes did partially, we need look no further than the former Soviet Union to see the consequences. The material and moral basis of that society was devastated by the dogma that all wealth is produced by labor. The same belief, in a less doctrinaire form, is impoverishing the "mixed" economies of Europe. While Keynes did not invent the welfare state, he made it intellectually credible.

Nothing is more powerful than ideas. We live by ideas and on them and we immortalize them in our institutions. Therefore it is a matter of supreme importance to us as individuals and to society whether our most fundamental ideas are true.

Keynes knew that! In the last sentence of the *General Theory*, the super-fox rises to hedgehog wisdom: "But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil."[11]

A true paradigm is a master teacher; it is a rich mine of new and unsuspected truths and previously invisible connections and relationships; it yields new facts, makes possible accurate predictions, and suggests new, unsuspected solutions. Louis Kelso found his own paradigm a bottomless cornucopia of new insights. He continued to learn from it right up until the very end of his life.

When Louis Kelso and I first met in 1963, he predicted that what he then called the theory of capitalism would be the dominant economic and political idea of the 21st Century; that as many shelves of books would be written about it as were written about Karl Marx and Frederick Engel's theory of communism during the 20th Century. I considered his optimism justified. Before meeting either Kelso or his co-author, Mortimer J. Adler, I had read *The Capitalist Manifesto* and *The New Capitalists*. My reaction had been, "Eureka, this is it!"

Dr. Adler had undergone a similar transformation. As the result of a single question Kelso put to him, on whether a human worker of any kind, skilled or unskilled, was any more productive now than two or three thousand years ago, he had "a blinding flash of light." After reading the unpublished manuscript which Kelso had put aside to concentrate on the practice of law, Dr. Adler pronounced Kelso's work as "the first clear and systematic statement of the idea of capitalism that has ever been presented to the world."

"Mr. Kelso's conception of capitalism as the economically free and classless society which supports political democracy and which, above all, helps political democracy to preserve the institutions of a free society is, to my mind, the most revolutionary idea of the century."[12]

At the beginning of the 21st Century, interest in Louis Kelso's economic thought is on the rise. Economists now admit that they do not understand economic growth—how to bring it about in the poor countries, or how to restore the "magic" at home after it has gone.[13] They cannot explain the economic decline of the middle class. Most unsettling, they still do not understand the cause of depression, nor do they know how to prevent the next one. Not long ago, Lester Thurow, a superstar of

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[11] *General Theory*, *Op* Cit., p. 384.

[12] Mortimer J. *Adler*, The *Capitalist* Revolution, two lectures published by Industrial Indemnity Company, March, 1957.

[13] See Paul Krugman, *Peddling Prosperity*, W.W. Norton & Company, N.Y., London, 1994, p. 9.

his profession, writing on the Asian crisis, admitted without apology: “Economic collapses are an intrinsic part of capitalism.”[14]

Louis Kelso’s binary economics paradigm first explains and then resolves these and many other “anomalies” in the conventional economics wisdom of our age. It particularly illuminates the problem of economic growth.

Economic growth is essential to modern industrial economies whose political commitment to full employment is constantly assaulted by technological change. Growth is the rising tide that is supposed to lift all the boats. As John Diebold pointed out, economic growth is essential to the painless introduction of technological change.[15] When economists assert, as they have done since the beginning of the Industrial Revolution, that technological change creates more jobs than it destroys, their tacit assumption is that economic growth will proceed at a fast enough clip to restore the employment lost. The conventional economic paradigm chains the full employment economy to perpetual expansion. It offers no surcease or escape from a necessity that already is threatening the viability of our planet.

Louis Kelso’s binary perspective delivers us from this deadly bind. He offers specific, detailed economic proposals for correcting the problem at its source, which is the ever-widening imbalance between production and consumption. He shows us how to accelerate economic growth by unblocking the purchasing power created by the free market but not distributed to consumers with present needs and wants. This is not, as the Keynesians believe, a problem caused by maldistribution of *income*. The cause goes deeper. Fundamentally—and this again is an insight unique to Louis Kelso—the problem arises from *maldistribution of the productive power of capital.*

Will there be another depression? There is nothing to prevent it except the logic of the private property free market itself.

Free market logic is, as the classical economists sensed, a natural economic fact. So is the productive and distributive power of capital. We are not free to disregard such basic facts or to act in opposition to them without penalty.

Reality is the subtlest form of coercion. Louis Kelso never doubted that his idea would prevail, because it is true. Truth sooner or later prevails. That is the biggest thing the hedgehog knows.

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[14] Lester Thurow, "Asia: The Collapse and the Cure," *New York Review of Books*, Feb. 5, 1998, p. 22.

[15] John Diebold, *Beyond Automation*, Praeger Publishers, N. Y., 1970 (copyright 1964), McGraw-Hill, Inc.