

# A New Look at Prices and Money:

## The Kelsonian Binary Model for Achieving Rapid Growth Without Inflation

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### Introduction

What is money? In his 1967 book coauthored with his wife Patricia Hetter Kelso, *Two-Factor Theory: The Economics of Reality*, the late Louis O. Kelso described money:

**Money is not a part of the visible sector of the economy; people do not consume money. Money is not a physical factor of production, but rather a yardstick for measuring economic input, economic outtake and the relative values of the real goods and services of the economic world. Money provides a method of measuring obligations, rights, powers and privileges. It provides a means whereby certain individuals can accumulate claims against others, or against the economy as a whole, or against many economies. It is a system of symbols that many economists substitute for the visible sector and its productive enterprises, goods and services, thereby losing sight of the fact that a monetary system is a part only of the invisible sector of the economy, and that its adequacy can *only* be measured by its effect upon the visible sector.<sup>1</sup>**

What is clear from this description is that money is a "social good," an artifact of civilization invented to facilitate economic transactions for the common good. Like any other human tool or technology, this societal tool can be used justly or unjustly. It can be used by those who control it to suppress the natural creativity of the many, or it can be used to achieve economic liberation and prosperity for all affected by the money economy.

How important is money? Meyer Amschel Rothschild, the founding father of one of the world's most powerful financial dynasties, has been quoted, perhaps apocryphally, as having said:

**Let me issue and control a nation's money and I care not who writes the laws.<sup>2</sup>**

Such a statement is a reaffirmation of the clear-sighted eighteenth century political insight of Benjamin Watkins Leigh, in the Virginia Convention, who observed:

**Power and Property can be separated for a time by force or fraud but divorced, never. For as soon as the pang of separation is felt, Property will purchase Power, or Power will take over Property.<sup>3</sup>**

It takes no genius to understand the relationship between money and market prices. Too many dollars chasing too few goods is the classic definition of inflation. And history is replete with cases where money has been politically controlled in ways that benefit only the few at the expense of the many.

In this paper a case will be made for a major transformation of any nation's monetary system so that in the future new money will be created in ways that would unharness the full productive potential of society, while closing what *The Wall Street Journal* (September 13, 1999, p. A1) recognizes as the growing wealth gap between the richest 10% and the rest of society<sup>4</sup>—and to do so voluntarily without the need to redistribute existing wealth. Prices, wages and interest rates would be controlled under the proposed model of development completely by competitive market forces, not by the whim of central bankers, politicians or organized power blocs.

This paper will aim at showing that Say's Law of Markets—that supply can create its own demand and demand its own supply—can be made to work if capital credit is universally accessible to all. This new paradigm, first developed by Louis O. Kelso and later refined by Robert Ashford and Rodney Shakespeare,<sup>5</sup> would result in an asset-backed money supply that would provide sufficient liquidity to banks and other financial institutions for financing all or most of the new productive assets which are added each year to grow the economy.

While this author recognizes that both Karl Marx and John Maynard Keynes, and their many followers in academia, have rejected Say's Law of Markets, this paper will point out how the binary economic model originally conceived by Louis Kelso refutes the criticisms of Marx and Keynes and offers a more sound moral and economic framework for promoting sustainable development within a market system. The Kelso model—recognizing both labor and capital as direct and interdependent sources of mass purchasing power—would be structured to create a more just and more productive system than any market system in the history of modern civilization.

Wealth distribution assumes wealth creation, and productive capital (i.e., technological and systems advances and improved land uses), according to recent studies, accounts for almost 90% of productivity growth in the modern world.<sup>6</sup> Thus, balanced growth in a market economy depends on incomes distributed through widespread individual ownership of productive capital, all nonhuman means of production. The technological sources of production growth would then be automatically linked by free market forces with the ownership-based consumption incomes needed to purchase new wealth from the market. Thus, Say's Law of Markets—which both Marx and Keynes attempted to refute—would become a practical reality for the first time since the Industrial Revolution began.

The challenge this paper will present, especially to academic economists, is to demonstrate mathematically how Say's Law of Markets can be reconciled both with the classical quantity theory of money and various measures of net national product (NNP) to permit accelerated rates of growth without inflation.

A side-effect of this proof is to relegate the Phillips' curve—that inflation and unemployment are inextricably linked—to the dustbin of economic history. *The ultimate aim of this paper is to present a logical and unified market system that is structured to combine economic efficiency with fundamental principles of economic justice.*<sup>7</sup> Implicit in this position is that no known economy in the history of civilization, particularly since the advent of modern technology, has

offered both genuine justice for all, and optimum rates of productive efficiency. If this author is correct, those frustrated by today's unfree and unjust market economies are urged to come together for serious study and discussion of an alternative model of development, the new paradigm of binary economics.

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## **Problems Not Effectively Addressed by Conventional Economics**

How will the U.S. economy finance the \$2 trillion required each year (at 2000 rates of growth)<sup>8</sup> to meet the nondefense capital requirements of the U.S. private and public sectors in the form of new plant and equipment, new hardware and software technologies, new rentable space and new physical infrastructure?

Assuming we can solve this problem, who will own the massive amounts of new capital brought into existence to meet our needs for energy self-sufficiency, new communities, and new housing, mass transit, new communications systems, resource recycling and conservation, expanded food and fiber production, etc.? Will those assets be owned by the same top 10% of U.S. families who own and control 90% of directly owned U.S. corporate stock? Will those assets be owned by government and quasi-government agencies? Will those assets, in the words of Peter Drucker, be "socialized" in the hands of money managers, pension funds or foundation bureaucrats? Or will that new capital become owned by many people whose incomes today depend almost exclusively on their (often subsidized) jobs, paternalistic government welfare and subsidy handouts, and private charity?

Can such massive investments be made without foreign oil dollars, or, for that matter, without exclusive dependency on the past savings accumulated by the rich or the reservoirs of accumulated small savings of the middle class and the poor? Can capital be acquired on expanded bank credit ("pure credit") secured by the future income (or future savings) derived from such new investments?

Can the Federal Reserve System become the "lender of last resort" so that the "full faith and credit" of "We, the People" can pump newly issued money into the banking system on a self-liquidating and asset-backed basis? And can this newly created credit be channeled under the supervision of local banks into *unsubsidized*, self-liquidating, commercially insured loans at 2-4% borrowing costs to fund feasible projects of enterprises that voluntarily want to acquire their future capital needs in ways that broaden the base of U.S. capital ownership in the process?

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## **Why is the Asset Gap Growing Between A Wealthy Elite and Other Citizens?**

What explains the growing maldistribution of capital ownership in America and throughout the global economy? Why is there a massive and growing capital gap between the already wealthy and those who have little or no capital assets and generally live from hand to mouth? Why is it

easier for a Bill Gates to increase his capital from \$10 billion to over \$90 billion in a few years than for the average American to accumulate in net worth enough to live on for two or three months?

Let us examine some of the structural root causes that enable the rich to get richer and the poor to become increasingly vulnerable to the forces of global change. Wealthy people can attract capital credit (i.e., other people's money) to add new and more powerful productive assets to their existing ownership stakes, because wealthy people can pledge their previous accumulations

as collateral, thus eliminating the potential risk to lenders in the event that the loan cannot be repaid. Most citizens, especially the poor, have no assets to pledge as collateral. Therefore, most people cannot qualify for capital credit to purchase, on the same terms as the already wealthy, newly added self-liquidating productive assets. Once feasibility standards are met, such assets, in the hands of reasonably competent management, will pay for themselves out of future profits or savings and then become a source of additional capital incomes for those with access to capital credit. Thus, those without assets (and therefore by definition people who cannot overcome the traditional collateralization hurdle) remain with little or no hope to share profits from their own assets and gain an independent source for their future consumption incomes.

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### **The Logic of Corporate Finance: A Key Tool for Creating New Owners Simultaneously with New Capital Creation Within a Market Economy**

The guiding logic of all corporate finance is that all projects must be self-liquidating. Newly formed capital, such as improved land, new structures and new tools, are never brought into existence by a well-managed enterprise unless the new investments will pay for themselves. Under ordinary circumstances, "payback" for new equipment is generally expected within three to five years. In the corporate sector, it is interesting to note, the corporate umbrella insulates the eventual owners of this new capital, generally the already wealthy, from personal risk in the event the corporation defaults on its loans or goes bankrupt.

Using conventional methods of finance, over \$2 trillion of new productive assets (or about \$7,500 worth for every man, woman and child) are added annually to both the private sector and public sector of the U.S. economy. Virtually none of this newly created capital is financed in ways that create any new owners when it is formed. Theoretically, all or at least most of these assets could be financed in ways that they could be broadly and privately owned, as suggested by Louis Kelso and other binary economists since the 1950s.

Binary economics would require that inclusionary self-liquidating capital credit be made accessible to corporate employees and other current non-owners of productive capital in order to turn them into economically independent capital owners. And, in the same way that the currently wealthy use credit to increase their wealth, and thus their incomes, this would be done without unreasonable self-deprivation during the working lives of people economically enfranchised under a comprehensive national expanded ownership strategy.

As the logic and techniques of binary corporate finance are extended throughout the economy, all new incremental productive power can automatically be built into individuals who have unsatisfied needs and wants—without diminishing their take-home pay or past accumulation of savings. This will break the monopoly of capital ownership held by the currently wealthy—those with functionally excessive productive power in terms of their consumer needs and wants. The savings of the currently wealthy would then flow into the most risky and speculative ventures, or for insuring capital credit for the non-rich, or for supplying consumer credit and other nonproductive forms of credit.

"Pure credit" can be defined as productive credit extended by a commercial bank, other financial institutions or a central bank in a manner independent of past savings, so that the amount borrowed plus all transaction costs are secured and repayable with future savings from the capital assets acquired with such credit. Limiting the extension of "pure credit" by the central bank to current non-owners and leaving the pool of past savings open for use by the currently wealthy and for nonproductive government and consumer borrowing would result in a

noninflationary expansion of the ownership of capital assets. Such high-powered credit would enable private lenders to expand the money supply for feasible private sector projects by discounting their "eligible" asset acquisition loan paper with the central bank. This expansion of the money supply could continue as long as underutilized resources, people and technology are available for supplying more marketable goods and services to the economy. "Pure credit" would thus free the economy to grow to the full physical limits of its workforce, available resources, technology, and the projected additional buying power of new domestic and foreign consumers.

After each increment of new capital has paid for itself from the future earnings (future savings) that it produces, effective demand and effective supply would be synchronized by normal market forces—and this would continue to do so as long as the new capital became a source of an expanded income for the poor and those in the middle-class who today do not have adequate and secure incomes to meet their needs. Binary economics would enable them to produce and earn more as owners of "procreative" capital in order to meet these needs.

From the standpoint of corporate productiveness, the binary economics approach would build all increases in capital productiveness (*i.e.*, value added by capital assets) into workers and other non-owners. New owners would then be entitled to all the income increases attributable to their growing shares of corporate ownership. Artificial pressures for increases in labor and welfare incomes that add to costs and therefore go into the price of products sold (*e.g.*, more pay for less work) would tend to diminish. Removing artificial restraints on capital creation would enable output to soar.

Once the cost of creating such capital is liquidated and the new money is cancelled out, the productive assets continue to produce wealth and incomes for its owners many times their original formation cost. Hence, where capital incomes are distributed broadly within a nation of owners, prices can eventually be reduced, while making the economy as a whole work more efficiently and equitably.

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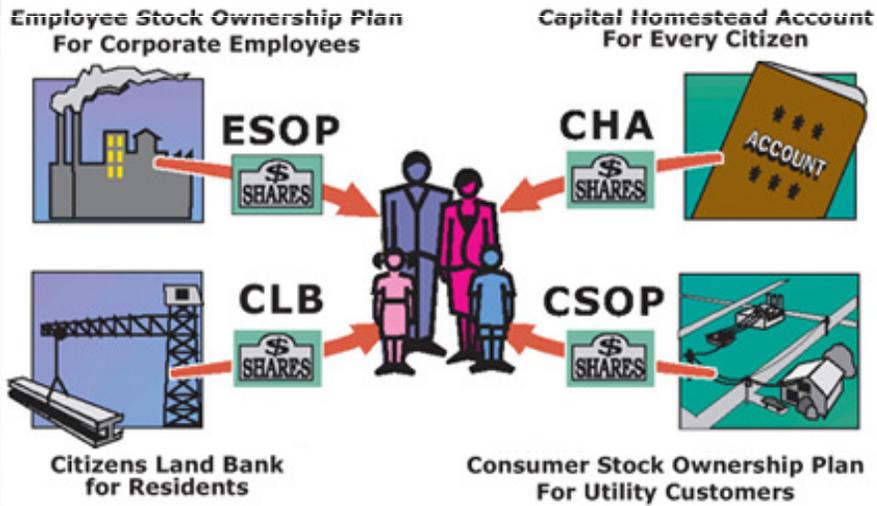
## **A Two-Tiered Interest Solution for Separating Good From Bad Uses of Credit**

Should the Federal Reserve establish a two-tiered interest structure that sharply differentiates between participatory and productive uses of credit and exclusionary and/or nonproductive uses of credit? Under such a system, the first or higher tier, as at present, would be based on market-determined yields on already accumulated savings available to the economy ("old money").

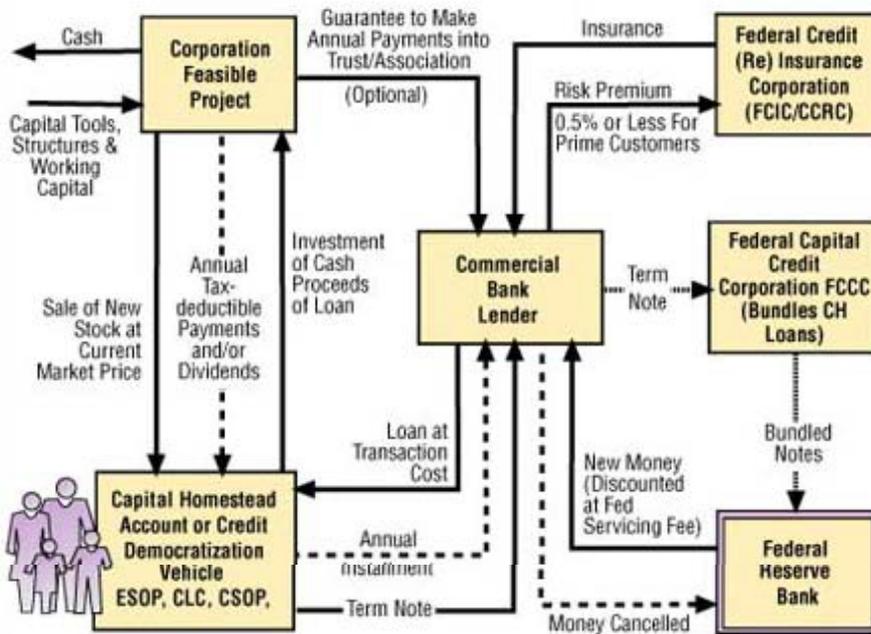
Interest rates on old money would contain whatever "inflation premium" is appropriate to offset the direct and indirect inflationary effects of present monetary, fiscal, employment and income maintenance policies. The lower tier would be based upon "new money" created exclusively for financing private sector capital expansion in ways that democratize access to future capital ownership and profits, a counter-inflationary process the Center for Economic and Social Justice calls "Capital Homesteading."<sup>9</sup> As illustrated below, Capital Homesteading would provide all citizens with on self-liquidating capital credit to purchase new and transferred capital secured by future profits of viable enterprises.

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# Capital Homesteading Vehicles



## Creating Money for Capital Homesteading



The lower tier of expanded bank credit for Capital Homesteading projects would be grounded on a Federal Reserve discount rate or "service fee" of 0.5% or so to cover all central banking costs. The markup above each bank's cost of money (estimated at 2 to 4% for low-risk capital credit) would be market-driven, based wholly on (1) the risk of loan default (the "risk premium"), (2) the cost of administering the loan, and (3) a reasonable profit for the lending institution in competition with other lenders.

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## **Capital Homesteading: A New Vision for the New Millennium**

Following the precedent established for decentralizing land ownership under the homestead acts of the 1860s, the nation should now adopt a Capital Homestead Act to share in a totally voluntary way the ever-expanding capital frontier resulting from the continuing advances of modern labor-saving technology. Under Capital Homesteading as a basic pillar of economic policy, the focus of politics will shift to the monetary, banking, insurance, tax and inheritance law reforms needed to create a nation where capital ownership is as accessible to every citizen as the political ballot. As such, the focus would be concentrated on dismantling legal and institutional barriers to more equal ownership opportunities.

All or a major portion of the \$2 trillion of the annual "growth ring" of U.S. productive capital can and should be financed through loans made to Treasury-qualified, tax-exempt Employee Stock Ownership Plan (ESOP) trusts and similar Capital Homesteading vehicles and secured by future enterprise profits. These other vehicles for democratizing access to capital credit would include Individual Stock Ownership Plans (ISOPs) to enable all American citizens and families to invest in a diversified portfolio of newly issued shares in well-managed and economically viable new and expanding enterprises, Community Investment Corporations (CICs) for putting ownership and control over local land in the hands of local citizens and Consumer Stock Ownership Plans (CSOPs) for spreading ownership of natural monopolies among regular customers.

An alternative approach to democratizing the capital credit needs of the U.S. economy is to enable every citizen to establish a Capital Homestead Account or "CHA" (a variation of the ISOP concept) at his or her local bank to receive direct personal access to capital credit as a fundamental right of citizenship. By putting more personal choice in the hands of new owners, their governance rights would likely be enhanced over top-down approaches to Capital Homesteading. With access to monetized credit through a CHA, each citizen from birth would have the funds to invest, with the help of an investment advisor, in full dividend payout shares of 1) the company that he or a member of the family works for, directly or through an ESOP, 2) the companies he regularly buys from, directly or through a CSOP, 3) a community investment corporation to link him to profits from and control over local land development, and 4) a variety of blue-chip growth companies with a history of profits. Capital incomes earned from dividends on one's CHA account offer a private sector supplement to prevent bankruptcy of the pay-as-you-go Social Security system. Under conservative projections, a citizen could accumulate from birth to retirement a tax-sheltered estate of \$200,000. Furthermore, over that period, he would receive dividend income totaling over \$750,000, and at retirement an estimated annual CHA dividend income of \$30,000.<sup>10</sup>

If lack of collateral is one of the major barriers to closing the wealth gap between the rich and the poor through the democratization of capital credit how can this collateralization barrier be

overcome? A substitute is needed for the collateral generally required by lenders to cover the risk of default. That substitute would be a system of credit insurance and reinsurance.

Lenders making "qualified" loans could either self-insure or pool the "risk premium" portion of debt service payments by insuring with commercial capital credit insurers against the risk of default, perhaps 80% to 90% of the unpaid balance. To spread further the risk of loan default, these commercial insurers could come together to establish a Capital Credit Reinsurance Corporation ("CCRC"). Some of the CCRC's reserves could be provided in the form of investments by the already wealthy. Or a portion of the reserves could be provided by the Federal, state or local governments, but only if the CCRC is structured to avoid the unlimited liability that taxpayers were exposed to by making the Federal Government "the insurer of last resort" of failing savings and loan banks in the 1980s.

To further support the CHA, a National Capital Credit Corporation (NCCC) could be set up, similar to Fannie Mae and Freddie Mac, to package and set national standards for insured, self-liquidating capital loans and then discount these loans at the discount window of one of the 12 regional Federal Reserve banks. The Federal Reserve would treat insured CHA loan paper like government debt paper as substitute backing for the U.S. currency.<sup>11</sup>

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## **Legislative Reforms to Create A More Just Market Economy**

After hearings devoted to careful scrutiny of Kelsonian concepts and program reforms,<sup>12</sup> the Senate and House Banking Committees should enact legislation designed to:

(1) Establish a public or quasi-public Capital Credit Reinsurance Corporation (or encourage private insurance companies to perform this function) to insure banks, insurance companies, and other lenders who make loan financing to Employee Stock Ownership Plan (ESOP) Trusts and similar credit mechanisms, such as the ISOP, CSOP and CIC. (This would be similar to the way the Federal Housing Agency insures mortgages on home financing but without making the government the insurer of last resort.)

(2) Amend Section 13 of the Federal Reserve Act to mandate that the Federal Reserve Board and Federal Reserve Banks increase the money supply responsively in ways that enable banks and other qualified lenders to make "qualified" Capital Homesteading loans on feasible (i.e., self-liquidating) projects by discounting the loan paper at a discount rate reflecting real Fed costs (i.e., "pure credit" rates that exclude any inflation premium), pursuant to regulations to be adopted by the Federal Reserve System. The Fed might also require as a condition of eligibility that such loans be insured by capital credit insurers and, for more security, that the insurers pool their risks with a capital credit reinsurance facility.

(3) Establish a counterpart of Fannie Mae and Freddie Mac to set national lending standards and insurance criteria for Capital Homesteading loans, with the power to package loans made by qualified financial institutions for discounting with the Federal Reserve System.<sup>13</sup>

(4) Remove the power that the Federal Reserve now has to change directly the quantity of money in circulation through purchase and sale of government securities via the Open Market Committee, thus preventing future monetization of government deficits and

forcing government into the competitive market to fund government debt. It should be noted that the new money added for Capital Homesteading would substitute dollar-for-dollar with the reduction in open market purchases of government debt paper.

(5) Eliminate the power of the Federal Reserve to control growth of the economy by raising and lowering interest rates, thereby allowing all interest costs above the lender's "cost of money" under the two-tiered interest rate system to be set entirely by competitive market forces.

In effect, these new policies would amount to launching and promoting a counter-inflationary alternative to today's exclusionary and wealth-concentrating monetary policy. With new consumer power linked directly to the productiveness of new productive assets, the economy would grow at the full extent of its human and nonhuman capacity instead of being artificially constrained by the Federal Reserve System.

In contrast to conventional investment finance, which has systematically perpetuated monopolistic access to the ownership of new productive capital while limiting the economic participation of 95% of U.S. households to their technologically vulnerable labor inputs, ESOP and other Capital Homesteading financing technologies provide a more rational alternative for raising the consumer power of American workers on a direct and individual basis, without violating the overall economy's laws of supply and demand and as a trade-off to unjustified wage increases or perpetual income transfer schemes.

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## **Reconciling Binary Economics with the Classical Quantity Theory of Money**

As previously explained, Capital Homesteading depends on the responsiveness of a central bank's discount mechanism to the market-driven demand of the lending community, a demand that originates with the unmet capital credit needs of a more broadly owned private enterprise sector. Some economists have raised the question as to whether such a transformation of monetary and credit policy would cause runaway inflation. This paper is intended to show that economic expansion that is consistent with the logic of binary economics will lead to long-term deflationary effects, but without the adverse consequences upon aggregate demand normally associated with periods of declining prices (e.g., overcapacity, unemployment, and reduced labor incomes).

Kelso's binary economic system, in sharp contrast to economies structured to distribute mass purchasing power exclusively through jobs and welfare redistribution, would link income increases directly with the productive contributions from new, expanded or transferred capital. This paper, however, will not discuss why traditional "productivity" theory leads to distortions in income maintenance policies, or why perpetual "cost push" and "demand pull" inflation is inevitable under traditional single-factor policies ("one man-one job"), nor will it explain other fundamental defects of government-subsidized "full employment" policies. (These points are fully covered in the previously cited basic writings on binary economics.) Rather, it will be demonstrated here that the use of monetized credit for enabling all persons to share equitably in capital ownership and capital incomes would conform to the classical quantity theory of money.

Formula for the Quantity Theory of Money<sup>14</sup>

$$M \times V = P \times Q$$

(or  $M \times V = P \times T$ , where Q and T are different symbols for the same variable)

M = Total stock of money in circulation (coin, currency and demand deposits)

V = Velocity of money (the annual rate of use, determined by dividing the Net National Product [NNP] by the total stock of money in circulation [M], or  $V = \text{NNP} \div M$ )

P = Average price level (as defined in the econometric model used by the Federal Reserve)

Q = Number of income transactions (also "T").

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## **Binary Economics is Based on Say's Law of Markets, the Input/Output Logic of a Market Economy**

Say's Law confirms the identity in a market economy between the market value of goods and services produced in a given time period and the aggregate purchasing power created out of the process of production and arising in the hands of the participants in production. More simply stated, "For every dollar spent, somebody gets a dollar in economic value." Under binary economics, each of the two basic factors of production—the human factor (labor) and the nonhuman factor (capital) produce wealth or income in the same physical, economic, political, and ethical senses.

There are thus two ways for an individual to derive an income from a productive activity. The most obvious is wages derived from the contribution of his labor. The other is through ownership of productive land, structures, machines and all tangible and intangible technologies devoted to the production of marketable goods and services. A person's "property right" in the nonhuman factor of production entitles him to receive the entire income or wealth produced by the thing(s) that he owns.

Of course, a free person also owns his own body, and thus has a right to the full fruits of his labor's contribution to the production process, which he can exchange voluntarily for his labor income, or wages. However, binary economics is careful to separate what is human from what is not. The value of the labor or capital contributed to the production process is determined by evaluating all human inputs and all nonhuman or capital inputs through the mechanism of open and competitive markets. These productive inputs can be measured individually by the value each adds as perceived by buyers in a freely competitive market.

Through expansions and transfers of capital under more innovative corporate finance, sounder tax and inheritance policies, and more realistic labor and income maintenance policies, the right to acquire capital and receive income through capital ownership would be made accessible to the masses of mankind, who today are systematically barred from effective ownership of capital.

The logic of an individual enterprise is demonstrated by double-entry bookkeeping. Increased "outtake" (*i.e.*, income) must be based upon increased production or distortions appear the books (and thus the business enterprise) are "out of balance" a simple observation about an economic reality.

An enterprise increases its profits by increasing production and sales and decreasing costs. Most managers do this by adding new or improved capital instruments, eliminating jobs, or both.

Binary economics carries the logic of double-entry bookkeeping and the nature of a firm's production advances to the level of an entire economic system. Viewing the entire economy, the summation of costs (i.e., prices for all inputs) must always equal the summation of all labor and capital incomes derived from the productive process. In other words, every dollar of cost on one side of the national ledger represents someone's income on the other side. This mathematical identity is the essence of Say's Law of Markets.

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**At the national level, Say's Law of Markets is expressed in one of two interchangeable ways.**

Formulæ for Expressing Say's Law at the National Level

(1) Flow-of-Product Definition of NNP:

$$\text{NNPF} = C + I + G$$

NNPF = Net National Product (the total money value of the flow of final products of the community).

C = Total spending for final consumer goods and services

I = Net capital investment (total capital investment less depreciation  $\pm$  changes in inventory).

G = Total government expenditures on goods and services (total government disbursements less transfer payments and interest on government obligations).

(2) Earnings or Income Definition of NNP:

$$\text{NNPE} = \text{EL} + \text{EC} + \text{ET}$$

NNPE = Net National Product (the total of factor earnings or income—wages, interest, rents, profits and transfer payments—that are the costs of production of society's final products).

EL = Total after-tax national earnings of labor (wages, salaries, commissions—*i.e.*, employment income).

EC = Total after-tax earnings of capital (profits, interest, rent—*i.e.*, property income).

ET = Total net government transfer payments (welfare, social security and other entitlements).

"NNPF" and "NNPE" are simply different ways of expressing the same thing:

$$\text{NNPF} = \text{NNPE} = \text{NNP}$$

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**The Relationship Between the Quantity Theory of Money and Say's Law**

There is a direct connection between the quantity theory of money and the various measures of the net national product. Taking the two identities and solving for the common factor in the following way demonstrates how they relate to each other. Thus,

1)  $V = \text{NNP} \div M$  (From the definition of the velocity of money)

2)  $M \times V = P \times Q$  (The Quantity Theory of Money)

3) Substituting for  $V$  gives  $M \times \text{NNP} \div M = P \times Q$

4) Eliminating  $M \div M$  (*i.e.*, "1") from the equation leaves  $\text{NNP} = P \times Q$

5) Substituting identities gives,  $M \times V = \text{NNP}$

6) And therefore  $M \times V = P \times Q = C + I + G = \text{EL} + \text{EC} + \text{ET}$

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### **Application of the Quantity Theory of Money to an Economy Planned to Operate in Accordance with the System Logic of Binary Economics**

Binary economics challenges some of the most fundamental and widely held assumptions underlying conventional schools of economic thought. Among the fallacies exposed by Kelso are:

- the inevitability of economic scarcity,
- the absurdity of "full employment" of workers as an efficient, realistic and morally sound foundation for long-term national income distribution and human development policy,
- the notion that economic growth must be financed by past savings,
- the blind assertion that there is an inevitable trade-off between unemployment and higher prices (the "Phillips Curve"), and many other myths that hide the illogic and structural faults inherent in any market economy that fails to provide for the wide diffusion of ownership of capital—the second, and with advancing technology, the more productive factor of production. Prices are only driven up by higher market costs when there are actual, not artificial or politically induced, shortages of workers, technology and resources.

Few will doubt that there are many system "leakages" in the form of underutilized people, technology and resources. This represents untapped productive capacity that binary economics would add to the productive process.

Let us now match Kelso's assertions with the hard logic of the quantity theory of money.

How was it possible during the World War II era (1940-1945) for the U.S. economy to transform itself from a peacetime Depression economy with unemployment rates never less than 15%, to annual wartime growth rates of at least 13% per year, without causing runaway inflation, with little or no unemployment and with 13 million of America's most able-bodied workers removed from the labor force? Why cannot similar growth rates be sustained in a peacetime economy? The adherents of the so-called Phillips Curve—suggesting that there must

be a trade-off between unemployment and inflation—say that this is not theoretically possible. Students of binary economics contend otherwise, pointing to the history of U.S. economic growth from 1865 to 1895, with industrialization blossoming and price levels declining. More compelling is the logic and untapped growth potential of the Kelsonian binary growth model. An economy transformed according to Louis Kelso's binary economic growth model and his principles of economic justice would radically unharness the full productive power of modern technology and create directly the expanded private consumer power for sustaining and justifying vastly accelerated peacetime growth rates.

Kelso offers a two-pronged approach for stemming inflation. First, Kelso logically and directly attacks the multiple causes of inflation under today's inefficient national economic game plan, including ever-rising government costs and the deficit financing of welfare and warfare, plus other nonproductive, resource-wasting activities; excessive consumer debt for people with insufficient present incomes; ever-rising labor costs in the face of decreasing labor (as opposed to capital) productiveness; growing waste of labor and corporate productiveness caused by the demotivation and alienation of millions of potentially productive workers by the injustices, absurdities, and opportunity barriers structured into contemporary economies.

The second prong of Kelso's program would modify our corporate, labor, government planning, taxation, and financing institutions to remove structural barriers to broader capital ownership and revive competitive market forces and faster rates of growth. It would adopt incentives for accelerating capital formation through means that would expand the base of capital ownership and build capital incomes incrementally and in reasonable quantities into the 95% of individuals and families for whom significant capital ownership is virtually impossible to attain today.

Let us now see how the classical quantity theory of money would apply to such a planned ownership program. By combining all the variables in the identity given above, we get,

$$M \times V = P \times Q = \text{NNP} = C + I + G = \text{EL} + \text{EC} + \text{ET}$$

### Assumptions for Analyzing the Formula

$$M \times V = P \times Q = \text{NNP} = C + I + G = \text{EL} + \text{EC} + \text{ET}$$

1. Government spending (G) would be held constant. Any future reductions in welfare and subsidy spending as current recipients begin receiving paychecks and, within a few years, dividend checks under the Capital Homestead Act, might first be applied toward retiring the national debt incurred in the deficit financing of war and welfare over the last 80 years. (In actuality, a strong argument could be made that G would be reduced under a healthier and expanding economy.) Thus, all increases (↑) to the nation's output (NNP) would result from added consumer spending (C) and expanded investment (I):

$$\uparrow \text{NNP} = \uparrow C + \uparrow I + G$$

2. Unit costs of labor would be assumed to remain constant for the economy as a whole. The reason is that the new policy would eliminate coercive, mercantilist and monopolistic influences on market wage rates by shifting increases in incomes from fixed wages and entitlements to variable increases based on expanded productiveness of assets and widespread sharing of ownership profits. Thus, increased purchasing power would be directly tied to increased capital incomes, with prices and wage rates set by market forces,

rather than through artificial schemes and income redistribution.

Assuming further that a new ownership-based social contract for workers is in place as a major component of a national Capital Homesteading strategy, the nation's supply of market-oriented productive labor will expand as artificially created and subsidized jobs are eliminated, as fixed labor rates become set by global market forces (rather than by political clout), and as barriers to labor mobility and global free trade are lifted. To build a broadly-owned, vastly expanded and more productive market economy, fixed wages would have to be justified by each person's market-determined labor value, opening up enhanced income and profit sharing opportunities for the unemployed, the underemployed, the handicapped, the elderly and others whose creative potential is now being suppressed by outdated and confused economic policies.

3. Total net government transfer payments (T) would be assumed to remain constant.

4. All future increases in total national incomes or net national product (NNP) would be tied directly to marketable production increases that take the form of increases in employment incomes (EL) and increases in ownership incomes (EC), as determined by competitive market forces and free mobility of workers and invested capital:

$$\uparrow \text{NNP} = \uparrow \text{EL} + \uparrow \text{EC} + \text{ET}$$

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## Analysis

Based on the above assumptions, all growth in net national product (NNP) or, in terms of the quantity theory of money,  $P \times Q$ , would be based on increased consumer spending (C) or increased investment (I), or some combination thereof. However, I is a derived demand, dependent wholly on overall projected or perceived increases in C. (See Harold Moulton, *The Formation of Capital, Brookings Institution*, 1935, p. 42.)

Since all increases in labor and property incomes, EL and EC, would be systematically channeled under the binary growth economic model to non-affluent persons, overall production could be rapidly expanded to the fullest physical and technological potential of the U.S. economy. The currently "non-wealthy" by definition have a highly positive propensity to consume and a largely unsatisfied proprietary desire. Thus underconsumers (whose Capital Homesteading assets would be independently accumulating through "future savings" earned as the assets pay for themselves) should be encouraged to spend all their current incomes to meet unfulfilled consumer needs, with the exception perhaps of a small amount set aside to meet household emergencies. Under Capital Homesteading the new owners would be "forced" to save to acquire their newly issued ownership shares since their future EC incomes would initially be used to repay the capital acquisition loans.<sup>15</sup> The limits of C would be the sum of projected EL plus EC remaining after the formation costs of each new increment of capital are paid. Taking interest payments into account, payback is normally within five to seven years of acquisition.

As was experienced during the 13% annual growth rates during World War II, when maximum market demand for non-consumer-destined production was artificially sustained by government, it is estimated that annual growth rates of at least 6% under the binary growth model would be entirely feasible. Expanded bank credit would become available for expanding productive capacity to the fullest extent of underemployed people and underutilized technology, and U.S. industry itself would be pumping marketing power directly and systematically into its potential

private customers through a private sector income distribution system linked to the payrolls and dividend rolls of each firm in the system.

Redistribution of income would become increasingly unnecessary. The accumulated savings of the already affluent who today enjoy monopolistic access to future capital ownership would become free to be channeled through the banking system to provide productive credit for those Capital Homesteading projects which do not meet the requirements for financing through the Fed's pure credit discount mechanism, thus further contributing to expanding the capital ownership base.

As a preliminary step to meeting such industry-generated expanded demands for consumer goods and services, industry would have to increase greatly its capacity to produce more. Expanding to full production can only be achieved by accelerating the rate of new capital formation (I) and by operating new and existing enterprises at their fullest potential.

The Capital Homestead Act offers a workable means for monetizing such expanded investment rates through our national banking system, without relying on the accumulated savings of the already wealthy (who by definition already derive sufficient EL and EC to satisfy fully their consumer needs). Without the Capital Homestead Act, all newly created capital would flow automatically into a relatively stationary ownership base, as it has since the beginning of the Industrial Revolution. This does nothing but foment more social disorder and more governmental intervention with every expanded use of technology.

At the microeconomic level, that of the individual business enterprise, capital is never added unless it will pay for its own formation costs out of future earnings of the investment itself (EC), generally within a few years. Thereafter it continues to produce wealth and income in amounts that may be ten, a hundred, even a thousand times its original investment costs (I). This wealth and income flows to whomever had access to the ownership financing used to form the new capital. The Capital Homestead Act makes this ownership financing, with its self-liquidating logic and immunity from personal risks of corporate finance, available to the masses, where it was formerly limited to present owners.

Since most increases in wealth production are attributable to unit increases in the productiveness of capital (with a corresponding decrease in the relative productiveness of labor), unit labor costs under the binary growth model would begin to stabilize and might even be reduced as displaced workers began to share the fruits of advanced labor-saving technology. Once unit labor costs become stabilized as workers receive rising dividend incomes after the formation costs of new capital are paid for, a uniquely socially beneficial deflationary effect would result: total output of wealth will have expanded at lower overall production costs. This is because profits (EC) represent a residual of corporate earnings after all other production costs are met. (On the other hand, where there are shortages of certain forms of work that cannot be performed by machines, or where affluent workers choose leisure over economic work, market forces will naturally bid up the costs of labor.)

With access to two sources of personal income, EL and EC, all potential customers of the overall corporate sector could afford to pay for all new consumer goods and services (including the costs of providing environmental protections and sustainable, nonpolluting energy technologies). The price of each product sold would represent total labor incomes and total capital incomes distributed directly through the enterprises involved to all participants in the productive process. Supply and demand at the market place would be matched, no matter how fast production levels expanded. Prices might even be reduced with no harmful economic effects to the new owners. In

fact, an economy might even find itself competitive once again in fields where its labor costs had become out-priced in world markets.

Viewed in the context of the quantity theory of money, increased consumer spending (C) and increased investment (I) would necessarily lead to an increased volume of income transactions (Q) in the overall economy:

$$P \times \uparrow Q = \uparrow C + \uparrow I + G$$

Assuming a national policy to maintain stable or lower prices (P), we can see from the formula

$M \times V = P \times Q$  that either the total supply of money in circulation (M), or the velocity of circulation of money (V), or both, would have to increase in order to accommodate increased Q ( $\uparrow Q$ ):

$$\uparrow M \times \uparrow V = P \times \uparrow Q$$

It makes no difference how rapidly Q was expanding, as long as Q represented new capital goods or new consumer products actually placed on the market where willing customers have sufficient job incomes (EL) or sufficient property incomes (EC) to purchase such products:

$$P \times \uparrow Q = \uparrow EL + \uparrow EC + ET$$

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### **Anticipating Short-Term Problems in Transition to A Binary Economy**

One note of caution is in order, however. While a growing economy needs a growing money supply, there is a slight technical lag between the time that the banking system creates money for new capital acquisitions and the time that such productive assets are actually placed in production and begin to produce income to complete the credit cycle. This has a minor and temporary inflationary effect, but one that is more than offset by the long-term counter-inflationary impact of the binary growth model.

The key to understanding this author's optimism is the recognition that the present economic system fosters many leakages and enormous wastes of human creativity, commercializable advanced technologies and nonproductive uses of natural and man-made resources. The binary growth model would close most of these leakages and reintroduce these wasted resources for the production of marketable goods and services. This very logic of the binary growth model would thus raise the physical production and sales of marketable goods and services far beyond current levels without raising production costs in the short run, and by actually lowering production costs over the mid- to long-term. Moreover, any minor adverse effect would be counterbalanced, even in the short-run, by reducing structural inflationary pressures in today's economy caused by:

- continually rising labor costs in the face of a continuing displacement of labor inputs resulting from technological improvements,
- more "created" jobs on government and subsidized payrolls to absorb technologically displaced workers who are unwilling or unable to find satisfying private sector jobs,
- higher taxes at all levels of government,

- expanded welfare and unemployment rolls,
- artificial consumer demand created by easy access to consumer credit,
- unnecessary and inefficient barriers to enterprise competition,
- vastly underutilized U.S. plant capacity and U.S. manpower,
- costly resistance by organized labor to automation,
- needless strikes, slowdowns, and worker sabotage,
- continuing government deficit spending and rising interest for non-economically productive spending covered by the national debt,
- and many other "demand-pull" and "cost-push" pressures on current price levels.

More enlightened national fiscal and monetary policies, geared to "full ownership" and "full and sustainable production" (instead of artificial and dehumanizing expedients to achieve "full employment") could easily adjust for this minor problem. In no way, however, does it justify any further delays in restoring health to the U.S. economy and greater efficiencies and fairness in how we distribute capital ownership and mass purchasing power.

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## Conclusion

Kelso's binary economic system and the social technologies that would become available under the Capital Homestead Act offer a new route to accelerated, quality growth without inflation in the U.S. economy. The logic and justice of binary economics offer an improved framework to move America ahead in accordance with its original founding principles, guided by customs, legal principles, institutions and traditions that are embedded in the fabric of this nation. The American Dream offered a revolutionary vision to all citizens to encourage each person and family to gain income self-sufficiency through ownership of productive assets. Binary economics offers a new paradigm to restore that vision, voluntarily and at no one's expense.

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## Notes

- 1 Louis O. Kelso and Patricia Hetter, *Two-Factor Theory: The Economics of Reality*, New York: Random House, 1967, p. 54.
2. Frederick Merton, *The Rothschilds, A Family Portrait* (New York: Atheneum, 1962).
3. Quoted in Salvador Araneta, *Bayanikasan, The Effective Democracy for All* (Manila, Philippines: AIA Press, 1976).
4. In his book, *Top Heavy: A Study of Increasing Inequality of Wealth* (New York: Twentieth Century Fund, 1995), Dr. Edward N. Wolff of New York University mentioned that "in 1992, the financial wealth of the top 1 percent was greater than the combined wealth of the bottom 90 percent." Based on his later analysis of the Federal Reserve's *Triennial Survey of Consumer Finances*, Dr. Wolff stated that "the nation's 400 richest families grew by an average of \$940 million each from 1997 to 1999, whereas over a recent 12-year period of 1983 to 1995, the modest net worth of the bottom 40 percent of households plummeted 80 percent." (See his paper "Recent Trends in Wealth Ownership" presented at a conference on Asset Ownership in the United States at the New York University, December 10-12, 1998.) Globally, the trends are worse. Jeff Gates in *Democracy at Risk: Rescuing Main Street from Wall Street*

(Cambridge, MA: Perseus Publishing, 2000), cited studies showing that "the world's two hundred richest people more than doubled their net worth in the four years to 1999, to more than \$1 trillion an average \$5 billion each.... This combined wealth ... now equals the combined annual income of the world's poorest 2.5 billion people" (p. xiv).

5. See *The Capitalist Manifesto*, Louis O. Kelso and Mortimer J. Adler, New York: Random House, 1958; *The New Capitalists: A Proposal for Freeing Growth from the Slavery of Savings*, Louis O. Kelso and Mortimer J. Adler, New York: Random House, 1961; *Two-Factor Theory*, Louis O. Kelso and Patricia Hetter, New York: Random House, 1967; *Democracy and Economic Power: Extending the ESOP Revolution*, Louis O. Kelso and Patricia Hetter Kelso, Lanham, MD: University Press of America, 1991; and *Binary Economics: The New Paradigm*, Robert Ashford and Rodney Shakespeare, Lanham, MD: University Press of America, 1999. Other articles on binary economics by Robert Ashford include: "A New Market Paradigm for Sustainable Growth: Financing Broader Capital Ownership with Louis Kelso's Binary Economics," Volume XIV, *Praxis*, The Fletcher Journal of Development Studies, pp. 25-59, 1998; "Louis Kelso's Binary Economy," Volume 25, *Journal of Socio-Economics*, pp. 1-53, 1996 (available on westlaw.com in its jjsocoecon data base); and "The Binary Economics of Louis Kelso: The Promise of Universal Capitalism," 22 *Rutgers Law Journal* 3, 1990 (available on the CESJ website and at [www-camlaw.rutgers.edu/publications/lawjournal/ashford.htm](http://www-camlaw.rutgers.edu/publications/lawjournal/ashford.htm)). A compendium of writings by many authors on this subject can be found in *Curing World Poverty: The New Role of Property*, John H. Miller, ed., St. Louis, MO: Social Justice Review, 1994. For a sympathetic analysis from a conventional Keynesian perspective, see Stephen V. Kane, "The Theory of Productiveness: A Microeconomic and Macroeconomic Analysis of Binary Growth and Output in the Kelso System," 29 *Journal of Socio-Economics*, 541-563, 2000.

6. John W. Kendrick, "Productivity Trends and Recent Slowdown: Historical Perspective, Causal Factors, and Policy Options," *Contemporary Economic Problems*, Washington, DC: American Enterprise Institute, 1979; also R. M. Solow, in *Mathematical Methods in the Social Sciences, 1959*, pp. 89-104, K. J. Arrow, S. Karlin, and P. Suppes, eds., Palo Alto, CA: Stanford University Press, 1960. Also: Edward Denison, "Accounting for United States Economic Growth: 1929-69," Washington, DC: Brookings Institution, 1974, and *Accounting for Slower Economic Growth: The United States in the 1970s*, Washington, DC: Brookings Institution, 1979.

7. See chapter 4 of *Curing World Poverty: The New Role of Property*, op cit.

8. As of the third quarter of 2000, the annual increment added to America's productive asset base of the nondefense economy was \$2.07 trillion, consisting of:

New equipment and software, private sector	\$1,162.4 billion
Nonresidential structures, private sector	286.6 billion
Residential buildings, private sector	362.3 billion
New equipment and software, public sector	108.0 billion
Structures, public sector	<u>154.5 billion</u>
	<b>\$2,073.9 billion</b>

With a U.S. population of 275.3 million in 2000, this amounts to \$7527 of new productive assets for each man, woman and child in America. (Source: *The Economic Report of the President*, January 2001, tables B-19 and B-21.)

9. A proposed comprehensive national ownership strategy is described in *The Capital Homestead Act: National Infrastructural Reforms to Make Every Citizen a Shareholder*, Norman G. Kurland, Arlington, VA: Center for Economic and Social Justice, 1999. (Available from CESJ's web site at <http://www.cesj.org>.)

10. Norman G. Kurland, "Saving Social Security," June 1, 2000, an occasional paper of the Center for Economic and Social Justice available from the CESJ web site, op. cit.

11. This idea was first advanced by Dr. Norman A. Bailey, former Special Assistant to President Reagan for

International Economic Affairs, in his article, *A Nation of Owners* (*The International Economy*, September-October 2000).

12. Described in such books as *The New Capitalists* (with Mortimer Adler), op.cit., and *Two-Factor Theory: The Economics of Reality* (with Patricia Hetter), op.cit. See also testimony of Mr. Kelso and Norman G. Kurland before the Financial Markets Subcommittee of the Senate Committee on Finance on September 24, 1973. The most detailed description of binary monetary reforms can be found in this author's article, "The Federal Reserve Discount Window," which appeared in the Winter 1998 issue of *The Journal of Employee Ownership Law and Finance*, Oakland, CA: National Center for Employee Ownership. (Also available from the CESJ web site, op. cit.)

13. This idea was also conceived by Dr. Norman A. Bailey. See f.11.

14. Paul Samuelson, *Economics*, 6th edition, New York: McGraw-Hill, 1964, chapter 14.

15. In fact, Harold Moulton pointed out in *The Formation of Capital* (Washington, DC: Brookings Institution, 1935, pp. 117-8) that forcing the non-wealthy to reduce their consumption incomes to acquire capital assets is counterproductive. In contrast to "pure credit" repayable with "future savings", the self-denial approach to asset accumulation reduces the feasibility of all growth assets (I), whose financing was based on the assumption of increased consumer demand (C). Cf. Samuelson, op.cit., p. 47.

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