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Broadening the Right to Acquire Capital with the Earnings of Capital: The Missing Link to Sustainable Economic Recovery and Growth

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ABSTRACT

This article presents a proposal to broaden the right to acquire capital with the earnings of capital as a means of promoting sustainable economic recovery and growth. It would open the markets for real and financial capital acquisition more fully and competitively to poor and working people (1) to distribute more broadly the earnings of capital and (2) to profitably employ more capital and labor.

The article notes that both the recession and the strategies advanced to promote economic recovery may be viewed as responses to the prospect of inadequate present and future earning capacity of both consumers and producers (1) to purchase what can physically be produced and (2) to repay existent and anticipated debt obligations undertaken to stimulate the economy.

To increase the prospects of sufficient, sustainable earning capacity, the approach advanced in this article is to extend to all people the same protections and benefits presently provided by government that facilitate market transactions whereby capital is acquired with the earnings of capital primarily for people in proportion to their wealth.

Although in theory, all people in a market economy are able to acquire capital with the earnings of capital, reliable empirical data reveal that as a practical matter, the major determinant of the ability of individuals to acquire capital with the earnings of capital is the existing distribution of capital ownership.

The theory of "binary" economic growth (on which the proposal advanced in this article is based) holds that the market return on capital depends not only on the wage rate, the scarcity of capital, its marginal productivity, and the interest rate, but also depends on the distribution of capital acquisition with the earnings of capital. The prospect of a broader distribution of capital acquisition with the earnings of capital carries with it the prospect of more broadly distributed earning capacity in future years, which in turn will provide the market incentives to profitably employ more capital and labor in earlier years. The idea that the broader distribution of capital acquisition with the earnings of capital will promote growth is not found in any of the widely accepted theories and models of economic growth such as those proposed by Schumpeter, Solow, Roemer, and Lucas.

By opening to all people the institutions of corporate finance, banking, insurance, government loans and guaranties, and monetary policy (the very institutions presently relied upon by the Federal Government to stimulate the economy) the practical ability to acquire capital with the earnings of capital can be more broadly extended to all people, and a more level and competitive economic playing field can be established, with the result that greatly enhanced prospects for greater and more broadly distributed earning capacity and growth can be reasonably expected and realized by all.

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I. INTRODUCTION

The current global recession reveals a substantial decrease in profitable production for an extended time despite the physical and technological capacity to produce more at lower unit cost. The collapse in real estate values, stock-market plunge, credit freeze, lay-offs, down-sizings, mergers, and business failures that have occurred, and the government actions either already undertaken and/or planned to revive the economy (including

1. investment in banks;
2. loans and loan guarantees
3 insurance and reinsurance;
4. purchase of toxic mortgages;
5. reduction in interest rates and taxes;
6. increased monetization; and
7. direct spending)

can be seen as a response to the prospect of inadequate earning capacity of both consumers and producers to purchase what can physically be produced and to repay existent and anticipated debt obligations.

The government strategies reflect a political compromise intended to promote (1) capital investment (2) jobs, (3) private consumption, and (4) government spending. The incentives for private capital investment are structured to facilitate capital acquisition with the earnings of capital primarily for people in proportion to their existing wealth.

The missing element in these strategies (that could easily be added without extra cost to anyone) is to broaden the right to acquire capital with the earnings of capital– i.e., to provide poor and middle class people with practical, competitive access to the same institutions of corporate finance, banking, insurance, loans and guaranties, and favorable tax and monetary policy (presently routinely provided to people primarily in proportion to their existing wealth) so that poor and middle class people can also enhance their earning capacity by acquiring capital with the earnings of capital and thereby enhance the prospects of sustainable economic recovery and growth.

To explain how the same strategies now being pursued to promote economic recovery can be simultaneously employed to broaden the right to acquire capital with the earnings of capital, and thereby enhance the prospects of sustainable economic recovery, this article offers an enriched understanding of production, distribution, and growth based on binary economics.[1]

II. OVERVIEW OF BINARY ECONOMICS

Binary economics rests on three fundamental, related propositions

(1) Labor and capital are "independent" or ***"binary"*** factors of production;

(2) Technology makes capital much more productive than labor; and

(3) Capital has a strong, positive, ***distributive*** relationship to growth, such that the more broadly capital is acquired with the earnings of capital, the more it can be profitably employed to increase production. (The principle of binary growth.)

(As used in binary theory, "capital" includes land, animals, structures, and machines – anything capable of being owned and employed in production. It does not include "financial capital," which is a claim on, or ownership interest in, real capital.)

Productivity and Productiveness: Binary economics distinguishes between

"productivity" (the ratio of the output of all factors of production, divided by the input of one factor, usually labor) and

"productiveness" (which retrospectively means "work done" and prospectively means "productive capacity").

The "independent productiveness" of labor and capital can be illustrated by considering any sort of work: e.g., sawing boards and hauling sacks. A person can saw ten boards per hour with a hand saw, and one hundred boards per hour with a machine saw. Working with a machine saw rather than a hand saw, the worker can saw ten times as many boards in the same time and therefore has become ten times as productive and has ten times the productivity. But when sawing each board with the machine saw, the worker is doing much less work. Per unit of production, labor productiveness has decreased and capital productiveness has increased.

The independent productiveness of capital is more clearly revealed in the work of hauling sacks: a person can haul one sack one mile in one hour and is exhausted; (1) with a horse, ten sacks can be hauled four times as far (yielding a forty-fold increase in production) and (2) with a truck, five hundred sacks can be hauled forty times as far (yielding a twenty thousand-fold increase in production). In terms of productiveness, the horse and truck are doing essentially all of the extra work.

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[1] For an analysis of binary economics as a distinct economic paradigm, see"Louis Kelso's Binary Economy," Volume 25 *Journal of Socio-Economics*, pp. 1-53 (1996) and *Binary Economics: the New Paradigm*, (1999) with Rodney Shakespeare (University Press of America).

Thus, the binary approach treats capital and labor as *independent (i.e., binary)* productive variables, and recognizes the distinct work done by each. The concept of independent productiveness does not negate the fact that both capital and labor are generally needed to complete specific kinds of work, or the fact that labor is needed to invent, design, create, install, operate, maintain, store, repair, manage, and finance capital. But the labor work involved in inventing, designing, creating, installing, operating, maintaining, storing, repairing, managing, and financing capital is not the work of the capital itself.

Six Powers of Capital: Based on its "independent productiveness," capital has six powers important to production, distribution, and growth. Capital can

(1) replace labor (by doing work formerly done by labor);
(2) vastly supplement the work of labor by doing much more of the kind of work that humans can do;
(3) do work that labor alone can never do (e.g., elevators lift tons hundreds of feet in seconds; airplanes fly; scientific instruments and chemical reactions create computer chips that cannot be made by hand; fruit trees make fruit while all farmers do is assist in the process);
(4) work without labor (e.g., washing machines, automatic bank tellers, gasoline dispensers, vending machines, automated factories, and fruit-bearing trees);
(5) pay for itself out of its future earnings (the basic rule of business investment); and
(6) distribute income roughly equal to the price of its output

Productiveness, Distribution, and Growth: Although each of these powers contributes to growth, only the first involves the substitution of capital for labor. Capital's contribution to growth involves much more than increasing the productivity of the people who work with it: Increasingly capital is doing ever more of the work. *The economic imperative is generally to produce more with more productive capital and less labor*. Per unit of output, although capital may be seen to concentrate higher productivity into fewer workers, as the general rule, the primary effect of technological advance is to make capital more productive than labor and thereby to replace and vastly supplement labor productiveness with ever greater capital productiveness. Moreover, *by virtue of its increasing productiveness, capital provides an increasing capacity to distribute income and leisure.*

Conventional Economics Compared: For Adam Smith, (1) the primary role of capital is to make labor more productive, and (2) per capita economic growth is the result of increases in human productivity. Smith reasoned that higher productivity allowed for the profitable employment of more people, the payment of higher wages, the distribution of more demand, and the investment in more capital which in turn would promote more of the same. But *there is nothing in Smith's analysis that views the broader distribution of capital acquisition as a second, and potentially greater and more sustainable means of distributing demand.*

Within Smith's system, things are worth the work people are willing to do to acquire them, and the profitability of capital depends on the wages needed to employ workers and the scarcity of capital, but not on the distribution of capital acquisition. Keynes continued this logic by reducing the economy to three fundamental variable: time, money and labor.[2] According to Smith and Keynes, capital is a dependent variable, and the distribution of its acquisition, in and of itself, will not promote growth unless it positively affects human productivity. Accordingly, whether capital is broadly or narrowly acquired simply does not matter, and so the right to acquire capital with the earning of capital is not important as means of promoting economic recovery. Although taking issue with other aspects of Smith's analysis, like Keynes, the founders of subsequent economics schools (e.g., Karl Marx, William Stanley Jevons, Carl Menger, Alfred Marshall, and Milton Friedman) did not disagree with this aspect of Smith's fundamental theory of production and growth.

Binary Growth: Because present demand for capital goods is dependent on demand for consumer goods in a future period, according to binary economics, a voluntary pattern of steadily broadening acquisition promises more production-based consumer demand in future years and therefore more demand for a fuller employment of labor and capital in earlier years. Thus, a broader distribution of capital acquisition and income strengthens the promise of capital to pay for itself with its future earnings, makes profitable the employment of more capital and labor, and enhances the prospects of sustainable economic recovery.

Therefore, the return on capital is related not only to its scarcity and the wage rate (as Smith maintained), the marginal productivity of capital (as per neoclassical growth theory), and the interest rate (as Keynes added), *but also to the increasing productiveness of capital and the distribution of its acquisition.* The positive relationship between the distribution of capital acquisition and growth is not based on the behavioral premise that people will work more productively if they own more or have an ownership stake in their employer. Such productivity gains are independent of binary growth. Rather, the unique binary premise is that the promise of broader capital acquisition, *in and of itself,* will cause the fuller employment of existing capacity and greater growth. The idea that the broader distribution of capital acquisition with the earnings of capital will promote growth is not found in any of the widely recognized theories and models of economic growth such as those A proposed by Schumpeter, Solow, Roemer, and Lucas.[3]

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[2] "It is preferable to regard labour, including of course, the personal services of the entrepreneur and his assistants, as the sole factor of production, operating in given environment of technique, natural resources, capital equipment and effective demand. This is why we have been able to take labour as the sole physical unit which we require in our economic system, apart from units of money and of time." Keynes, *General Theory of Employment, Interest and Money*, Harcourt, Brace & World, Inc. (1936) pp. 213-214.

[3] See e.g., Schumpeter, Joseph, *Capitalism, Socialism, and Democracy,* Harper (1942, 1950), and The Theory of Economic Development, Harvard University Press (1911, 1934); Solow, Robert M., "A Contribution to the Theory of Economic Growth", Quarterly Journal of Economics.,Vol. 70 (1) pp. 65-94 (1956) and "Technical Change and the Aggregate Production Function", Review of Economics and Statistics, Vol. 39, pp. 312-20 (1957); Roemer, Michael, Malcolm Gillis and Dwight H Perkins, *Economics Of Development,* Norton (1956); and Lucas, Robert and Thomas J. Sargent, *Rational Expectations and Econometric Practice,*

Productiveness, Prices, Values and Efficiency: A broader distribution of capital acquisition also affects price and value. As long as most people derive little or no income from capital acquisition, most consumer goods will be worth the work people are willing to do to acquire them. However, people can express value not only by the work they do but also by the work they let their capital do. Compared to the person with no horse, to the person who owns a horse, many more sacks are worth hauling; and the economy of sack-hauling will grow as horse (and truck) acquisition becomes more broadly distributed. In an economy in which the institutions that facilitate capital acquisition with the earnings of capital are opened more broadly, the value of goods is not limited to the work people are willing and able to do by way of their labor, *but also includes the work they are willing and able to let their capital do.*

Moreover, the willingness of laborers to work at a given wage depends on their competitive opportunity to acquire capital with its earnings and then receive its full net return. Accordingly,

(1) the technical relationship used in the theory of marginal productivity that governs conventional understanding of the relative employment of capital and labor in production and

(2) the factor income shares derived from production

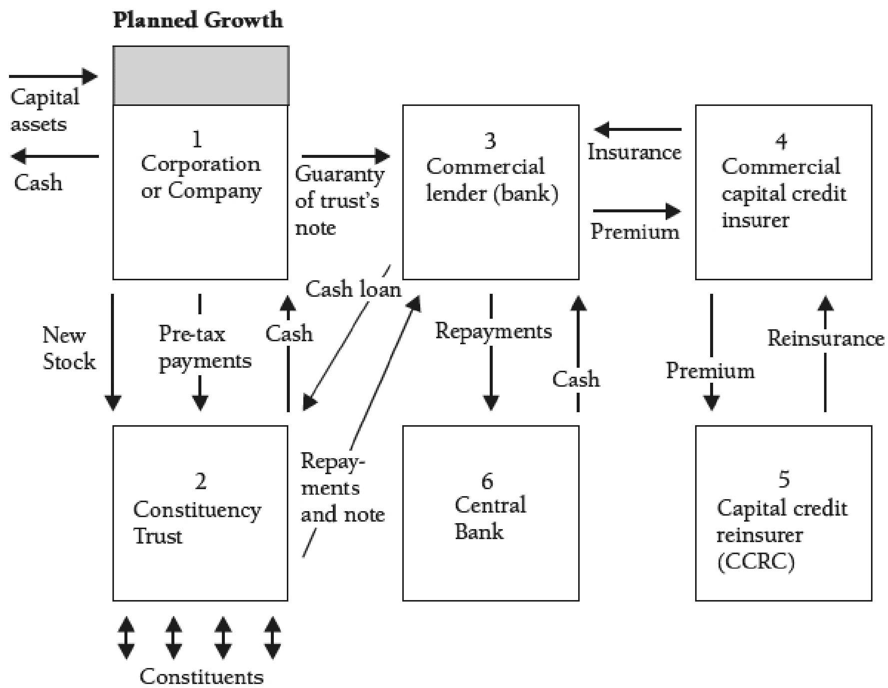
are significantly dependent on the distribution of capital acquisition with the earnings of capital. From a conventional economic perspective, in terms of its impact on pricing, capital/labor substitution, employment, and factor income shares, the distribution capital acquisition is either irrelevant or of only minor consequence.

III. A PROPOSAL TO BROADEN THE RIGHT TO ACQUIRE CAPITAL WITH THE EARNINGS OF CAPITAL AS A MEANS OF PROMOTING SUSTAINABLE ECONOMIC RECOVERY

Figure 1depicts (1) a single binary financing transaction and (2) the aggregate of all such transactions within an economy. It relies on the same institutions that the Federal Government is presently using to promote economic recovery, but does so in a way that can practically include all people in the process of capital acquisition with the earnings of capital. The implementation of this proposal requires no transactions; but it provides a more open system of property rights to enable market participants voluntarily to price the value of broader capital acquisition.

University of Minnesota Press (1981).

Figure 1
General Theory Diagram



Source: From Ashford and Shakespeare (1999, p. 237).

1. Federal law would authorize credit-worthy corporations to establish tax-exempt "constituency trusts" empowered to borrow funds and acquire "full-return" common shares of stock from participating corporations for the benefit of employees, consumers, and neighbors of the participating companies, as well as for the benefit of welfare recipients and other poor and working people,

2. On the strength of the corporation's guarantee to distribute the anticipated profits of the capital acquired, the corporate common shares of stock to be acquired by the loan, and market-priced, commercial capital credit loan insurance as a substitute for collateral, the commercial lender loans funds to the trust in return for a promissory note.

3. The trust invests in "full-dividend" common shares of the corporation at fair market value. These shares pay their full return (net of reserves for depreciation, research, and development to maintain the competitive productive capacity of the capital) first to repay the capital acquisition loan and then to provide capital source income to supplement wages and welfare.

4. Because the corporation is required to pay out all earnings on the binary shares, it is not taxed on that corporate income.

5. With the cash received for the issuance of its stock, the company (a) makes the investment and (b) (if all goes according to plan) distributes the income earned on the capital investment to the constituency trust which uses the funds to repay the loan obligations and then distributes all net earnings to the beneficiaries.

6. Consistent with necessary monetary discipline, the Federal Reserve is authorized to discount the trust's outstanding promissory note at its administrative cost.

7. Based on experience with present bank loan-service charges, insurance charges of the Federal Housing Administration, and the administrative costs of the Federal Reserve, the cost of borrowing to the constituency trust has been estimated at approximately at less than 5% per year, consisting of
    1. 2% bank service charge,
    2. 2% for the capital credit insurance and
    3. 1/4% for the Federal Reserve's administrative costs.[4]

The establishment of a binary economy is accomplished as a legal matter entirely through traditional and largely well-settled means: by the revision of a few national laws related to banking, corporations, employment, insurance, and taxation, and by the reliance on traditional corporate, trust, financial, and insurance principles and institutions.

Although these changes may seem substantial, they merely open to all people the institutions of corporate finance (which enables corporations to acquire capital before they have earned the money to pay for it, and which enables existing owners to become richer on future corporate earnings even as they sleep). These are the same capital acquisition opportunities that are presently being employed to promote economic recovery but in ways limited to people primarily in proportion to their existing wealth. This proposal to broaden the right to acquire capital does no more than better enable poor and working people also to acquire capital with the earnings of capital and thereby to supplement their labor earning capacity increasingly with capital earning capacity, just as richer people presently are better able to do.

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[4] Kelso, Louis O., and Patricia Hetter, pp 70-73, 108. (1986). *Democracy and Economic Power: Extending the ESOP Revolution through Binary Economics*. Cambridge, MA: Ballinger Publishing Co.

IV. PROJECTING BINARY GROWTH

The growth effects of the approach set forth above can be analyzed by considering America's three thousand largest credit-worthy companies. At diminishing unit costs, most of these companies can profitably produce much more of the goods that people would purchase if they had the earning capacity to do so.

Presently, almost all capital acquired by these corporations is acquired with the earnings of capital, and much of it is acquired with borrowed money.[5] At the same time, the ownership of this corporate wealth is highly concentrated: Approximately 1% of the people own 50% of the wealth and 10% own 90% of the wealth, leaving 90% owning little or none.[6] Thus, capital returns its value at a rate reflective of its long-term (suppressed) earning capacity as it buys itself primarily for a small minority of the population.

If members of the poor and middle classes are enabled to compete with existing owners for the acquisition of corporate shares representing the capital requirements of credit-worthy companies, they would bring to the corporate bargaining table a chip not possessed by richer people: a pent up appetite for the necessities and simple luxuries of life that richer people have long enjoyed from capital income. After the acquisition debt obligations are repaid, the distributed earnings of capital acquired by members of the poor and middle class will create more production-based consumer demand than if that capital had been acquired by richer people. If acquired by richer people, more of the capital earnings would seek investment opportunities but in the context of weaker consumer demand.

If the techniques of corporate finance presently used to enable existing owners to acquire capital with the earnings of capital were opened competitively to all people then, the present demand for capital investment and employment would increase in anticipation of the broadening distribution of capital income to poor and working people with unsatisfied consumer needs and wants.

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[5] During the fifteen year period from 1989 through 2003, in the case of major Amrican companies, the sources of funds for capital acquisition, in approximate terms, reveal that annually retained earnings accounted for at least 70% and more usually 80% of the capital acquisition. Borrowing accounted for almost all of the rest. Sale of stock as a source of funds capital acquisition never exceeded 5% and was negative in most years. See Richard A. Brealey & Stewart C. Myers, Franklin Allen *Principles of Corporate Finance* Chapter14, pp 561-563 3rd edition, 2004). *Stock Market Pricing and Securities Regulation*, (87 *Mich. L. Rev.*, 613 at 648, 1988).

[6] Edward N. Wolff, *Top Heavy: A Study of Increasing Inequality in America* (New York, Twentieth Century Fund, 1995) and Edward N. Wolff, "How the Pie is Sliced: America's Growing Concentration of Wealth," *The American Prospect*, No. 22, (Summer 1995), pp. 58-64.

Figure 2, set forth below, illustrates the growth-sustaining feature of an ownership-broadening economy.

Figure 2

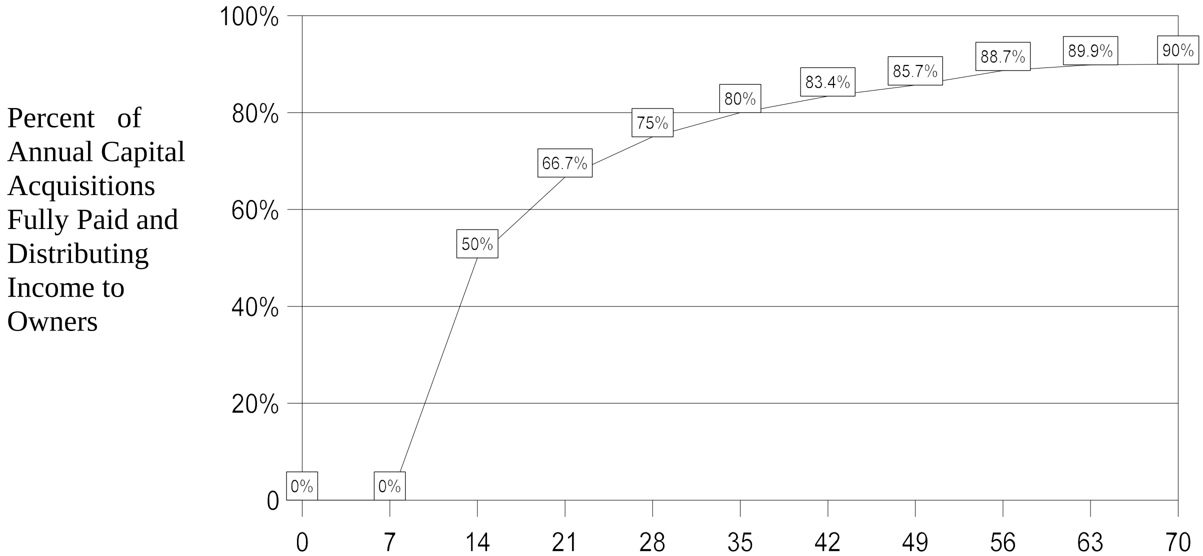

Figure 2 assumes a seven-year cost recovery period for capital investment. It shows the number of years of annual acquisitions that will have paid for themselves over time. Figure 2 assumes that in every year after the implementation of the binary economy, some number, N, of an economy's credit-worthy companies have profitably utilized binary financing to acquire some percentage, X, of their capital investments. Figure 2 also assumes that the capital credit insurance is profitably priced to repay the lending banks for those financings that fail to repay their acquisition loans so that N and X are net of those failures. Figure 2 also assumes that N, X, and the rate of return on capital remain constant throughout the period.

Although beginning slowly, the broadening distribution of capital acquisition and income will increase steadily and thereby provide the basis for binary growth. Each year after the initial cost recovery period of the most productive capital, more binary capital will have paid for itself and will be distributing capital income to poor and working people. Consistent with the conservative assumption of a seven-year capital cost recovery period, figure 2 shows the steady growth in annual capital acquisitions. In the eighth year, the first annual acquisition of capital will have paid for itself and will begin paying its full return to the new owners. In the ninth year, the second annual capital acquisition will be fully paid for and will therefore begin paying its full return to the new owners. In fourteen years, 50%, and in the twenty-eighth year 75%, of the annual capital acquisitions will have paid for themselves, and will begin paying their full annual return to the new owners, and so on. In the long run, the linkage between supply (in the form of the incremental productiveness of capital) and demand (resulting from the widespread market distribution of capital income to consumers) approaches 100%. The more binary financing that is undertaken, the greater the distributional growth effects.

Maintaining Market Share in a Growing Economy: To maintain market share in the projected growing economy, producers will have to increase production and productive capacity *before* binary income begins to be distributed to its new owners. Because present demand for capital goods is positively affected by anticipated future demand for consumer goods, the broader distribution of capital acquisition and capital income should be reflected in increased capital spending within producers capital planning investment horizon. With a capital cost recovery period of seven years, and a capital planning investment horizon of five years, market incentives for increased capital investment by producers of consumer goods might materialize for some producers in the third year. Furthermore, the producers of capital goods needed by the producers of consumer goods to increase their productive capacity may experience market incentives for increased capital spending and labor employment as early as the first year.

Broader Capital Acquisition Reduces Systemic Risk: Over time, the growing capital-based consumer demand generated by binary financing will make more capital investment less risky and expensive, and more credit worthy, insurable, and profitable. Over the same time, in a economy without the expanded market opportunity to acquire capital with the earnings of capital, with relatively less capital-based consumer demand, capital investment will be riskier, and therefore more expensive, and less capital investment will be credit-worthy and profitable.

V. SOME ADDITIONAL AFFECTS OF BROADER CAPITAL ACQUISITION THAT WILL ENHANCE THE PROSPECTS OF SUSTAINABLE ECONOMIC RECOVERY AND GROWTH.

1. As capital income is more broadly distributed to taxpayers, they will pay more in taxes thereby increasing government revenues and providing a basis for lower general tax rates.

2. As capital income is more broadly distributed to welfare dependent people, government transfer payments and general tax rates can be reduced, and corporations whose shares provide that income can be given a tax deduction.

3. As poor and working people are provided a more competitive means of acquiring the least risky, most insurable capital acquisition, more investors will have incentive to move further out on the investment risk curve, thereby providing more investment funds for (a) entrepreneurial activities, (b) the development of new technologies, (c) start-up companies, and (d) smaller companies.

4. With a broadening distribution of capital acquisition and income so that the supply generated by technological change and increased investment will be increasing balanced by a corresponding increase in demand, the amplitude of the booms and busts of business cycles will be reduced.

VI. CONCLUSION

The present recession reflects a severe lack of confidence in the sufficiency of present and future earnings to purchase what can be produced and to repay present debt obligations. With an enhanced understanding of economic growth that recognizes that the broader distribution of capital acquisition with the earnings of capital carries with it the market promise of greater and more broadly distributed capital-based, future earning capacity, the Federal Government can (1) continue to rely on the institutions of corporate finance (routinely enjoyed primarily by well-capitalized people) to promote economic recovery and also (2) greatly enhance the prospects of sustainable success by broadening capital acquisition with the earnings of capital– i.e., by providing poor and working people with access to the same capital acquisition opportunities presently open to people in proportion to their existing wealth. With a more open system of corporate finance, the economy can operate voluntarily to broaden the distribution of capital acquisition with the earnings of capital and thereby provide the market foundation for more broadly distributed capital income and sustainable economic recovery and growth.