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# Improving Social Mobility in America: How Capital Ownership Can Fix the Problem

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## I. Introduction

As machines have replaced men in the production of goods, the ownership of capital assets has become the most important factor in determining the wealth status of individuals in America. Unfortunately, almost all of America's capital assets are owned by approximately percent of the population.[1] It is becoming more difficult every generation for Americans to earn a decent salary based on their labor input alone. Many are upset with the current economic system, which can be seen on our streets with the Occupy Wall Street movement or in a political speech where the president speaks of the one percent. A growing sentiment is that the nation is slowly losing its title as the land of opportunity.

Broad ownership of private property as a fundamental principle of democracy and freedom was encouraged by America's founding fathers. Unfortunately for the United States, between 1979 and 2007 the middle class shrank. Only 40 percent of American neighborhoods currently have an average income within 20 percent of the national median, compared to 60 percent in the 1970s.[2] During those same years, the national income going to the richest .01 percent of Americans-which is nearly 16,000 families with an average income of 24m-quadrupled from just over 1 percent to almost 5 percent.[3] That is a larger portion of the national pie than what the "top .01% received during the infamous first Gilded Age."[4] Robert Putnam of Harvard University states "Put away the rear-view mirror and look at future social mobility,

[1] Robert Ashford, *Broadening the Right to Acquire Capital with the Earnings of Capital*: *The Missing Link to Sustainable Economic Recovery and Growth* (2009), *available at* http://surface.syr.edu/lawpub/9 [hereinafter Ashford, *The Missing Link*].
[2] *The Rich and the Rest*, THE ECONOMIST, Oct. 13, 2012, at 12 (special insert).
[3] For Richer or Poorer, THE ECONOMIST, Oct. 13, 2012, at 3 (special insert).
[4] *Id.* (In American history, the Gilded Age refers to substantial growth in population in the United States and extravagant displays of wealth and excess of America's upper-class during the post-Civil War era.).

we're about to go over a cliff."[5] Disturbingly, recent studies, such as the one conducted by a Finnish economist which showed that more than 40 percent of the sons of the poorest 20 percent of Americans stay in that quintile, while only 25 percent in Nordic countries, indicate that social mobility is more limited in America than perceived.[6]

A study by Vanderbilt University provided evidence that senators' votes are influenced by the preferences of their rich citizens, but not their poor ones.[7] This is likely the reason why legislation reform that has targeted the promotion of broader capital allocation has been reformed. Louis Kelso ("Kelso"), lawyer, economist and investment banker, developed a plan to utilize the principles of corporate finance-the idea of buying capital assets with the future earnings of that capital asset-to allow all Americans to increase their ownership interest in capital. Kelso believed that freedom is only truly achieved if all individuals are provided the ability to acquire economic independence and that broad capital ownership improves democratic institutions.

The analysis that follows examines the idea of Kelso's binary economy-an idea that attempts to increase wealth in America by encouraging programs and pursuing legislation that would broaden the capital ownership base. Section II of this paper examines the historical events that have led to America's ever-increasing wealth gap problem. The section first reflects on the founding fathers' reasons for implementing policies that led to the broad distribution of private property, and then provides a historical account of how the industrial revolution has benefitted America at the macro-economic level, but has caused wealth distribution problems at the individual level.

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[5] *The Rich and the Rest*, *supra* note 2, at 15 (quoting Robert Putnam).
[6] *Id.*
[7] *See* LARRY M. BARTELS, UNEQUAL DEMOCRACY: THE POLITICAL ECONOMY OF THE NEW GILDED AGE 275 (2010).

Section III describes the fundamental principles of binary economics and contrasts Kelso's ideas with other economist including Adam Smith and Karl Marx. Section IV provides a brief summary on how the basics of corporate finance should not only serve companies, but individuals, and then provides a workman-like description of the institutions needed to implement a binary economy. Finally, the paper conducts a case study on the employee stock option plan ("ESOP") and provides suggestions for implementing legislation that will encourage employers and banks to adopt the programs and provide the credit needed for a healthy American economy.

## II. How Industrialization Created the Wealth Gap Problem in America

The original concept of the "American Dream" was a system where a person is free and able to achieve prosperity through one's abilities and hard work, and not due to a class hierarchy.[8] In the late 18th century, the idea of owning property became to be seen as a right in which all United States citizens had a right to benefit from.[9] The Virginia Declaration of Rights listed the means of acquiring and possessing property as an inherent right.[10] Thomas Jefferson implemented policies that heavily favored the broad distribution of real property.[11] During Jefferson's political life, it is estimated that 80 percent or more of Americans lived on the farms they owned.[12] John Adams was quoted as saying "power always follows property"[13] and

[8] JAMES TRUSTLOW ADAMS, THE EPIC OF AMERICA 404 (1931).
[9] *See* DONALD WORSTER, THE WEALTH OF NATURE 95-111 (Oxford University Press 1993) (discussing early Americans' conceptions of property.).
[10] VA. CONST. art I.
[11] *See* Merrill Goozner, *Forty Acres and a Sheepskin*, THE AMERICAN PROSPECT, Mar.-Apr. 1999, at 90.
[12] RICHARD PIPES, PROPERTY AND FREEDOM 209 (1999).
[13] Letter from John Adams to James Sullivan (May 26, 1776), *in* 9 JOHN ADAMS, THE WORKS OF JOHN ADAMS 376 (Charles Francis Adams ed., 1971) (1854); *see also* Michael Lind, *The Smallholder Society*, 1 HARV. L & POL'Y REV. 143, 144 (2007).

advocated to make "the acquisition of land easy to every member of society," or to divide the land into small quantities, so that numerous Americans could own real property.[14]

Until the mid-19 century, land was the most valuable asset in the factors of production, but that changed as the industrial revolution transformed America's economic philosophy. The factors of production-an economic term that describes the inputs that are used in the production of goods or services in the attempt to make an economic profit-include land, labor and capital.[15] During this transition, capital began to replace land as the most valuable asset.

The industrial revolution increased America's material output. From a macro-economic standpoint, the nation became much richer than the early agrarian society formed by the founding fathers.[16] However, because capital ownership was directly linked to existing ownership, capital assets were becoming increasingly concentrated, resulting in a wealth gap at the individual level.[17]

During this time, Abraham Lincoln adopted the Homestead Act,[18] which was premised at least partly on the belief that the broad distribution of property was good for America.[19] Lincoln's legislation provided 287.5 million acres of land grants to 21-year old males who agreed to live on and farm the property for five years, broadening the amount of land owners in

[14] Letter from John Adams, *supra* note 13, at 377.
[15] *See* LOUIS O. KELSO & MORTIMER J. ADLER, THE CAPITALIST MANIFESTO 78 (1958) [hereinafter KELSO & ADLER]. (Land is considered all the natural resources, such as oil and silver, used in the production of a good. Labor is all of the work that laborers perform at all levels of an organization. Capital represents all of the tools and the machinery used to produce a good or service.).
[16] *See* Robert Ashford, *Binary Economics, Fiduciary Duties, and Corporate Social Responsibility: Comprehending Corporate Wealth Maximization and Distribution for Stockholders, Stakeholders, and Society*, 76 TUL. L. REV. 1531, 1550 (2002).
[17] LOUIS O. KELSO & PATRICIA HETTER, HOW TO TURN EIGHTY MILLION WORKERS INTO CAPITALISTS ON BORROWED MONEY, 9 (1967) [hereinafter KELSO & HETTER].
[18] The Homestead Act of 1862, ch. 75, 12 Stat. 392, repealed by PUB. L. 94-579, tit. VII, 90 Stat. 2787 (1976).
[19] Geoffrey D. Korff, *Reviving the Forgotten American Dream*, 113 PENN. ST. L. REV. 417, 433 (2008).

the United States.[20] Unfortunately for leaders seeking to promote broader ownership of property, neoclassical economic thought, which did not consider the difference between individual or corporate ownership with regards to growth, became increasingly more popular towards the end of the 19th century, and with it came the end of the Homestead Act.[21]

There are many important reasons why broad ownership adds value to society, but from an economic standpoint, the most essential reason is that an industrial economy requires a level of consumption adequate to ever increasing levels of productiveness.[22] If this problem is not resolved, an industrial nation will be prone to boom-and-bust periods.[23] Karl Marx predicted that these fluctuations would lead to the inevitable collapse of capitalism.[24] Marx believed that since the few who were capitalists could consume only a small portion of the goods an industrial society was able to produce; and since the laboring masses who kept at a bare subsistence level did not have enough purchasing power to consume the residue, he argued that mounting crises of overproduction and under consumption are inevitable.[25] Understanding this issue, Kelso posed the question: "Why are there so few capitalist in our capitalist society?"[26]

[20] Trina Williams, *The Homestead Act: A Major Asset-Building Policy in American History* 6 (St. Louis Washington University/Center for Social Development, Working Paper No. 00-9, 2000), *available at* http://www.community-wealth.org/_pdfs/articles-publications/individuals/paper-williams.pdf.
[21] Korff, *supra* note 19, at 433-34.
[22] *See* KELSO & ADLER, *supra* note 15, at 78.
[23] *Id.*
[24] KARL MARX, THE COMMUNIST MANIFESTO, 36 (Frederic L. Bender ed., Norton Critical Ed., 1988) (1848).
[25] *Id.*
[26] Robert H.A. Ashford, *The Binary Economics of Louis Kelso: The Promise of Universal Capitalism*, 22 RUTGERS L.J., 3, 32 (1991) [hereinafter Ashford, *Louis Kelso*].

**III. Binary Economics**

Binary economics attempts to solve the aggravating problem that the industrial revolution created, specifically, that it takes capital to acquire additional capital.[27] Binary economics gets its name from the fact that there are two independent factors of production: human and non-human.[28] Kelso believed that in a private property economy, there are two different ways to earn a living: first, through one's labor and second, by utilizing one's capital assets.[29] In other words, a person can be a labor worker and a capital worker.

Kelso believed that people are poor because they have not acquired the capital necessary to supplement their labor input, and they can be made economically autonomous only with assistance in acquiring this capital.[30] Rather than socializing capital ownership, a binary system would socialize credit to enable everyone to acquire private capital.[31] Because industrialization requires mass consumption, Kelso reasoned that "to maintain a market economy, increased productive power, which is fairly traceable to capital, must be linked with increased consumer power through ownership."[32]

The three distinguishing features of binary economics are: 1) labor and capital are "independent" (or "binary") factors of production; 2) technology makes capital more productive than labor; and 3) capital has a strong, positive distributive relationship to growth such that the

[27] *See* LOUIS O. KELSO & PATRICIA H. KELSO, DEMOCRACY AND ECONOMIC POWER 15 (1986) [hereinafter KELSO & KELSO].
[28] See Robert H.A. Ashford, *The Binary Economics of Louis Kelso: A Democratic Private Property System for Growth and Justice*, *available at* http://www.cesj.org/binaryeconomics/binary-cwp1ed.pdf (last visited April 1, 2013) [hereinafter Ashford, *Growth and Justice*].
[29] *See* KELSO & HETTER, *supra* note 17, 58-63.
[30] *Id.* at 39.
[31] Ashford, *Louis Kelso*, *supra* note 26, at 5.
[32] *Id.* at 9.

more broadly capital is acquired, the more it can be profitably employed to increased output, and the more an economy will profitably grow.[33]

**A. Labor and Capital Are Independent**

Conventional economics and Kelso's binary economics disagree on the idea of productivity as it relates to human labor.[34] Many traditional economists believe that there cannot be growth without increases in labor productivity and appear to "view tools or machines as an extension of a person's hand."[35] The analysis declares all growth in output to be founded in labor productivity.

Kelso rejected Adam Smith's theory that reduced the productive input of capital to a function of labor.[36] Kelso believed it was necessary to "examine productiveness, not just productivity."[37] Binary economics attempts to "quantify the proportion of output contributed by total labor input and total capital input."[38] The theory argues that productiveness can be ascertained by comparing the total proportion of the total output with the support of both labor and capital with what labor inputs could have produced alone.[39]

An example will help simplify the important distinction between traditional economic productivity and Kelso's idea of productiveness.[40] Assume a person can dig a hole in one hour by hand. After the invention of the shovel, that same person can dig four holes in one hour.

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[33] Robert Ashford, *Memo on Binary Economics to Attorneys for Women and People of Color re: What Else Can Public Corporations Do for Your Clients?*, 79 ST. JOHN'S L. REV. 1221 (2005).
[34] ROBERT ASHFORD & RODNEY SHAKESPEARE, BINARY ECONOMICS, THE NEW PARADIGM, 28 (1999) [hereinafter ASHFORD & SHAKESPEARE].
[35] *Id.*
[36] Robert Ashford, *Louis Kelso's Binary Economy*, 25 J. SOC. ECON. 10 (1996).
[37] *Id.*
[38] *Id.*
[39] Ashford, *Growth and Justice*, *supra* note 28, at 110.
[40] *Id.*

Traditional economics would state that labor has four times the productivity because four times as much work can be performed in the same period. In binary economics, "the productiveness has changed from 100 percent labor before the invention of the shovel, to 25 percent labor and 75 percent capital input with the shovel." Thus, from the binary economics perspective, the laborer has only one-fourth the productiveness, rather than four times the productivity.[41] Assuming the company made $25 per hole, under a binary economic analysis, after one hour, the worker will have earned $25 and capital will have earned $75. After four hours, the worker's claim would be $100 and capital would have earned $300. Therefore, though labor's claim is the same on a per hour basis, the income earned from each unit of output is decreased after the introduction of the shovel, while the capital owner's compensation significantly increases.

**B. Technology Makes Capital Much More Productive Than Labor**

As scientists and entrepreneurs invent machinery that performs tasks that labor once performed, "the relative number of uneliminated mechanical workers will diminish."[42] Consider an example of a company that owns a building with ten manual elevators and employs ten elevator operators to run them.[43] The company's chief financial officer goes to the company president with a feasibility study showing that at the price of secured debt, the company can reduce overall costs by installing automatic elevators.[44] The study shows that the elevator maintenance costs, plus interests costs, net of standard tax benefits (including depreciation, and research and development expenses), are less than the operator labor costs that would be eliminated. The ten manual elevators are replaced by another ten automatic elevators, and the

[41] *Id.*
[42] KELSO & ADLER, *supra* note 15, at 46.
[43] Ashford, *Louis Kelso*, *supra* note 26, at 11.
[44] *Id.*

ten operators lose their job. Here, the important takeaway in the factor of production analysis is that capital has totally replaced the labor workers' input.

John Locke's labor theory of appropriation states that starting with everything in common, men rightfully appropriated those things with which they mixed their labor power.[45] Kelso believes that going beyond that original appropriation, it is possible to generalize Locke's theory by saying that, "a man's right to acquired property derives from the productive use of such property as he already owns, whether that is his own labor power, his land, or his stock of workable materials and working instrumentalities."[46]

"An objective evaluation of the services of labor through free competition among all relevant factors in production determine the appropriate wages that labor earns."[47] If the increasing productiveness could be attributed to labor, labor would be able to justly claim a larger distributive shares of the total wealth produced.[48] But as technological advances have made machines increasingly more efficient in the production of wealth, the problem of conflict between distributive justice and the welfare of workingmen becomes more and more aggravated.[49]

**C. Capital Has a Strong, Positive Distributive Relationship to Growth**

The most crucial point that Kelso introduced was his remarks regarding binary growth.[50] Generally stated, binary growth stands for the principle that the more broadly capital ownership

[45] GREGORY ALEXANDER & EDUARDO M. PENALVER, AN INTRODUCTION TO PROPERTY THEORY 39 (2012).
[46] See KELSO & ADLER, *supra* note 15, at 56.
[47] *Id.* at 73.
[48] *Id.*
[49] *Id.* at 73-74
[50] The phrase binary growth is synonymous with the statement "capital has a strong, positive distributive relationship to growth."

is acquired by individuals on market principles, the greater the potential for economic growth.[51] Kelso's proposition contradicts the claims of neoclassical economics.[52] Under the neoclassical theory, economic growth results from increases in productivity and investment and decreases in transactions costs, but it makes no difference who owns the capital. Neoclassical economists argue that redistributing capital "merely spread around pieces of the same pie, but it does not increase the size of that pie.[53] They even argue that redistribution may negatively influence capital allocation, resulting in a smaller pie."[54]

But Kelso keenly observed that those who owned capital assets on the individual-microeconomic level have a tremendous impact on macro-economic level.[55] This intuitively makes sense and seems obvious when considering Marx's theory of under consumption. The more capital an individual owns, the greater the ability for that individual to participate in the economy as a producer and consumer. Ashford adds to Kelso's insight by stating, "The more fully each individual provides productive input in the economy not only as a worker but as an owner, the more fully he or she can participate as a consumer, and the larger the economy will be."[56]

This principle becomes even more important as a society becomes industrialized. An industrial nation should be especially aware that individuals should own both capital assets and also earn wages from their labor. If capital ownership is primarily only available to existing owners of capital, then consequently, there will be less consumer demand. Conversely, if an

[51] *See* Ashford, *Growth and Justice*, *supra* note 28, at 104.
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*

economy allows the middle class and poor, who have unsatisfied needs and wants, to acquire capital, "they will spend more money on goods and services, thereby fueling a larger economy than if the capital were acquired by the few rich."[57]

As Marx warned, if capital acquisition is only available for existing owners, the distribution of capital income will be insufficient to support consumption, and growth will be suppressed. Binary economics attempts to solve the consumption problem, but the answer is practical only if the key institutions can be implemented into our economy.

## IV. Implementing a Binary Economy

A binary economy would include many of the same institutions that the Federal Government currently uses to promote economic activity. But instead of a system that rewards existing owners as the current system does, in a binary economy, all people would benefit from the ability to acquire capital with the earnings of capital. The most damaging consequence of our current system-one that links the formation and ownership of new capital to the ownership of existing capital- is the progressive concentration of the ownership of capital.[58] In an economy where capital continues to replace labor in productiveness, the need is for a private property system that enables all people to participate in the market for capital acquisition. Kelso believed that the fundamentals of corporate finance provided that answer.

### A. Corporate Finance

The purpose of corporate finance is to enable corporations to acquire capital assets before it has earned the money to pay for those assets, while simultaneously enabling shareholders to

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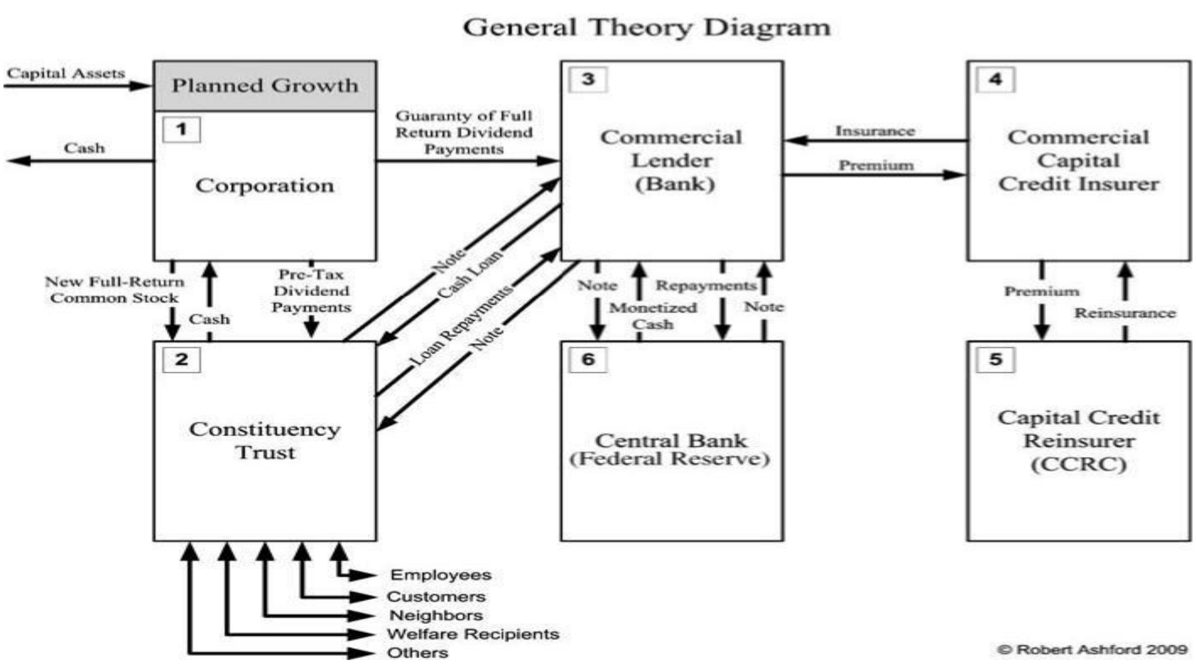
[57] *See* Ashford, *Growth and Justice*, *supra* note 28, at 104.
[58] LOUIS O. KELSO & MORTIMER J. ADLER, THE NEW CAPITALIST 19 (1961).

acquire an equity interest in those assets by paying for them out of the earnings of the assets so acquired.[59] Unfortunately, most people without the necessary collateral to obtain credit are effectively prevented from benefitting from corporate finance.[60] Kelso believed that the benefits of corporate finance to the well-capitalized 10 percent of Americans were a devastating and unnecessary mistake. Thus, he developed a plan to utilize institutions that already exist to expand the benefits of corporate finance to the masses.

### B. The Six Institutions of General Theory

Kelso offered his General Theory as a way to solve our economy's fundamental growth and distributional problem.[61] Figure 1 is a depiction of Kelso's General Theory simplified by Robert Ashford.

Figure 1[62]




59 *See* ASHFORD & SHAKESPEARE, *supra* note 34, at 240
60 *Id.* at 241.
61 *Id.* at 238.
62 Ashford, *The Missing Link*, *supra* note 1, at 95.

It illustrates how institutions can participate profitably in a system of corporate finance that enable people without capital to compete fairly alongside people with capital for the acquisition of capital assets.

The six institutions of a binary economy include: 1) corporations, 2) constituency trusts, 3) banks (lenders), 4) private commercial capital credit insurers, 5) the Capital Credit Reinsurance Corporation and 6) the Federal Reserve (central bank). Though all of these institutions exist today, they only aid existing capital owners; but with appropriate binary legislation, these institutions would provide people without capital to compete on more equal footing with the well-capitalized.[63]

**1. Getting Started: The Company's Business Plan**

The first step in binary financing requires a credit-worthy company to develop a business plan. A credit-worthy capital acquisition plan requires that the capital acquisition is reasonably expected to pay its acquisition cost at a competitive rate and there is sufficient collateral to secure the loan in the event of default on the repayment.[64]

**2. The Constituency Trust**

The second step in binary financing is the establishment of a constituency trust. A constituency trust is a legal vehicle that allows a trustee to make capital acquisitions on behalf of the beneficiaries. The trustee, acting on behalf of the beneficiaries, borrows funds from a bank

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[63] *See* Robert Ashford, *Binary Economics: The Theory That Gave Rise to ESOPs* (2006) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092194 (last visited April 2, 2013).
[64] *See* ASHFORD & SHAKESPEARE, *supra* note 34, at 243.

and invests in common stock of the company called binary stock.[65] Because employee-shareholders will often have limited, if any, experience with the management of capital, nor are they personally supplying any of the credit, capital or assuming any risk of investment failure, trustees provide the beneficiaries with the services of investment professionals which give banks more confidence to make binary loans.

When binary financing is chosen by a company to finance a company's capital needs, a constituency trust uses the funds it borrowed from the lender to invest in binary stock issued by the company.[66] Thus, a company receives the needed cash to make capital acquisitions and the constituency trusts now has an equity interest in the company, represented as binary stock.

Because the ownership interest is considered binary stock, the company is now obligated to distribute all earnings represented by stock to the constituency trust.[67] The acquired stock is utilized as collateral to secure loan and is released after the loan is paid off.[68] In other words, the trustee must first use the earnings the binary stock produces to satisfy the loan repayment before net earnings are available for distribution to the beneficiaries.

**3. Banking in a Binary Economy**

To obtain financing from banks, a company must show that the capital acquisition can pay for itself. The feasibility question analyzes the ability of the proposed capital acquisition to pay for its own acquisition cost in a competitive period, usually three to seven years.[69] Generally, the company provides a plan to the bank projecting the cash inflows and outflows

[65] *Id.* at 245.
[66] *Id.* at 247.
[67] *Id.*
[68] *Id.* at 247-48.
[69] *See id.* at 256.

from the beginning until the point at which revenues from the operations are projected to repay the acquisition debt.[70] If the bank determines that the plan is credit-worthy, then the issue turns to security.

The security question evaluates what collateral is available to the bank if the capital fails to pay for itself.[71] Most banks will not lend even if the company has a credit-worthy plan if the company does not provide an adequate amount of security to protect the bank from potentially significant losses.[72] In conventional debt financing, to satisfy the security issue, a bank typically requires not only a security interest in the assets acquired, but also a pledge of the underlying corporate stock. But, this is where binary financing and conventional debt financing significantly diverge.

**4. Capital Credit Insurance**

Because the terms of binary stock prevent existing shareholders from claims on the earnings of binary stock, they have little incentive to take on risk of business failure; naturally, they would prefer the bank's claim on any default in the binary financing be wholly satisfied without recourse to the equity of existing shareholders.[73] As a result, in a binary financing transaction, the lender would be forced to issue non-recourse loans, which would limit the bank's recovery on default to those assets specifically pledged. If there were no answers to this problem, binary financing would be dead on arrival. Fortunately, Kelso understood this issue and developed the idea of binary capital credit insurance that would act as a substitute for collateral.

[70] ASHFORD & SHAKESPEARE, *supra* note 34, at 257
[71] *See id.*
[72] *See* id.
[73] *Id.*

Kelso's keen insight was to see that risk could be priced by independent private capital credit insurers and included by the lending bank in the cost of borrowing.[74] Robert Ashford added to this vision by noting that all that is needed for "sound insurance pricing is solid, well-documented past experience that fairly reflects the likely future experience."[75]

In a binary financing transaction, the lending bank would search for the best private capital credit insurance. The banks would pay a premium to the capital credit insurer (though they would charge this premium in fees) and the insurer provides the bank insurance against the possibility that the loan is not repaid.

The capital credit insurance solves many of the problems existing shareholders and lending banks have with binary financing transactions. First, the company's revenues are protected from action by the lender, which protects the existing shareholders from the risk of loss from business failure. Second, the bank is insured for any losses resulting from the business' failure to repay the loan.

But capital credit insurance would not protect the constituency trust from losses. Thus, although the binary shareholders receive a tremendous benefit in investing in capital before acquiring that capital, if their binary investment fails to pay for itself, they will end up losing their investment in the trust.[76] Importantly, managers of the company and the trustee will be held responsible for failed investments and will find it more difficult to receive binary financing in the future.[77] Also, although banks will be insured for binary losses, their future eligibility to

[74] *See* KELSO & KELSO, *supra* note 27, at 41.
[75] ASHFORD & SHAKESPEARE, *supra* note 34, at 259.
[76] *Id.* at 261 n. 164.
[77] *Id.*

participate in binary financing will be affected by records of their binary lending record.[78] Thus, banks could be disqualified from receiving binary financing if continually out-performed by their peers.

The establishment of credible and effective capital credit insurers is the most critical step to the establishment of binary financing. A binary economy depends upon the proposition that the risk of capital acquisition traditionally determined by adequate security in the form of corporate equity, can instead be priced as insured risk premium and included in the cost of borrowing. Robert Ashford believes that it can and states, "Just as every driver must pay an insurance premium, with the amount varying according to factors such as age, make of car, and previous driving record, so must binary financing insurance be based on the risk involved in the financing."[79]

**5. Capital Credit Reinsurance Corporation**

As binary growth creates an expanding US economy, capital credit insurers will seek reinsurers to mitigate their risk. Reinsurance is the practice of insurers transferring portions of risk portfolios to other parties by some form of agreement in order to reduce the likelihood of having to pay a large obligation resulting from an insurance claim.[80] The intent of reinsurance is for an insurance company to reduce the risks associated with underwritten policies by spreading risks across alternative institutions.[81]

[78] *Id.*
[79] *Id.* at 263.
[80] DICTIONARY OF FINANCE AND INVESTMENT TERMS 577 (7th ed. 2006).
[81] ASHFORD & SHAKESPEARE, *supra* note 34, at 264 n.166.

Kelso believed that in the initial stages of a binary economy, it would be important for the government to establish the Capital Credit Reinsurance Corporation, a government agency, to serve as a reinsurer for the private capital credit insurers.[82] Though opponents would assert that creating a government agency to reinsure private business is inevitably making the taxpayer an underwriter of private companies, Kelso stated that the federal government has already assumed the risk of the aggregate failure of America's top companies and that the government assumes no greater risk in a binary economy.[83]

**6. The Federal Reserve's Monetary Policy and the Cost of Binary Financing**

Traditional financing has created a system where the well-capitalized enjoy an overwhelming advantage in the capital markets because only they have the collateral to secure the credit which enables them to acquire new wealth-creating capital assets.[84] Kelso envisioned the central bank and monetary policy as the solution to leveling the playing field for all participants.[85] He proposed that the central bank be authorized to discount the promissory note issued by the borrowing trust. Kelso suggested that the discount rate should be .25 percent, representing the maximum necessary cost to the central bank for administering the discount operations. Thus, the lending bank can tender the note and receive 99.75 percent additional cash for new lending.

The bank serves as a conduit for binary financing coming from the central bank.[86] Because the money is coming from the central bank and not the existing owners of the bank, the

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[82] *Id.* at 264.
[83] *Id.* at 266.
[84] *See* KELSO & KELSO, *supra* note 27, at 39.
[85] ASHFORD & SHAKESPEARE, *supra* note 34, at 267.
[86] *Id.*

only market change the lending bank can fairly charge is the cost of screening, administering, policing and collecting.[87] The banker's spread- the bank's average gross revenues for money lent minus the cost of the money to the bank- should be the only cost which is usually around 2%.

Therefore, the total cost for the company and the trust would be:

- Capital credit insurance 2-3%
- Central bank's administrative cost .25%
- Lending bank's administrative cost 2-3%
    - Total 4-6.25% [88]

The six institutions mentioned above provide the foundation for a binary economy. But we have already experimented with the idea of broadening the number of capital owners in America. Kelso teamed up with Senator Russell Long and legislation was passed in 1974 which created the Employee Stock Option Plan.[89]

**C. The Employee Stock Option Plan ("ESOP"): A Binary Economics Case Study**

Kelso understood that as technology advanced, society became more automated in its use of capital to produce goods, which caused the returns of capital to increase, while diminishing the return to labor.[90] Kelso's answer: the Employee Stock Option Plan ("ESOP").[91] Kelso

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[87] *Id.*
[88] *Id.* at 269.
[89] *See* Michael E. Murphy, *The ESOP at Thirty: A Democratic Perspective*, 41 WILLAMETTE L. REV. 655, 657-58 (2005).
[90] KELSO & KELSO, *supra* note 23, at 15.
[91] *Id*. at 59. (Kelso had many other ideas for his binary economy. The other seven type of plans Kelso introduced include: 1) the Mutual Stock Ownership Plan (MUSOP), 2) Consumer Stock Ownership Plan (CSOP), 3) the

observed three major benefits from employee ownership: 1) increased employee participation in the work place, 2) it reduced the likelihood that employees would slack off on the job, and most importantly, 3) the ESOP would increase employee-shareholders' personal wealth.[92]

The most valuable feature of the ESOP is its ability to acquire, in trust for employees, stock in their companies on nonrecourse credit, and to pay for it with the stock's pretax income.[93] An ESOP that borrows funds to acquire company stock is called a leveraged ESOP.[94] In a leveraged ESOP, an employer establishes a trust to hold stock purchased from the company.[95] The trust obtains a loan from the bank and uses the money to purchase the stock.[96] Generally, the trust is administered by a committee created by the board of directors and the committee is a fiduciary to the employee-shareholders.[97] The stock serves as collateral for the loan and any dividends are used to pay back the principal and interest on the loan.[98] As with other contribution plans, employers makes cash contributions to the ESOP.[99] Gradually, as the loan is paid off, the stock held in trust is proportionally released from its security obligation and held for

General Stock Ownership Plan (GSOP), 4) the Individual Capital Ownership Plan (ICOP), 5) the Commercial Capital Ownership Plan (COMCOP), 6) the Public Capital Ownership Plan (PUBCOP), and 7) the Residential Capital Ownership Plan.).

[92] KELSO & ADLER, *supra* note 15, at 52.

[93] Ashford, *Growth and Justice*, *supra* note 28, at 105.

[94] Joel Hobbs, *Employee Stock Ownership Plans (ESOPs), Including S Corporation ESOPs and Anti Abuse Measures*. 8-6, *available at* http://www.irs.gov/pub/irs-tege/epchd804.pdf (last visited April 20, 2013).

[95] *See id.*

[96] *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, *Fundamentals of Employee Benefit Programs* ch. 9, 93-100 (6d ed. 2009), *available at* http://www.ebri.org/pdf/publications/books/fundamentals/2009/09_ESOPs_RETIREMENT_Funds_2009_EBRI.pdf (last visited April 23, 2013).

[97] *Id.*

[98] KELSO & KELSO, *supra* note 27, at 62.

[99] Korff, *supra* note 19, at 444.

the benefit of the employee-shareholders.[100] To encourage the use of ESOP plans, there are tax benefits for both the company sponsoring the plan and the bank providing the credit.[101]

Currently, there are approximately 10,000 ESOPs in the United States, covering 10.3 million employees, which is roughly 10 percent of the private sector workforce.[102] Federal legislation has had a tremendous impact, both for good and bad, on ESOP growth rates.

Chart 1: Minimum number of companies with ESOP.[103]

| **Year** | **Minimum Number of Companies With ESOP** | **Participants** | **Assets** | **Plan Terminations** | **Proportion of Union Companies** |
|---|---|---|---|---|---|
| 1975 | 1,600 | 250,000 | NA | NA | NA |
| 1980 | 4,000 | 3,100,000 | NA | NA | NA |
| 1990 | 8,100 | 5,000,000 | NA | NA | NA |
| 1993 | 9,200 | 7,500,000 | NA | NA | NA |
| 1999 | 10,700 | 6,320,000 | $340,200,000,000 | 7.3% | NA |
| 2000 | 10,500 | 6,400,000 | $315,000,000,000 | 9.7% | 1.4% |
| 2005 | 10,000 | 11,700,000 | $717,500,000,000 | 5.4% | 1.8% |
| 2010 | 10,000 | NA | NA | NA | NA |
| 2011 | 10,900 | NA | NA | NA | NA |

During the first 15 years that ESOPs were recognized by the federal government, ESOP programs grew from 1,600 in 1975 to just over 8,000 in 1990. However, in 1989, leveraged ESOPs came under congressional scrutiny under the Omnibus Budget Reconciliation Act of

100 KELSO & KELSO, *supra* note 27, at 64.
101 *Id.*
102 THE ESOP ASSOCIATION, *ESOP Statistics*, *available at* www.2.esopassociation.org (last visited April 1, 2013).
103 THE NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, *A Statistical Profile of Employee Ownership* (2012), *available at* http://www.nceo.org/articles/statistical-profile-employee-ownership (last visited April 3, 2013).

1989 (“OBRA 89”).[104] Prior to OBRA 89, qualified lenders could exclude from gross income 50 percent of the interest earned on ESOP loans.[105] This benefitted not only banks, but also the employees participating in the plan as lower interest rates were provided to the ESOP. Subsequent to OBRA 89, lenders only qualified for the tax benefits if three conditions were met: 1) after the acquisition, the ESOP owned more than 50 percent of the total value of all outstanding stock of the corporation; 2) the loan was not for more than 15 years; and 3) voting rights were passed through to participants (meaning that the trustee could no longer be allowed to vote for the interest of the employees).[106]

Congress should repeal the OBRA 89 because it obviously was responsible for stopping the momentum that ESOPs enjoyed throughout the 1980s. Of the 10,000 employers who have adopted ESOPs for their employees, only 330[107], or three percent, are publicly traded companies.[108] More than any other type of business organization, public companies, because of their tremendous advantage in economies of scale, large capital holdings and prominent national reputations, have the ability to provide their employees a conservative, yet lucrative investment opportunity. Also, pubic companies are required to file certain annual reports with the SEC on their form 10k. These compelled disclosures would allow for more transparent reporting on the benefits and risks of ESOPs.

But it is highly unlikely that public companies will adopt leveraged ESOPs because most shareowners will be unwilling to allow the ESOP to acquire more than 50 percent of the total

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[104] THE EMPLOYEE BENEFIT RESEARCH INSTITUTE, *Employee Stock Ownership Plans*, *available at* www.ebri.org/pdf/publications/books/fundamentals/fund09.pdf (last visited April 1, 2013).
[105] *Id.*
[106] *Id.*
[107] There are nearly 15,000 public companies registered in the United States.
[108] THE ESOP ASSOCIATION, *supra* note 102.

outstanding stock in the corporation, especially when voting rights must be passed through to participants. Existing shareholders would immediately lose power during annual voting and employee-stockowners would be able to demand higher salaries, rather earned or not. Thus, because the corporation will not adopt the policies required in order for banks to obtain qualified lender status, banks will have little reason to provide leveraged ESOP credit to the public company.

Therefore, Congress should eliminate, or at a minimum, reduce the total percent of stock in the corporation the ESOP must own for the loans to obtain qualified lender status. Alternatively, Congress could eliminate the requirement that voting rights must pass through to participants in the ESOP, allowing for the trustee to vote as a fiduciary of the ESOP participants.

While the OBRA 89 has been a nightmare for ESOP proponents, the Small Business Job Protection Act of 1996 ("SBJPA") has been a tremendous step forward. The SBJPA allowed S corporations to adopt ESOPs. S corporations offer far greater opportunities for tax savings than are available to C corporations.[109] To illustrate the difference, if 50 percent of an S corporation is owned by the ESOP, then 50 percent of the earnings of the company will be attributable to the ESOP and will be exempt from taxation.[110] If the ESOP owns 100 percent of the stock of an S corporation, the entire earnings of the company will be tax-exempt.[111]

A closer look at the current financial crises reaffirms Kelso's opinion that ESOPs would benefit both the employer and the employee. A 2010, University of Chicago study showed that

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[109] *Dividends Versus Distributions In ESOP Planning*, CHANG, RUTHENBERG AND LONG P.C., (2013), *available at* http://www.seethebenefits.com/showarticle.aspx?show=3448 (last visited on April 5, 2013).
[110] *22 ESOP Myth & Misconceptions*, MENKE & ASSOCIATES, INC., (2009), *available at* http://www.menke.com/archives_articles/22-myths-and-misconceptions-3-31-09.pdf (last visited April 20, 2013).
[111] *Id.*

employees of ESOPs were laid off at a rate of four times less than employees of conventionally-owned companies.[112] This figure not only benefitted the employee and the employer, but also the federal government. Data from the General Social Survey (GSS) shows the savings from the low layoff rate of ESOP participants was 13.7 billion in 2010, almost 14 times more than the estimated one billion a year tax expenditure attributed to the special laws promoting ESOP creation and operation.[113]

In addition to job security, the data from the University of Chicago study also indicates that employee satisfaction rises when companies participate in an ESOP. Thirteen employees with stock ownership planned to leave their companies in the coming months, whereas 24 percent of employees without employee ownership plans planned to depart.[114] This provides not only a healthy working environment for workers, but the benefits of employee retention for company management. Evidence also provides that ESOPs promote greater attachment, loyalty, willingness to work hard and most importantly, improves the overall performance of firms.[115]

The most comprehensive study of the performance of ESOPs was conducted by Douglas Kruse and Joseph Blasi of Rutgers University (the "Rutgers Study").[116] The Rutgers Study obtained files from Dun and Bradstreet[117] on ESOP companies that had adopted plans between 1988 and 1994. They matched 1,100 ESOP companies with 1,100 companies who had not adopted ESOPs that were comparable in size, industry and region and followed the companies

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[112] THE ESOP ASSOCIATION, *supra* note 102.
[113] *Id.*
[114] *Id.*
[115] SHARED CAPITALISM AT WORK: EMPLOYEE OWNERSHIP, PROFIT AND GAIN SHARING AND BROAD-BASED STOCK OPTIONS 12 (Joseph R. Blazi, Richard B. Freeman and Douglas L. Kruse ed., The University of Chicago Press, National Bureau of Economic Research) (2010) [hereinafter *The Rutgers Study*].
[116] *Id.*
[117] Dun & Bradstreet, Inc. is a public company that licenses information on businesses and corporations for use in credit decisions, business-to-business marketing and supply chain management.

for a decade.[118] The Rutgers Study showed that ESOPs increased sales by 2.4 percent per year.[119] The Rutgers Study, like the Chicago study, showed that ESOP companies stay in business longer. Of the companies surveyed, 77.9 percent of ESOP companies remained in business, while only 62.3 percent of non-ESOP companies survived.[120]

Chart 2: Difference in Post-ESOP to Pre-ESOP Performance[121]

| | |
|---|---|
| Annual Sales Growth | +2.4% |
| Annual Employment Growth | +2.3% |
| Annual Growth in Sales per Employee | +2.3% |

Opponents argue that ESOPs are dangerous because they prevent diversifying risk by requiring the employee to own stock in the same company they work for. But the Rutgers Study showed that it is substantially more probable that ESOP companies have other retirement-oriented plans, such as 401k plans or defined benefit plans.

Congress should create regulation that encourages companies to adopt both leveraged ESOPs and 401k plans. The two distinct plans would allow for employees to obtain the benefits of a diverse portfolio by contributing to their retirement in a 401k plan, while simultaneously allowing employees to earn supplemental income from their ESOP benefits. Congress should eliminate the 10 percent tax penalty imposed on employees who sell shares from their ESOP accounts before the age of 59. The elimination of the tax penalty would promote a more

118 *The Rutgers Study*, *supra* note 115, at 12.
119 *Id.*
120 *Id.*
121 THE NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, *Research on Employee Ownership, Corporate Performance, and Employee Compensation*, available at http://www.nceo.org/articles/research-employee-ownership-corporate-performance (last visited April 6, 2013).

expansive economy by encouraging consumer spending, while maintaining adequate and responsible retirement accounts for employees through the companies' 401k plans.

**V. Conclusion**

Congress should act boldly and pass legislation that will encourage employers of both public and private companies to adopt leveraged ESOPs. Kelso's binary economic model provides America the opportunity to create wealth for the 90 percent without taking from the richest 10 percent. By developing a more dynamic economy, a greater number of consumers will have the ability to purchase goods, tax rates will lower as a result of more people earning money from labor and capital assets, and tensions between rich and poor will diminish.

The alternative, permitting only existing capital owners to benefit from the principles of corporate finance, is to continue to permit a serious wealth gap problem in America. Politicians have focused their efforts too much on the idea of every American owning their own home. That narrow approach to ownership has obviously failed. As a people who value freedom and a market based economy, we should heed Marx's warning about under-consumption and develop bolder ideas that will provide the many with more.

The institutions to support a binary economy are already in place. We have already seen the potential benefits of a binary economy with ESOPs initiated by approximately 10,000 companies across America. Every company that qualifies should seek to benefit themselves, their employees, and the United States government by adopting an ESOP and a 401k plan. The 401k plan could continue to serve as a retirement vehicle, while the ESOP could distribute extra spending money to employees as soon as the bank has been repaid on the loan. This would give employees with more money to spend which will increase economic growth in America.

With the right legislation, the ESOP could be to modern day Americans what the Homestead Act was to the brave who traveled west in 1862. Binary economics provides us the opportunity to re-establish the principles that are founding fathers knew was critical for a successful democracy- the broad distribution of property throughout society. It could have a powerful impact on our economic system as a whole and reaffirm to every citizen that America is still the land of opportunity.