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“Binary Economics: The Theory That Gave Rise to ESOPs”

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A b s t r a c t

Many people know about Employee Stock Ownership Plans (ESOPs) which, along with profit-sharing and pension plans, are treated as deferred compensation plans under Section 401 and related sections of the Internal Revenue Code. ESOPs have been established by thousands of American corporations, including some of the largest, and cover millions of employees. There is a national trade association (The ESOP Association), that is now celebrating its 50th year in existence, and other organizations established to support employee ownership, including the Ohio Center for Employee Ownership that first published this article in its publication entitled *Owners At Work* (2006/7).

Most people aware of ESOPs, however, do not realize that ESOPs are part of a broader approach to expanded capital ownership, broader prosperity, and economic justice known as binary economics. Binary economics was first advanced by Louis Kelso, who is also widely known as the inventor of the ESOP. But Louis Kelso's approach to economic theory is only partially reflected in the present ESOP legislation. Binary economics offers a plan for more widespread economic prosperity for all people (not limited to employees) than is presently offered by mainstream economics.

Once ESOP participants understand binary economics, they may choose to advocate legislative reforms that will better serve their own economic interests and also the economic interests of their companies and the country as a whole. These reforms would transform ESOPs into much more powerful Super ESOPs in a full binary economy of the future. The Super ESOP will empower employees to acquire shares of stock in their companies entirely with the earnings of capital and on much more favorable terms than at present. Moreover, the Super ESOP will empower employees and others to acquire a diversified portfolio of shares in other credit-worthy companies entirely with the future earnings of the shares they acquire.

This article briefly describes the binary economics and its important connection with the ESOPs. For a fuller explication of binary economics, see the following four articles which can be downloaded for free from <<SSRN.COM>>: (1) “Binary Economics - An Overview,” (2) “Binary Economics and the Case for Broader Ownership,” (3) “Capital Democratization, and (4) Memo on Binary Economics to Women and People of Color re What Else can Corporations Do for Your Clients?”.

Binary Economics

THE ECONOMIC THEORY THAT GAVE RISE TO ESOPs

Robert Ashford

Editor's note: Where should employee ownership go from here? When we want to go beyond the present and take big steps forward, it can be helpful to begin by returning to basics. Robert Ashford reminds readers of the basis of economic thinking underlying ESOPs and proposes a next step inspired by the seminal ESOP thinker Louis Kelso.

Many employees of ESOP companies do not realize that their ESOPs are part of a broader approach to expanded capital ownership, broader prosperity, and economic justice known as “binary economics.” Binary economics was first advanced by Louis Kelso, who is also widely known as the inventor of the ESOP. But Kelso’s approach is only partially reflected in the present ESOP legislation. Binary economics offers a plan for more widespread economic prosperity for all people than is presently offered by mainstream economics. Once ESOP participants understand binary economics, they may choose to advocate legislative reforms that will better serve their own economic interests and also the economic interests of their companies and the country as a whole. These reforms would transform ESOPs into much more powerful Super ESOPs in a full binary economy of the future.

The Super ESOP will empower employees to acquire shares of stock in their companies *entirely* with the earnings of capital and on much more favorable terms than at present. Moreover, the Super ESOP will empower employees to acquire a diversified portfolio of shares in other credit-worthy companies *entirely with the future earnings of the shares they acquire*.

How Do People Acquire Capital?

Acquiring capital with the earnings of capital (rather than the earnings of labor) is by no means a “pie in the sky” concept. The logic of profitable business is to invest in things that pay for themselves in a competitive period of time. The purpose of corporate finance is to enable corporations to acquire productive capital *before* they have earned the money to pay for it. Credit-worthy corporations and wealthy people (i.e., “well-capitalized people”) do it all the time. To enhance their ability to acquire capital with the earnings of capital, profitable corporations and wealthy people use their existing capital as collateral to borrow money to acquire more capital (including sometimes whole companies) and then repay the loans with the profits of the capital they acquire. In the binary economy, the participation of poor and working people in this process of acquiring capital with the earnings of capital would be greatly expanded.

To foster economic growth and prosperity, mainstream economic policy promotes capital acquisition with the earnings of capital primarily for well-capitalized people, but most people presently have little or no participation in this process. ESOPs have somewhat opened the door to capital acquisition

for a portion of the work force through a combination of deferred labor compensation, future company revenues, and corporate tax deductions. However, the full potential of ESOPs to empower their participants to acquire capital with the earnings of capital and to expand this empowerment to many more employees remains suppressed by mainstream policy.

Compared to well-capitalized people, poor and working people are severely disadvantaged when it comes to acquiring capital. In general, mainstream economic policy requires them to acquire capital by using their current labor earnings while those who already own substantial capital can acquire additional capital either with their capital earnings or with borrowed money that is repaid with the earnings of the capital acquired. Because most employees need their current labor earnings to provide for their families’ current living expenses, Kelso proposed an approach to capital acquisition that does not require workers to use their current labor income either but rather enables them to acquire capital using the future income of the capital acquired just as wealthy people are presently able to do.

Binary economists maintain that (1) using labor earnings is *not* the best way for poor and working people to acquire capital and (2) limiting capital acquisition with the earnings of capital primarily to wealthy people is *not* the best way to promote economic growth and prosperity. According to government statistics, almost all non-residential capital in the United States is acquired with the earnings of capital; and very little non-residential capital is acquired with the earnings of labor. Most poor and working people do not have enough labor earnings to support themselves and their families and consequently find themselves increasingly in consumer debt. If most poor and working people are ever to acquire viable capital estates and eliminate their consumer debt, they will need to acquire capital with the earnings of capital just as wealthy people do.

Moreover, to promote optimal growth and prosperity, binary economists maintain that everyone (not just wealthy people) should be empowered to acquire capital with the earnings of capital. The capital that presently profitably pays for itself (i.e., “buys itself”) with its own earnings primarily for well-capitalized people can do so even more profitably if poor and working people are brought into the process. Once poor and working people are empowered to acquire capital with the earnings of capital just as wealthy people do (1) poor and working people will grow more prosperous by increasingly earning more spendable income from their ownership of capital, (2)

credit-worthy companies will more profitably (a) employ their productive capacity and (b) invest in more productive capacity, and (3) the economy will grow more quickly.

Kelso's Special Insight: Capital Does Work

The difference between the mainstream and binary approaches to promoting economic growth, prosperity, and capital acquisition all boils down to a fundamentally different understanding of the role of capital in production, distribution, and growth. According to mainstream economics, the primary role of capital is to make labor more productive. According to binary economics, the primary role of capital is to do a growing portion of the work and distribute a growing portion of the income earned from production.

Consider the work of washing machines, automatic bank tellers, vending machines, and photocopiers. Although labor is required to invent, design, build, install, operate and maintain them, millions of such capital devices are doing much work that was once done by entirely by people in ways that do not relate in any direct way to increased labor productivity.

For example, a person hauls one sack of grain one mile in one hour and is exhausted. With a horse, ten sacks can be hauled four times as far (yielding a forty-fold increase in output); and with a truck, five hundred sacks can be hauled forty times as far (yielding a twenty thousand-fold increase in output). Although no sacks would be hauled without people to load the sacks, lead the horse or drive the truck, the work of loading, leading and driving is *not* the work of hauling. The horse and truck are doing essentially all of the extra work. If one person loaded sacks on the backs of ten other people and led the people doing the hauling, who would deny the work of the ten haulers? Then why deny the work of the horse or truck? The notion that the great increase in output is primarily the result of increased labor productivity does not describe reality.

Of course, people who provide the labor needed to invent, design, finance, build, install, operate, monitor, repair, and manage capital, earn income by doing so. Nevertheless, the work of inventing, designing, financing, building, installing, operating, monitoring, repairing, and managing capital is *not* the work of the capital itself. Although it is good to be able to earn by laboring, it is better still to *also* be able to earn by owning; and the full binary economy will empower everyone to earn increasingly by owning.

Thus, the "binary" in binary economics means "composed of two." It refers to the two ways of doing work and earning income: by way of labor and by way of capital. "Labor" includes all forms of physical and mental labor; and "capital" refers to anything non-human that can be owned and

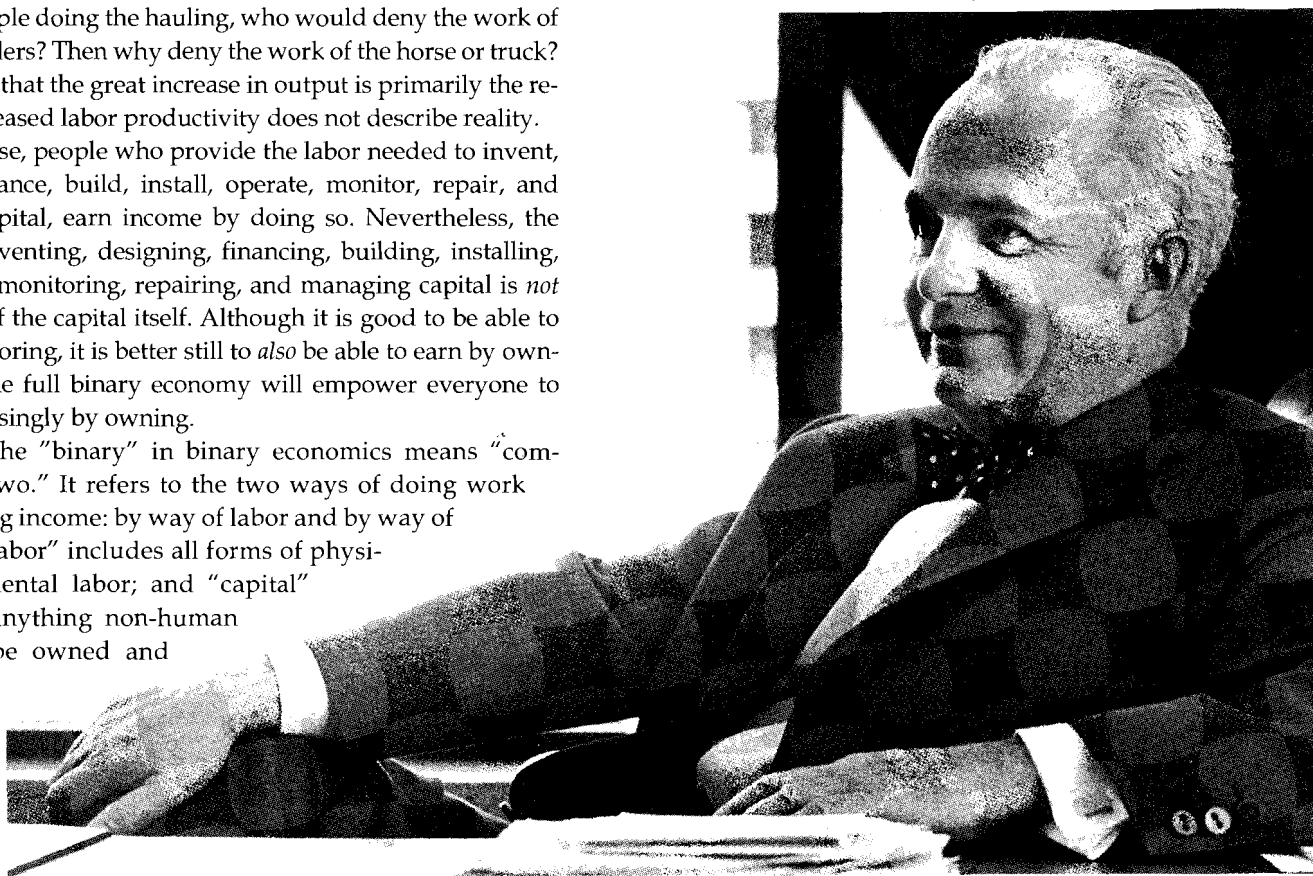
that can be employed to do work (including land, animals, structures, machines, tools, patents, copyrights and other intangibles protected as property).

When analyzing how production and productive capacity have grown over the last several hundred years, mainstream economics interprets the primary role of capital as merely increasing labor productivity, thereby allowing for a rise in output per unit of labor, higher wages, and the profitable employment of more labor. According to binary economics, however, in contributing to economic growth, capital does much more than increase the productivity of the people who work with it. Increasingly capital is doing a growing portion of the total work. *The economic imperative is generally to produce more with more productive capital and less labor.* Although capital may be seen to concentrate higher productivity into fewer workers, as the general rule, per unit of output and in the aggregate, the primary effect of technological advance is to make capital more productive than labor and thereby to replace and vastly supplement the productiveness of labor with ever greater capital productiveness.

Moreover, capital works on both sides of the production-consumption equation by providing vastly increased (1) productive capacity and production and (2) capacity to distribute income and leisure. Thus capital can not only (1) replace labor, (2) vastly supplement the work of labor with the work of capital, (3) do work that labor alone can never do, and (4) do work with little or no labor, but capital can also (5) pay for itself out

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Louis Kelso in 1974. (photo courtesy Baron Wolman)



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of its future earnings and thereby (6) broaden its ownership to distribute more broadly the income necessary to purchase its increased output. According to binary economists, in a private-property market economy, it is the capacity of capital both to do much more work and to distribute much more income and leisure than labor that explains how broadening capital ownership promotes greater employment of existing capacity (both capital and labor), capital investment, growth, and prosperity.

Broader Ownership Will Support a Larger Economy

Present demand for capital investment (and the labor employment necessary to create and operate it) is dependent on demand for consumer goods in a future period. When poor and working people begin to earn more capital income, they are more likely than wealthier people to spend it for necessities and discretionary items. Without broadening ownership, when wealthy people earn capital income beyond their consumption needs and desires, they will seek to invest that income, but with the prospect of comparatively less consumer

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demand. Therefore, a voluntary pattern of steadily broadening capital acquisition, ownership, and income promises more production-based consumer demand in future years and both strengthens the promise of capital to pay off loans used to buy it out of its future earnings, and makes profitable the employment of more capital and labor. Thus the prospect of more broadly distributed capital ownership boosts not only consumption but also demand for investment and employment.

According to mainstream economics, making labor more productive offers great benefits. It (1) increases company profits, (2) enables companies to profitably hire more workers, (3) enables companies to profitably pay higher wages, (4) increases the distribution of income to consumers, (5) causes a fuller employment of productive capacity and (6) increases economic growth by making more production profitable.

While not disputing that increased labor productivity *can* have these effects, binary economists maintain that the increasing productiveness of capital coupled with broadening capital ownership provides even greater benefits for employees and their companies. The mainstream reliance on increasing labor productivity to promote fuller employment of capital and labor and a greater distribution of consumer income has an inherent limitation that arises from the fact that capital is continually replacing and vastly supplementing the work of labor with the work of capital. Thus, labor's percentage claim on total pro-

duction is decreasing as capital increasingly does more of the work. The mainstream approach (capital acquisition primarily for wealthy people and jobs and welfare for everyone else) cannot distribute sufficient consumer income to a broad enough consumer population to fully employ existing capacity and promote optimal investment and sustainable growth. It must be supplemented with the additional consumer income that naturally results from the coupling of the increased productiveness of capital with a broader pattern of capital acquisition. Thus, from a binary perspective, growth is primarily the result of increasing capital productiveness and the distribution of its ownership rather than increasing labor productivity.

Based on the mainstream economic preoccupation with productivity, workers are taught to think that by focusing on increased labor productivity, there is a stronger argument for higher wages. That thinking should not divert attention from the crucial need of every worker to acquire capital with the earnings of capital and the financial interest of major corporations to enable their employees to do so.

Conclusion

Louis Kelso advanced binary economics not only as a means of enabling employees to acquire shares in the companies that employ them, but also as a means of enabling all poor and working people to acquire diversified portfolios of shares in the largest and most credit-worthy corporations. Few if any wealthy people fail to acquire a substantial diversified portfolio of shares in these companies either directly or through trusts and mutual funds. Guided by the principles of binary economics, and using the same techniques that work for well-capitalized people, the Super ESOPs of the future will have the capacity to empower poor and working people to acquire gradually viable, diversified capital portfolios of shares in these companies, paid for with the earnings of the shares they acquire, just as well-capitalized people do, in ways that enhance the profitability of those companies, more fully employ their productive capacity, and greatly expand sustainable economic prosperity and growth.

The binary approach to ownership broadening will be entirely voluntary and will operate without taxing or redistributing the capital or income of existing owners. The increased growth and broadening prosperity of the binary economy will be gradual; but once understood, these binary benefits will prove increasingly attractive to corporations, their shareholders, and employees; and the binary approach to capital acquisition will transform the American economy into one of much greater abundance for all.

© 2007 by Robert Ashford. All rights reserved. Robert Ashford is Professor of Law at Syracuse University College of Law where his subjects include corporations, professional responsibility and binary economics. For a detailed explanation of the reforms necessary to establish the Super ESOP, readers are referred to **Binary Economics: The New Paradigm**, by Robert Ashford and Rodney Shakespeare, available from University Press of America. He can be reached at rhashford@aol.com. OAW