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ASSET DISTRIBUTION AND PRODUCTIVITY: BEST PRACTICES FOR DEVELOPING THIS SYNERGISTIC RELATIONSHIP

A Thesis

Presented to

the Faculty of Social Sciences

University of Denver

In Partial Fulfillment

of the Requirements for the Degree

Master of Arts

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by

Wendy Willbanks Wiesner

June 2010

Advisor: Dr. Tracy Mott

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Title: ASSET DISTRIBUTION AND PRODUCTIVITY: BEST PRACTICES FOR DEVELOPING THIS SYNERGISTIC RELATIONSHIP
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Abstract

Productivity is an essential component of lasting corporate success. It is also a critical ingredient in the recipe for making a vibrant and prosperous community.

Economics recognizes that both capital and labor make contributions to productivity through the functions of investment and production. Enhancements to productivity can be obtained in multiple areas, including technological advancement, corporate expansion, market penetration, and product development. Sustained productivity growth, however, is predicated upon continual process improvement and market innovation.

Identifying precisely "who" and "what" are contributing to productivity is challenging. Because capital and labor interact, it is difficult to determine whether the positive effect is due to the man or the machine. Evaluating the contributions of labor alone is complicated, as people are productive both as individuals and in working together as a group. It is hard to imagine a situation where a competitive advantage is obtained without cooperation. Nevertheless, economics is theoretically geared toward atomistic contributions to productivity.

Making any significant achievement within a corporation or community requires input from a variety of entities having a willingness to commit their time and energy to a particular effort. Because the path to improvement involves making mistakes and learning-by-doing, patience is involved. Often short-term gratification must be sacrificed

for long-term gain; incurring costs today in the hope of revenues tomorrow. This trade-off affects both costs and profits. Because short-term profits are the predominant incentive for investment capital, and marginal costs are the key determinant of wages, favorable behaviors on either the investment or production front are not automatically rewarded. Attention must be given to asset development, if incentives are to be structured properly.

In this paper, I emphasize the importance of using specific asset-based methods and financial tools to fairly and efficiently distribute contributions to productivity. Corporations will find these methods equally desirable because they can be used to generate low-cost, highly-accessible finance capital. These incentive structures include the Employee Stock Ownership Plan (ESOP), as well as other financial instruments that are built upon the foundation of the ESOP. These include the CSOP (Customer Stock Ownership Plan), the CIC (Community Investment Corporation), and the CHA (Capital Homesteading Account).

Although these variations of the ESOP address a wide variety of situations, they have yet to be tax-qualified like the ESOP. I am hopeful that this will change. To cover the landscape of what is available right now, however, the structures that include the Community Development Corporation (CDC), the Community Land Trust (CLT), and the Individual Development (IDA) are investigated.

Because the future prosperity of individuals, corporations, and communities depends upon continuous improvement and innovation, contributions to productivity are of primary importance. Just as important is the creation of a life and work environment that is competitive, efficient, and fair.

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Chapter One: Observations and Experiences

Conventional Economic Wisdom--Productivity and the Creation of Value

For over two hundred years, economists have been developing theories of value. In spite of various competing arguments that preclude any full agreement in this area, making the attribution and assessment of value a tangible, concrete, mathematical exercise remains a primary goal of economics.

The production process is one way that value is created. The factor inputs of capital and labor each have a unique contribution to productivity, one that is measured in the marginal product of capital and labor. The marginal productivity of labor must equal its marginal cost, or the wage. The marginal productivity of capital equals its rate of return. The traditional assumption is that input costs adjust automatically, in response to competitive pressures and the demands of the marketplace.

In addition the contributions made by the acknowledged factors of production including capital and labor, contributions are also embodied in the efficiency of the production process itself. It is expected that methods and processes improve over time, with the development and implementation of new technologies ever-expanding productive capacity. It is assumed that the productivity-enhancing effects of innovation are realized by labor, as technological advancements incorporated into equipment, machinery, tools and information processing make labor more efficient.

For production to create value, current and future investment must occur. Theoretically, this process is facilitated by a transformation of savings into investment, a function that is performed by financial intermediaries. Traditional sources of finance include loans generated by financial institutions or other financial intermediaries, and public and private equity markets. Investment capital can also be generated within the corporation, with the re-investment of retained earnings. Availability of this type of finance is predicated upon the creation of surplus value, or profits. Today, a majority of the capital that finances corporate expansion is carved out of retained earnings.

At this point, it can be noted that the theoretical conceptions of production and investment are direct and straightforward. Simplicity is what makes this no-nonsense approach possible. If economic conclusions are to be made on the basis of quantitative analysis, a reductionist viewpoint is required. Driving toward tidy, concrete answers, however, requires making a multitude of essential assumptions. I have found that these artificially-imposed limitations make it virtually impossible to make an empirically realistic or reliable determination of who, are what, contributes to productivity. Thus, the wellspring of value-creation remains a nebulous and opaque entity.

Limitations of Conventional Economic Wisdom in the Attribution of Value

Regarding the economic models associated with the production process, there are four areas where over-simplification has the potential to produce confusion and mis-understanding. First, there is an assertion that a person's contribution in the value-creation process can be measured directly by the marginal product, and that marginal cost, or the wage, is a realistic reflection of this contribution. Second, there is the belief that the benefits generated by technological development and advancement will

automatically be reaped by labor, albeit in an abstract fashion. Next, there is an assumption that contribution to productivity that can be fully realized and measured at any point in time, as a snap-shot view of the situation. Third, capital and labor are viewed in a compartmentalized fashion, thus eliminating the possibility that a complex relationship between the two is a source of productivity enhancement. Finally, the treatment of an individual as distinct labor unit, with a unique marginal cost and product attached, attributes value to individualized efforts that are motivated by competition. There is no avenue to consider the possibility that collaboration, cooperation, and collective effort creates value.

The conception of investment also has limitations that can be clearly identified. Most questionable is the assumption that savings automatically transforms itself into investment, as Say's Law would attest. Economic theory views this process as naturally efficient, guided by a quest to maximize the return on capital. With the expectation that this process effectively occurs without intervention, within a mysterious black box, it appears to me to be a magical thought.

Extracting any truth out of this assumption relies upon faith in financial markets. One must believe that there is an innate capacity, or a natural proclivity on the part of the financial sector to channel capital into productive investment. This interpretation ignores the possibility that financial intermediaries and firms may have conflicting interests, especially in their conception of the investment horizon. It is a reasonable expectation that financial intermediaries will be motivated by the highest short-term returns. Conversely, firms will find that innovation and development requires learning-by-doing,

trial and error, and inevitable mis-steps. Because the innovative process is not linear, it requires patience, risk-tolerance, and a long-term approach toward investment.

Without question, any attempt to quantify contributions to productivity so that the larger question of value creation can be resolved is a necessarily imperfect exercise. Human beings are rich, varied, intertwined and complicated, just like the environment in which they live. Nevertheless, various professional experiences have led me to seriously question whether the prevailing economic wisdom not only sacrifices completeness to achieve tangible conclusions, but is actually misguided to the extent that efficiency and fairness are routinely compromised.

In the next set of anecdotal examples, I will highlight how the commonly-held economic viewpoints regarding contribution to productivity and value prove themselves to be flawed. In these situational examples, there is no systemic means of linking productivity and contribution to returns and rewards. The incentives are distorted, the outcomes do not promote the achievement of long-term objectives, and an environment that could have otherwise fostered continuous innovation and development is polluted.

These experiences have led me to search for market-based methods that fairly, accurately, and efficiently distribute financial gains and the contributions made to productivity. My findings will be discussed later in this paper, after I have covered the anecdotal evidence that brought these concerns to the forefront.

Chapter Two: Two Examples Coming from the Real World

A Situation Where Information has Value

Few companies last over 100 years, but NCR, formerly known as National Cash Register, is one of them. NCR has always been in the business of automating transactions, but since the 1980's, the focus has narrowed to providing self-service technologies within the retail and financial sectors.

From grocery store self check-out systems to automated teller machines (ATM's), NCR has given customers the ability to help themselves. Less apparent to the casual observer, but equally significant in impact, are the back-office technologies pioneered by NCR. One example of NCR technology that has radically altered back office operations are image-based check and remittance processing systems. Fundamentally changing core processes, these systems eliminate encoding, proofing, and sorting in all but the rarest of occasions. Comprised of hardware equipped with image cameras and readers, along with software that incorporates neural networks and artificial intelligence, these systems are very sophisticated. They read multiple fields of what could be considered to otherwise be indecipherable customer handwriting.

For customers that include money center banks, the U.S. government, and the Federal Reserve, this technology has permanently altered the amount of administrative labor required to run any back office financial operation. This image-based technology that got its initial traction in check and remittance processing departments addresses a

multitude of functional areas. A host of documents, including loan and mortgage originations, Certificates of Deposit and account opening forms, can all be handled with limited human intervention.

It is important to note that the proliferation of this technology compliments the recent growth of the internet. The ever-increasing number of documents generated online capitalizes upon the efficiencies that have already been realized in the back office. Because the complete process has already been dissected and well understood, both existing and new systems can readily evolve.

To effectively translate human activity to machine operation, the cooperation of the people that have been manually performing the process in the past is essential. Imparting this knowledge is like a technology transfer, with the enabling methodology referred to as a work flow analysis. This effort, which requires asking many detailed questions, breaks a process into granular operations. For the technology to work properly, for it to deliver the maximum benefit, the points of failure must be identified. Furthermore, the opportunities for improving efficiency must be determined if the system is to be cost-justified.

Here a conundrum arises: the individuals who provide the answers to the questions—those who provide the key information and details that determine the efficacy of system—are providing the justification for their own demise. Technological advancement makes labor more productive, and as a result replaces it.

In this case, it is clear that a wage-based reward system does not take into consideration either the short or long-term contributions that have been made in a highly cooperative effort. Worse yet, there are in fact strong incentives to avoid the open

communication and sharing of practical, on-the-job information that promotes the efficient implementation of the system.

Perspective regarding this situation, if guided by economic theory, provides certain insights. With this assessment comes the acknowledgement that the proliferation of technology eliminates jobs, yet offers the possibility of new types of employment. These newly created opportunities may even be more desirable than the administratively-oriented, manual, repetitive, relatively low-wage jobs that have been eliminated. The opportunity exists to allocate labor more efficiently, into areas where machines are less capable than humans. (As technology evolves, it is possible that this argument may become irrelevant).

Nevertheless, the original problem endures: the contributions to productivity in this particular situation are not correctly recognized or appropriately attributed. Because the value is added in the asset development process, the contributions to productivity are realized in the return on investment. Investment quality is reflected in the return on investment, as well as in corporate profits. If the company is financing the investment out of retained earnings, the company benefits in both the investment and production spheres.

In this and many other situations like it, the quality of the asset and the investment is predicated upon the contribution of knowledge and experience, not just the provision of capital. The problem is that wages consider only the contributions to production, not the impact upon investment. Capturing this contribution requires sharing in the profits or the ownership of the corporation. This paper is committed investigating these asset-sharing methods.

A Case Where Publicly-Raised Equity Capital Becomes a Blunt Instrument

Troy Systems Incorporated began as a company manufacturing and selling Magnetic Ink Character Recognition (MICR) hardware and supplies. MICR technology generates specifically-formatted, machine-readable characters or fonts. These numeric characters conform to a universally-established format that is recognized by central banks and financial institutions.

Troy's original systems were industrial-grade impact-printing devices with enormous MICR ribbons. The equipment was deployed in the back-offices of national governments, central banks, blue-chip corporations, and financial institutions. Applications which are still in use today include check and remittance printing, along with the production of various other documents that are well-suited for machine readability, including lottery tickets.

This technology evolved to include distributed laser-printing systems for bank branches, insurance company offices, and regional or satellite corporate offices. Checks could be printed instantaneously in payroll departments, at teller windows, and at insurance company offices. This manageably-sized technology was affordable, flexible, and applicable in a wide variety of environments. One notable application is the on-the-spot adjudication and payment of insurance claims.

The emergence of online systems and the internet meant that the company had to offer new systems that could capitalize on electronic payment technologies. To adapt to rapidly-changing market conditions, Troy purchased corporations that had and existing solution and customer base. These companies had turn-key systems that were built to

utilize the national payment system owned by the Federal Reserve Bank, referred to as the Automated Clearinghouse House (ACH) network.

The most prominent product acquired and developed at this time was an electronic check system branded “eCheck Secure”. The initial application for eCheck Secure was the nascent online brokerage industry. The electronic check system allowed brokerage customers to trade instantaneously, at any time of day or night, from the comfort of a home computer. Other applications followed, with eCheck offered as on online payment system for internet shopping sights, electronic shopping carts, and online financial institutions. The eCheck Secure product was the earliest entrant in this market that would later be dominated by a few players.

Troy was a relatively small company, thus investment capital would have to be raised to acquire the companies that offered the electronic payment solutions. The decision was made that the family-owned company would go public. The strategy was to acquire other companies with stock rather than cash or debt. Throughout the technology industry, stock had become the currency for acquisitions.

This change in ownership gave employees the opportunity to participate in one of two ways. The first method, and Employee Stock Purchase Plan (ESPP), was made available to all employees. This program allowed employees to purchase discounted company stock that could be sold once the company completed the ownership transition. The second method of distributing ownership was through company stock options offered to key company employees. Some of these options were gifted, and others were subject to future purchase. These were restricted stock options that could not be executed until a

certain target date a few years after the corporation became listed on the public stock market.

The company went public in 2000, at the height of technology IPO wave. Soon after Troy went public, it became relatively clear that Troy stock, like other technology stocks, gained value from speculative investment activity. The company quickly developed a formula for maximizing stock value by issuing a press release every Friday, one in which the announcement would be made that at least one new customer had been secured.

Troy stock values soared every Friday, exhibiting exponential gains in value. The pressure to produce a new customer announcement every Friday became intense. Influencing investor expectations and maintaining a high level of exposure and interest became more critical, as the competition from other IPO's intensified. The beneficiaries of this predictable pattern were investors or outsiders that were not affected selling restrictions. Employees that purchased stock through the ESPP were also able to profit, as were extended family members that were not directly involved in the operations of the company.

Most likely to benefit were the ESPP participants who had a shorter-term view of their employment or the company itself; employees with a longer-term view were less-likely to sell their stock, anticipating that the stock would have sustainable value. Some held their stock out of company loyalty, others had a basic perception that investing in public equity markets meant long-term holding to realize value.

When the technology sector crashed a few years later, Troy stock values went down with the rest of the technology stock crowd. The stock value had gone from a

height of over $100 per share to less than $2.00 per share, just as the window for selling restricted stock options had opened. The company eventually went back to private ownership, with the original owners buying out the prior owners and management of the acquired companies at a financial low-point.

In this case, incentives for contributing to productivity have been perverted. Those who benefited included the following: 1) family members who held stock with no restrictions; 2) employees with a short-term attitude having less concern for the company as an ongoing concern; and 3) the original private owners of Troy who purchased companies with real products and revenue streams for a fraction of their original, pre-acquisition value.

This distortion meant that key, productive employees of Troy Systems with restricted stock options, along with the employees and owners of the acquired corporations that made real contributions to productivity, were on the losing side of the transaction. Employees and investors that bought-into the corporation, who exhibited patience and developed trust—two positive qualities that are capable of enhancing productivity over time—either did not reap any rewards, or sacrificed the initial value of their corporations in the process.

Public equity markets are just one avenue for obtaining finance capital. As a result of my observations and experiences, I have investigated other methods of raising finance capital that have a greater propensity to fairly and efficiently combine investment with ownership, for both employees and other stakeholders. In the next section, I provide an overview of the risks associated with traditional methods of obtaining finance capital, along with what I perceive to be more desirable, yet practical alternatives.

Chapter Three: Practical Alternatives for Creating "Good" Investment Capital

For individuals, corporations, and communities to become more resilient and productive, investment in current and future capacity must be made. This is becoming increasingly more difficult today, given the current economic environment in which the availability of corporate finance is very limited, even for companies that have a solid track record and business plan. Constriction of industrial credit was a trigger of economic crisis, and its continued scarcity is thwarting economic recovery today.

The dearth of capital can in part be attributed to the complexion of global capital. This powerful economic force is naturally focused on short-term gains, and little concerned with long-term value. These are the new rules for competing in the investment world, and many corporations, and most individuals, are no match for this highly-focused, highly-trained juggernaut. Non-professional financiers will most likely be on the losing side of the bet until new ways of approaching investment opportunities are championed.

The solutions offered in this paper shift the focus from large, impersonal outside finance markets to internal opportunities, where corporations, communities, employees, customers, and individuals have the opportunity to invest in one another. This approach creates a competitive advantage in three ways: 1) knowledge of sophisticated financial markets is not what matters, rather the information regarding the specific business, which is more readily available on the inside; 2) all parties have skin in the game, thus more

commitment to one another; and 3) the actions of all participants have the capacity to effect the outcome, or the return on investment.

It is more critical than ever for corporations and individuals to strive for efficiency, develop new processes and technologies, and foster a culture of innovation to survive. Because business conditions are increasingly driven by cost containment, culminating in a global race to the bottom, labor markets are precarious, wages are stagnant, and unemployment is high. Employers are challenged to maximize employee productivity and invest in new technology to stay competitive, at a time when capital is incredibly scarce. Retaining a customer base is more challenging, as intense price competition erodes loyalty and forces defections. Both companies and individuals need equity cushions to survive today, and expand in the future.

This paper is about corporations, employees, customers, and community members using certain structures in the current legal and financial system to distribute assets safely and effectively. In the process of creating and maintaining these enabling structures, participants cooperate with one another. It is in the very act of cooperating where productivity begins to thrive, where assets built today become the solid financial foundation of tomorrow.

It was Louis Kelso, lawyer-economist and inventor of the ESOP (Employee Stock Ownership Plan), who developed the philosophical and legal architecture capable of harnessing this potential energy. Although the details of the ESOP will be discussed at a later point in this paper, Kelso's broader perspective that informed the invention of the ESOP is important at this point in the discussion. The comments that Kelso (1975) made in an interview with the journalist Mike Wallace have contemporary resonance:

> “Americans," says Kelso, "are a nation of industrial sharecroppers who work for somebody else and have no other source of income. If a man owns something that will produce a second income, he'll be a better customer for the things that American industry produces. But the problem is how to get the working man that second income" (Kelso Institute, 2000, p.1).

Individuals need assets, and corporations need finance. Individuals and companies working together, using the proper financial instruments and structures, can accomplish this task. This collaboration also creates a competitive advantage in that a closer alignment of production and consumption better serves real needs.

What is required is a change in our thinking about financial intermediaries. What I am suggesting is a flattening of the bureaucratic structure that provides finance, with consumers and producers working directly together, literally or figuratively as a community, to meet their finance needs. Much legitimate demand for finance is never met, given that most financial enterprises are not in the business of deeply understanding the nitty-gritty of business enterprises, unless the finance arm is private equity, where the goal of finance is often to “possess” a company rather than support its growth or expansion.

Community Development Financial Institutions (CDFI’s) are by design an exception, in that their organizational structure fosters the development of community, company or industry-specific expertise, so that in-depth understanding can be used to guide finance decisions. This hands-on, cooperative, more localized approach to finance has its place, even in a structure that brings end users, workers, and corporations together at the planning and development table. In stark contrast, global capital is not fundamentally structured to have either knowledge of, or direct connection with, the community, industry, or company. In fact, the recent growth in the finance industry has

been in the development of financial vehicles that fully alienate capital from its productive application, by selling-off, reconstituting, pooling, and subdividing whatever was the original purpose of finance. Such examples are collateralized debt obligations and credit default swaps, the culprits in the recent crisis. In simple terms, bankers that do not know the end-user customer distort markets and cause systemic problems.

In the mean time, I have written about providing asset building opportunities primarily in closed markets, where speculation is not an issue. Because they are closed markets, it is not a zero sum game, with one winner and one loser. Both parties win by cooperating with one another. The next section of this paper addresses asset-building approaches that can be used today; they are practically, politically, and institutionally feasible.

Chapter Four: Overview of Asset-Distribution Methods

Rewarding All Stakeholders for Their Contributions to Productivity

In this paper, I provide an overview of financial instruments and organizational structures that are either expressly designed, or inherently capable of sharing assets. In each case, I point out their intrinsic strengths and weaknesses, and compare the instruments to one another. In some cases, I find that a financial instrument or structure that is not available today is superior to what already exists. I present both what is available now and discuss how the situation could evolve.

The tools that I favor build assets out of current productivity, using financial structures and instruments that are already part of the U.S. legal fabric. These tools distribute productivity to stakeholders, who are defined here as those with a fair claim, or an earned or natural right to the distribution. It is the participation of these stakeholders, either as employees, customers, or community members, that fundamentally contributes to the success of the entity in the first place. Thus, the distribution is like an earned endowment.

These earned endowments include equity stakes, property ownership, matched accounts for individuals, and shared ownership of public goods and services. In searching for the best methods to fairly and efficiently distribute assets, I have focused upon four areas of opportunity. First, I will cover corporate-sponsored plans that extend ownership to employees. Second, the opportunity to expand corporate ownership to

include customers is investigated. Next, I discuss community-based development and ownership of both private and public assets. Finally, individual accounts that provide a repository for assets are examined.

Chapter Five: Corporate-sponsored Plans that Incorporate Employee Ownership

From the Defined-benefit Account to the Defined-contribution Account

The earliest form of asset-sharing and distribution for corporate employees came in the form of a pension plan. The earliest pension accounts were termed defined benefit plans, in that the company would promise an employee a defined benefit, or a certain monthly amount, after retirement. The employee had no responsibility or control over the pension account, which was administrated by a trustee.

By the 1960's, traditional defined-benefit plans had earned a reputation for being under-funded and lacking in transparency. By the early 1970's, there was a groundswell of public support for pension reform, which culminated in the Employee Retirement Income Security Act (ERISA) of 1974. This sweeping legislation formally recognized the financial vehicles that could be offered within corporate pension plans, and specified the tax incentives, accounting rules, and notification/reporting requirements that would be required for each type of account. ERISA also clarified issues regarding employee participation, distribution, vesting, matching and termination.

From an employee perspective, ERISA was especially significant for two reasons. First, employee recourse rights were mandated. As specified within the U.S. Department of Labor's Frequently Asked Questions about Pension Plans and ERISA, pension plan beneficiaries have "the right to sue for benefits and breaches of fiduciary duty." The second important provision, applicable only to defined benefit plans, was the creation of

the Pension Benefit Guaranty Corporation. This federally chartered corporation is defined within the aforementioned Department of Labor Frequently Asked Questions as an entity that "guarantees payment of certain benefits if a defined plan is terminated" (Department of Labor, p. 1, 2010).

Types of Defined-contribution Stock Plans

ESOP, ESPP, Stock Option Plan, and Individual Equity Plans.

While establishing rules and regulations for all pension plans was historically significant, the fact that ERISA re-defined what constitutes a pension plan was revolutionary. ERISA birthed the defined-contribution pension account, the most popular form of pension plan in existence today. A defined-contribution account defines the amount of cash or stock that the employer contributes to an account, but does not guarantee a certain monthly or lump-sum payout at retirement. The balance in a defined-benefit account is invested, usually in some type of stock plan. According to a National Center for Employee Ownership (NCEO) article titled "How to Choose an Employee Stock Plan for Your Company", defined-contribution stock-based plans fit into four broad categories. These categories include the ESOP (Employee Stock Ownership Plan), the ESPP (Employee Stock Purchase Plan), Stock Option Plan, and Individual Equity Plans (including the gifting or purchase of restricted stock). (National Center for Employee Ownership, 2010).

A Focus on the ESOP—its Unique History and Legal Framework

The first stock-based plan in the NCEO categorical reference is the ESOP. Because the ESOP is the only defined-contribution plan given special provisions within

ERISA, I will now cover its unique aspects. Also, I will highlight potential areas of confusion between the ESOP and the other stock-based plans.

Unlike other financial instruments that have emerged after-the-fact out of the financial system's legal framework, the ESOP was fully intentional. The brainchild of lawyer-economist Louis Kelso, the ESOP is an innovation with no financial or legal precedent. Although the worker cooperative shares the premise of employee ownership with the ESOP, the enabling financial architecture of the ESOP is unique.

According to historical information published by the Kelso Institute (2000), the ESOP was first used in 1956 to facilitate an employee leveraged-buyout of Peninsula Newspapers, Inc. of Palo Alto, California. Less than a few decades later, the ESOP was formally recognized by the U.S. Federal Government, with the passage of the Regional Rail Reorganization Act, and finally in 1974, the ESOP was written into ERISA as a special provision. The ESOP would be exempted from a rule restricting pension funds from investing more 10% in company stock. This rule, which had been conceived to protect employees from the risk associated with a non-diversified portfolio, also made it impossible to transfer a significant percentage of corporate ownership to employees. (Kelso Institute, 2000).

Because the ESOP was recognized by many as both an ingenious and practical method of transitioning corporate ownership, special tax provisions to make a change of control more financially feasible became part of the legal recognition of the ESOP. In the past, large tax liabilities made it difficult for owners to pass the ownership of a company to other stakeholders. Another problem was that stakeholders often could not raise the capital to buy out the owners.

The ESOP solved this problem with favorable tax treatment bequeathed to it within ERISA. Of particular note are three special ESOP tax provisions that are highlighted within The Democracy Collaborative at the University of Maryland's 2005 book titled *Building Wealth: The New Asset-Based Approach to Solving Social and Economic Problems.* The first provision addresses the large tax liability that owners incur when selling a private corporation. To offset this significant expense, the owners of closely-held corporations, as long as they own at least 30% of the corporation, can defer capital gains tax when the company is sold to a worker-owned coop or an ESOP. The next ESOP tax provision aids employees in raising sufficient capital to buy-out a corporation. Given that employees in nearly all instances lack the capital to execute an employee buy-out, the ESOP has been IRS-qualified to buy shares from owners using tax-deductible corporate funds. These funds may be obtained by borrowing against the future earnings of the company. The final ESOP special tax provision applies once a change of control occurs, when a lack of liquidity may pose a problem. To increase the chance that the ESOP will be a long-term, ongoing concern, it is allowed to fund itself with tax-deductible money or stock contributions. (The Democracy Collaborative at the University of Maryland, 2005).

Confusion between the ESOP and other stock-based plans.

At this point, it is important to re-emphasize that the ESOP is entirely different than the other recognizable stock-based plans. Because it is both common and understandable that the ESOP is frequently confused with the ubiquitous instrument known as The Section 401(k) Plan, discussing the key distinctions between them is critical. As documented by Wang in 2002, the 401(k), in contrast with the ESOP, was

not expressly established as part of the 1974 ERISA legislation. It was invented after-the-fact by private pension fund advisor Theodore Benna. The special ESOP exemption within ERISA was the enabler, however, in that it opened a loophole for the 401(k). In creating the 401(k), Benna took advantage of the ESOP exemption that allowed defined-contribution plans to have portfolios with more than a 10% investment in company stock. In addition, the 401(k) could also be crafted so that corporations could match employee deductions with company stock, tax-free. (Wang, 2002).

The blurring of lines between the ESOP and the 401 (k) was just one point of confusion that was created with the advent of defined-contribution plans. The new types of accounts that had specific treatment within ERISA were complex on their own merit, before even considering those that evolved out of the legislation. Given the difficulty, the law of unintended consequences displaced the ability to anticipate permutations and innovations that would come out of the legislation. Simply the nomenclature used to describe the sophisticated instruments was not intuitive, in that the difference between stock "ownership", "purchase", and "option" was not readily apparent.

As a result, there is still much confusion when one attempts to distinguish one defined-contribution plan from another. There are some qualities of defined-benefit contribution plans where generalizations can be made, however; and this is where I now turn the attention.

The Impact of Defined-contribution Plans

An employer's perspective.

Cutting through the aforementioned confusion, in addition to navigating the complex details of defined-contribution plans, proved to be time-consuming for both

employers and their employees. As a result, employers would incur large, tangible set-up and maintenance costs in establishing defined-contribution plans. The substantial reward, however, would be the employer's ability to shift the responsibility for the performance of the pension account to the employee. This change of control relieved the employer of the commitment attached to defined-benefit plans—the promise to pay the employee a certain fixed amount, irregardless of any market conditions. Another desirable element of the defined-contribution plans was the provision of significant tax-based incentives. These tax breaks had the effect of boosting corporate earnings, the effects of which were magnified if the employer were to contribute company stock to the plan.

An employee's perspective.

Whereas the impact of the defined-contribution plan on employers was largely positive, the effect upon employees is a mixed bag. Whether employees would fare better or worse with the defined-contribution plan relative to the defined-benefit plan would depend to a large extent upon the employer's stock performance, stock market conditions, and the financial management abilities of the employee.

To properly manage the defined-contribution account, the employee had to first understand the provisions of the account. There were specific rules, requirements, and timeframes for enrolling, vesting, allocating, withdrawing, and terminating. Attaining the knowledge to establish a comfort level would require a substantial commitment of both time and energy. A labor force that had been accustomed to counting upon a pre-specified amount at retirement had to take financial control, and the payout at retirement would hinge upon the employee's ability to engage.

Because most defined-contribution plans were populated with investments in the public stock market, the employee had to personally contend with market-based risk. As with an individual financial portfolio, self-determined market strategies could be executed by the employee, within the boundaries of investment options provided by an employer. Given the significant responsibility involved, in addition to the special initiative required to sign-up for the account in the first place, many employees did not even enroll.

It was now up to the employee, fully dependent upon the stock market, to either reap the rewards or suffer the losses. ERISA had delivered on its goal to provide more information and control over the pension account to the employee, in an environment where not all employers had been competent in performing their fiduciary duty. The price of this emancipation was the absorption of responsibility and risk; the reward would be the opportunity to build assets above and beyond a defined-benefit level.

Resting upon this observation, we conclude generalizations regarding defined-contribution benefit plans. Now we move forward to establish criteria that will identify specific differences between the various defined-benefit accounts.

Criteria for Evaluating Defined-contribution Benefit Plans

Today, the level of risk and the opportunities for reward depend upon the type of defined-contribution plan that the company offers. Each plan differs in how it shares the gains from productivity today, and fosters continuing productivity growth in the future. For corporate asset building programs to be helpful and effective, they must thoughtfully balance equality with meritocracy and risk with reward. Going a step further, if a corporation desires to be a significant, positive force in society, one that provides

solutions to the larger problems the civilization is facing, the opportunity lies here: to make inclusive plans that offer individuals with limited ability to generate assets anywhere else, given their limited access to capital, credit or savings, the ability to build solid financial assets in their workplace pension plan.

In determining the precise factors that make a defined-contribution benefit pension plan most capable in achieving the goal of building assets for employees, I have established the following criteria:

1. Offering the opportunity to build equity for a larger number of employees is better than one that builds equity for a fewer number.

2. Providing asset-building capability without requiring an equity contribution from the employee is preferable, in that the employees at the lowest income levels with less ability to save are not prevented from participating.

3. Closely coupling employee productivity with reward is most favorable.

4. Facilitating the sale of company stock through a market mechanism that values fundamentals, and mitigates speculative risk (closely aligning productivity with reward).

5. Making employees as owners privy to information, so that they are able to augment the perspective of the plan fiduciary with their own analysis of the situation.

6. Providing the opportunity for employees to participate more fully, both as owners of company stock and as individuals fully vested in the long-term success of the company.

7. Opening a window for the sale of stock, or allowing a hardship withdrawal or loan in the case of a qualifying event, i.e. disability, elder care, hospice care, medical expenses.

8. Allowing the employee to borrow against the pension account for the purpose of building other forms of lasting assets, i.e. education, quality child care, housing.

9. Establishing a structure that encourages continuous improvement in productivity on the part of all employees, in a manner that increases the likelihood that the company will be an ongoing concern.

Given the large wish list, business economists would be the first to ask, "what is in it for the corporation"? The traditional response would be that employers want defined contribution plans because they significantly reduce the future liability associated with defined-benefit plans. Therefore, asking for too many things in a defined-contribution plan would eliminate its competitive advantage from a cost-avoidance perspective.

Furthermore, the neoclassical model assumes that defined-contribution plans can be conveniently sold as an employee benefit like health care, providing the justification for the company to reduce wages. Or, the argument could be made that the defined-contribution plan would simply be used as a self-serving tool to unload company stock. (Clearly this line of reasoning requires that corporate compensation policies are rational, an assumption that empirical evidence could contradict).

The neoclassical model does support the possibility that employers would offer defined-contribution plans simply because they have the potential to maximize the well-being of employees, thus making loyalty and productivity the potential reward. One point that both employers and employees can agree upon is that increasing productivity is good, both in the short and long run. Undoubtedly, optimizing productivity is a key objective in the crafting of a defined-contribution plan.

Aside from the effect of the defined-benefit plan upon the employer/employee bargain, there is another critical dimension to examine, the relationship of the pension plan to corporate finance. ERISA offers employers a variety of tax incentives to sweeten the defined-contribution plans, and in certain cases has enabled companies to use pension plans as a source for low-cost equity finance. The potential advantages of defined-contribution benefit plans to corporations can be summarized as follows:

1. Ability to use pension plan as a source of corporate equity.
2. Favorable tax policies associated with initial funding and maintenance of the plan.
3. Tax-free distribution of dividends.

Another issue that is important to note is that defined-contribution pension plans can provide a corporation with protection from an unwanted buyout or takeover. When employees hold a significant amount of company stock, it is more difficult for outsiders who wish to obtain a significant equity position in the company.

The ESOP, the Section 401K Plan, ESPP, Stock Option Plans, Individual Equity Plans

Now we are ready to look more carefully at the specific features of the defined-contribution pension plans. On the first criteria, regarding the availability of an equity building opportunity for the largest possible number of employees, the ESOP, the ESPP, and the Section 401K Plan provide an opportunity for everyone to participate. The National Employee Ownership Center specifies that the ESOP must include everyone who has worked for 1,000 hours in a 12-month period; the Section 401K Plan is also available to all employees that meet age and service requirements. Employees who have been at a company for over 2 years can participate in an ESPP. Stock options and Individual Equity Plans are most often selected offerings used as incentives for primarily senior-level employees. (Rosen, 2002).

Within the plans that are made universally available, including the ESOP, the ESPP, and the Section 401K Plan, the ESOP is the only plan where the individual has no personal equity at stake. In an ESOP, the company contributes the stock to employees; very rarely does an employee purchase any stock. Conversely, an ESPP always requires employees to purchase the company stock, at a discount. While a Stock Option program also requires the employee to purchase the stock, she only does so in an environment where the market price covers the cost of the option, thus guaranteeing a return. The

401K is funded by employee equity in the form of payroll deductions, which are matched in varying degrees depending upon employer policy.

Now that we have covered the straightforward subjects of “who qualifies” and “who contributes”, we move to the complicated matter of how to best align productivity with reward. How does one determine who contributes more or most to company productivity? Is productivity effectively captured by considering relative wage levels? Do other factors matter, like years at the company, or critical nature/difficulty of the job performed?

The deliberation looks a bit like the traditional diamond/water paradox. Good management, like the diamond, is assumed to be rarer than labor, thus explaining the pay premium. But without labor, the necessity of which is akin to water, there would be no product or service to manage; yet a potentially large army of the unemployed, in as great a supply as water, never to be exhausted, reduces both its price and its value.

Neoclassical economics values employees by the marginal product of their labor. In a production environment, it is straightforward to measure the product of labor in terms of output generation. It is much more difficult to determine the marginal product of labor in the management realm, where revenue generated, customers retained, expenses minimized, shareholder value created, or deadlines met provide a yardstick, but one not always directly attributable to the individual.

Stock options and the issuance of restricted stock most often distribute the gains from productivity to the “diamonds”, or a select group of management-level employees. These plans frequently bank on future productivity, given that they are often used as incentives to either attract or retain talent. Identified as contributors to the oft-cited

concern of grossly inflated of executive pay, stock options and the issuance of restricted stock have been associated with the increasing income disparity. These instruments have also been subject to abuse, in that they can be used to circumvent executive compensation policies, or to obfuscate the reality of a corporation's financial condition by recognizing compensation liabilities off of the corporate balance sheet. These incentives have also been accused of perversely rewarding executives for short-term productivity at the expense of long-term corporate viability, as "cashing out" becomes the objective.

While Stock Options and other Individual Equity Plans most often selectively distribute productivity gains to management in particular, the Section 401K Plan distributes productivity gains based upon wage level. Given that the contributions to the Section 401K Plan are a flat percentage of total wages, the larger the wage, the larger the employer match. The ESPP does not take productivity into consideration at all, as every employee is entitled to purchase stock in the same amount, at the same time, at the same price.

The ESOP allocations are made without an industry standard or formula, relying fully on the discretion and judgment of management. In the article titled "A Brief Overview of Employee Ownership in the U.S.", it is noted that "allocations are made on the basis of relative pay or some more equitable formula." (National Center For Employee Ownership (NCEO), 2009, p. 1). If this discretion is executed with care and stewardship, it is possible that contribution to productivity could be more equitably and realistically measured, by taking into account other influencing factors such as loyalty, experience, growth and development. It is worth further investigation how shares might be fairly granted to employees for generating new ideas, products, and markets, or to

those that find ways to improve production techniques or administrative processes. Expanding the idea of stock grants to encompass more than a provision of incentives for senior executives to meet revenue and profit targets could be a beneficial strategy for both employees and employers.

At this point in the paper, I am able to narrow the focus, given the initial set of criteria that I have established. It has been noted that Stock Options and Individual Equity Plans do not in their current form offer the opportunity to build equity for a substantial and diverse employee population. Therefore, at this juncture, they do not fit into the purpose of this particular paper, which is to underscore the importance of expanding asset-building opportunities and to highlight the most effective and practical tools that can be used to accomplish the task.. The ESPP can also be placed on the sidelines, given that another significant focus of this paper is to correlate asset-building with productivity, and the ESPP is not designed to accomplish this task. Additional research on these particular stock-based plans must be left as a tangential, nevertheless important future endeavor.

Although it is already questionable as to whether the Section 401K Plan has any special effect upon asset accessibility or productivity, I will continue to look more closely at this type of account for other reasons. Specifically as it relates to both the ESOP and Section 401K Plan, I will cover the issue of asset building and uncertainty in equity markets, in situations where there is no diversification mandate.

Comparison between the ESOP and the Section 401K Plan.

The next step is evaluating the criteria of having the ability to sell company stock for a market price that is fair and equitable. This consideration highlights the potential

dangers of pension plans that are heavily weighted in company stock. The worse case scenario happens when the employee uses savings to buy into a pension plan with a large percentage invested in company stock, a situation that by nature lacks the investment diversity to minimize risk. Furthermore, there are restrictions in the plan preventing the employee from selling the stock. If the company or the stock price falters, the risk to the employee is two-fold; she could be stuck with de-valued stock and find herself without a job. She may have also substituted a maximum contribution to a Section 401K Plan for savings or other investment.

If a company is publicly-traded, a turn in the news or sentiment regarding an individual company stock can be deleterious to an employee's account. In Wang's article of 2002 addressing problems associated with the Section 401K Plan, she has the following comment: "Studies have shown that though overall market risk has stayed relatively constant, individual stock volatility — which stems from company-specific events — has more than doubled over the past 30 years. In reality, the evidence for wealth building is mixed at best." She continues to say that "On average the typical 401(k) company stock delivers a return in line with the S&P 500's — but at above-average risk. For every big gainer like Citigroup (up 94 percent over the past three years), there has been a disaster like Owens-Corning (down 95 percent). This conclusion made in 2002 has special irony, in that Citigroup's stock performance validated Wang's concern by falling over 95 percent over the past few years. (Wang, 2002).

Although the Section 401K Plan does not have to have a majority of its assets invested in company stock, this is often the case, given that matches of company stock made in employee accounts enjoy favorable tax treatment. This is what happened in the

well-known case of Enron, where Martine Costello's article in CNN Money titled The "Enron Problem" points out that 58% of the Enron 401K was invested in company stock. (Costello, 2002).

Some argue that cases like Enron are rare. In Costello's 2002 article, David Wray, president of the Profit sharing/401(k) Council, comments that "most companies don't go bankrupt, and the stock has value in the long term" (Costello, 2002, p.1). This perspective has gained some credence in the aftermath of the global financial crisis, given the significant stock market rebound. It is possible that the preservation of stock market values has become so politically important that interventions will be always be made to prop up values. Nevertheless, Citigroup stock is still languishing in 2010, and Bear Stearns, like Enron, declared bankruptcy. In the case of Bear Stearns, employee equity was wiped out, and the fiduciary may face litigation.

The pension plan fiduciary is charged with protecting the employee's financial interests. If there is negative information that leads the fiduciary to believe that the value of the stock is going to be significantly impacted, the fiduciary is charged to act. But, there is an inherent conflict of interest because the fiduciary is most often employed by the company.

Offsetting this risk to a certain extent are structural aspects of the ESOP that are not characteristic of the Section 401K Plan heavily weighted in company stock. The most important factor mitigating ESOP risk is the likelihood that the ESOP employee has not contributed her own savings to fund the pension plan. In contrast, the Section 401K Plan requires funding by the employee, with the employer providing only the matching

portion of the account. Therefore, the Section 401K Plan places the employee's personal contribution at stake.

Another structural quality of the ESOP that mitigates risk is the fact that most ESOP's reside within privately-held corporations, with Rosen (2008) noting that 90% of ESOP's are held in private corporations. (Rosen, 2008). Because the value of most ESOP's are not determined in publicly-traded markets, speculative risk is minimized. In the event that the ESOP does reside in a publicly-traded corporation, it is possible that employee ownership is positively correlated with stock price. As referenced by the National Center for Employee Ownership, a study completed by American Capital Strategies in 1995 found that in public companies where employees owned over 10% of the corporation, "these companies consistently outperformed the broader market indexes" (National Center for Employee Ownership, 2010, p. 2).

Another factor that mitigates ESOP risk is the increased likelihood that ESOP companies, relative to non-ESOP companies, will augment their retirement plans with offerings that are not tied to company stock. Research conducted in 2001 by Douglas Kruse and Joseph Blasi of Rutgers University and referenced by Rosen (2002) found the following to be true: in ESOP companies, defined benefit plans are offered 30.1% of the time, whereas in non-ESOP companies this employee benefit is offered in only 4.9% of the cases. The same study found that the ESOP companies were more generous in offering all types of retirement plans. ESOP's offered non-401(k) profit sharing 35.7% of the time, relative to the non-ESOP companies in 8.0% of instances. ESOP companies had a 401(k) 33.3%, whereas non-ESOP companies offered it 6.2% of the time. Other defined contribution plans were offered 14.7% of the time in ESOP companies, and 2.3%

in non-ESOP corporations. (Rosen, 2002, p. 2). This same research concluded that ESOP participants accumulate on average three times more value in their retirement plans than non-ESOP plan participants. (Rosen, 2002, p.2).

In ESOP companies, do employees give up wages for these benefits? Research shows this is not the case in all but 1% of the companies studied by a group at Washington State University. This study, quoted by Rosen in 2002, found that ESOP's on average paid wages 12% higher, and a median wages 8% higher, than the control companies studied. (Rosen, 2002, p. 2).

The most important distinction that mitigates risk and builds long-term employee equity is the nature of the ESOP to operate not just as a pension plan or an employee benefit, but as structural means of facilitating employee inclusion. When its full effect is harnessed, the ESOP transfers ownership both in a financial and cultural sense. The Democracy Collaborative at the University of Maryland (2005) provides the following assessment of the ESOP "ownership culture":

> ESOP's that have adopted it (the ownership culture) have made significant changes in the way they do business. Although these changes often fall short of work-place democracy, this sector of the ESOP world has succeeded in increasing worker participation, further raising productivity and helping stabilize jobs and community in the process (The Democracy Collaborative at the University of Maryland, 2005, p. 59).

Specifically regarding the reference to ESOP's and their positive effect upon job stabilization, the Democracy Collaborative is referring to the requirement that ESOP companies buy-out the ownership stakes of terminated employees. Therefore, a decision on the part of an ESOP company to close a plant or layoff employees is not to be taken lightly.

When an ESOP company makes significant company decisions about subjects like plant closings or layoffs, employees have a say in the matter. This right to "participate" is mandated within ERISA. When shareholders are voting on "major issues" such as closings and mergers, ESOP plan participants can instruct their pension trustee how to vote on the issue. (The Democracy Collaborative, 2005, p. 60). The Democracy Collaborative (2005) has found that many ESOP corporations are taking the concept of participation to an even higher level, by having employee representatives on corporate boards. Even though this representation is not mandated by ERISA, 21% of ESOP companies in the year 2000 had an employee representative on the board. (The Democracy Collaborative, 2005). It would be interesting to know how many companies have an employee board representative in 2010.

It is important to recognize, however, that having representation or a voting interest is only one aspect of participation. Participation also means the desire and the ability to engage at various levels within the corporation. In ESOP companies, or any company for that matter, observable organizational forms are an indication of levels of involvement or engagement. The National Center for Employee Ownership (NCEO) in its article titled "A Guide to Doing Research on Employee Ownership" notes that "high involvement companies would be likely to employ such practices as self-managing teams, open book management, and cross-functional teams." The article makes the following conclusion that "the more ownership and the more involvement, the better the results tend to be" (National Center for Employee Ownership, 2010, p.1).

Undoubtedly, the organizational structure of a corporation is one dimension that can make employee participation at all levels more natural. Corporate structure,

however, can not unilaterally foster a genuine ownership culture; creation of this atmosphere is predicated upon the open-minded attitudes of the part of both employees and management. If the relationships between either functional groups or individuals in the company are more adversarial than cooperative, more compartmentalized than expansive, it is difficult for the representation that is mandated within ERISA to manifest itself in the kind of participation that makes a positive impact on the bottom line.

United Airlines, one of the most famous ESOP conversions, is a textbook example of this type of behavior. Pilots protected the interest of pilots, flight attendants took care of flight attendants. ESOP companies that demonstrate the largest gains in productivity are the ones where employees don't solely think like, or just relate to, their own "group", be it pilots, engineers, or shop floor technicians. Rather, they interact as owners with the common goal of making the company successful.

The United Airlines ESOP also had a higher probability of failing, given that the change of control was made when the company was experiencing severe financial problems. This is one major reason that corporations have adopted an ESOP structure in the past, in order to avoid the possibility of bankruptcy. If the ESOP fails in this instance, is it difficult to make the case that the situation is worse than it would have been if the company had failed in the first place, especially if the consideration is made that the employee has not put up any personal equity to buy company stock. One perspective on the situation is that a bankruptcy-avoidance ESOP at the very least buys its employees some time. (National Center for Employee Ownership, 2009).

Neoclassical economics might say that the fundamental premise of the ESOP is flawed, if its success is predicated upon the presence of relationships that have an

altruistic quality. Even if we assume that relationships that are more cooperative than competitive are not realistic or "normal", it is important to remember that the ESOP does promote self-interest, which is embodied in the corporate contribution of stock to its employees. Studies do corroborate that the financial incentive is a powerful one, in that productivity is positively correlated with larger employee ownership holdings. There is also a reinforcing element in that employee participation increases when employees own a larger percentage of the corporation.

The conclusion is that productivity flourishes where material employee ownership is accompanied by a representative, participative organizational structure and culture. It is an encouraging sign that recent statistics published by Rosen (2008) show employees as majority owners in 40% of ESOP's, a number which reflects a growing trend toward majority ownership. Although employees in large, public companies with ESOP's most often do not own enough stock to gain a sense of ownership, these plans are in the minority, constituting only 10% of ESOP's. (Rosen, 2008, p.3).

The presence of an ownership culture is a serious point of distinction between the Section 401K Plan heavily weighted in company stock and the ESOP. One significant advantage of an ESOP with an ownership culture is the increased likelihood that management will give employees more access to company information. Even in the instances where open book management is not standard practice, employee engagement and participation fosters transparency. In the past, it has been a lack of transparency that has enabled corporate management in cases like Enron to mislead investors and employees about the financial condition of the corporation.

When management and labor are aligned in purpose—to create shared value within the corporation—energy is expended in pursuing common goals. This internal alignment is all the more important if the ESOP is being used as a source of equity finance. Outside finance naturally has a different understanding and set of objectives than internally-provided equity. Most often, outside finance will have limited understanding of corporate dynamics and industry particulars, with emphasis placed predominantly upon meeting short-term revenue goals. The long-term viability and prosperity of the company may not even be the objective of external finance, which in some cases may financially benefit more by ultimately taking over a company.

From a corporate perspective, the condition that makes the ESOP most attractive as a corporate finance tool is the tax deductibility of both principal and interest when the ESOP is used to obtain a loan. "For many companies, this is an excellent strategy for corporate financing and can cut borrowing costs by one-third." (Employee Stock Ownership Plans, 2009, p.2). "The company may then use the proceeds for any acceptable business purpose such as purchasing equipment, buying another company, taking a private company public, or financing the sale of the stock." (Employee Stock Ownership Plans, 2009, p.3). No other stock incentive plans have this feature.

The other favorable aspect of the ESOP regarding tax policy is the ability for the plan to distribute dividends to plan participants tax-free. This provision alone can have an exceptionally positive effect upon corporate earnings. The recognition of this benefit has spurred further financial innovations, most notably in the form of the KSOP, or an ESOP within a 401K. This move is largely transparent to the employee, who often does not even realize that a change has occurred. The ability of a 401(k) to masquerade as an

ESOP, qualifying for ESOP-like incentives without making the same level of contribution that is made by an ESOP company has been an area of concern in the past. To address any free rider issues, clarity in making distinctions between financial instruments is critical. It is important to remember that ESOP companies meet special requirements to qualify for the incentives created within ERISA. With the typical ESOP employee's retirement plan three times larger than that of the non-ESOP employee, the argument can be made that these incentives do in fact directly benefit employees.

A Closing Word on Defined-benefit and Defined-contribution Plans

It is true that even though an employee has an opportunity to build assets in any defined-contribution plan, there are risks and concerns. It is not a sure thing like a defined-benefit plan payout. In the long term, however, I find that the plan which is most congruent with an overall emphasis on asset building is one that can capture each employee's contribution to productivity in a negotiable asset that holds fundamental, not just speculative value. This is most feasible in a privately-held corporation, where the market for stock is limited to those who are actually involved in the operations of the company. In this case, the value of the stock should more closely resemble the realities of the business.

A private company also has an advantage in that it is more likely to be of the size and scale where an individual's contribution to productivity can be more clearly understood, rewarded, and harnessed. It is also in this environment where a dearth of equity finance is both demonstrable and detrimental. Without access to capital for expansionary purposes, a company is thwarted in making its greatest contribution to its

current and future employees, and the economy at large. It is here where the ESOP most clearly demonstrates its elegance.

Now we finish the section on corporate-sponsored benefit programs that offer employees and employers the opportunity to recognize contributions to productivity in the allocation of assets. After various equity-oriented financial instruments were examined, the ESOP garnered the major focus. In the next few sections, I will examine the methods that make corporate ownership available to all identified stakeholders. In the process, well-recognized methods that are currently being employed are examined. Additionally, new approaches that have been proposed but yet to be implemented will be considered. It will not come as a surprise to the reader that financial instruments evolving out of the ESOP will be a significant part of the discussion.

Chapter Six: Corporate-sponsored Benefit plans and Customer Ownership

The ESOP Modified to be a CSOP (Customer Stock Ownership Plan)

Conceptually and logistically, the basic idea and structure of the ESOP can be expanded for use in many other applications. One application is the distribution of corporate ownership not just to employees, but to other stakeholders of a company, including customers and consumers. As with the ESOP, this ownership stake offered the corporation a primary source for low-cost equity finance.

It was Louis Kelso, the inventor of the ESOP, who specifically broadened its application to include the CSOP, or a Customer Stock Ownership Plan. As documented by the Kelso Institute, the first use of the CSOP was in 1958, when it successfully enabled a group of farmers in California's central valley to buy out a key supplier, Valley Nitrogen Producers.

Although the CSOP can be tactically used to transfer ownership of a corporation to its stakeholders, it does not have the status within the Federal government or the IRS like the ESOP. Because it does not enjoy the same favorable tax treatment, it is not well recognized like the ESOP.

Although the original use of the CSOP was as a leveraged buyout instrument, Kelso anticipated that it would be used in a much larger context. Kelso visualized that the consuming public could both finance and own part or all of the companies that provided their goods and services. Corporations could facilitate this expanded ownership

operation by using financial tools the built upon the framework of the ESOP. Clearly, Kelso had a plethora of ideas grounded in the use of various innovative financial instruments, and he spent a lifetime developing these concepts. Since his death, the communication, advocacy and development of Kelso's work has become the labor of the Center for Economic and Social Justice (CESJ), where much of the information in this paper about the ESOP and related financial instruments has been obtained.

Kelso's intent for the CSOP was philosophically and functionally very similar to that of the ESOP. His fundamental thought process was that business relationships, either between employer and employee, or producer and consumer, can be very synergistic. In the case of the ESOP, if employees experience direct financial benefit when the company does well, they have a significant incentive to make the company successful. When the company does well, the employees do well on two fronts--both as wage earners and investors in the company. As employees, they have made a commitment to the company, and it is this type of major commitment that makes any source of finance both available and reliable. It is in the ESOP that the elements of employment and investment are forged together with a necessary, mutual commitment between employer and employee. A lack of commitment on either side hurts both parties.

Advantages of Stakeholder Finance Relative to Traditional Sources of Finance

While employees or customers as investors have automatic incentives to be committed to the long-term welfare of the corporation, it is the converse with traditional contemporary finance. As the financial sector increasingly becomes the domain of large multi-nationals, the incentives to make anything more than a short-term commitment

diminish. The magnitude of these organizations increases the likelihood of strict constraints and standardized operating procedures. These automated responses, which often include uniformly calling in existing loans and restricting all lending in a downturn, translate into pro-cyclical, contractionary policy. Direct government action is then triggered to augment the negative effects.

If business cycles are viewed as natural phenomenon, it is to be expected that all businesses will be less liquid at certain points in time. When a downturn would otherwise have been temporary, the actions of finance have the potential to force defaults that would have otherwise not occurred. This response can turn the downside of a business cycle into a crisis, similar to what has been commonly observed during the global financial crisis that started in 2007. This perspective regarding economic crisis has recently gained more credence. A Wall Street Journal cover page article authored by Lahart (2007) documents new-found interest in Hyman Minsky's Financial Instability Hypothesis, which argues that this downward spiral will take place. (Lahart, 2007).

It is reasonable to expect that an employee as investor would be less likely to overreact or overcorrect than a capital provider from the outside. Employees, unconstrained by standard operating investment procedure, would conceivably have the benefit of insider knowledge, coupled with a longer investment horizon. This perspective could be especially beneficial in labor negotiations, where wage concessions in a downturn could be guaranteed payback in the future, out of profits generated during a recovery.

The customer as financier could be expected to act in a similar partnership-oriented fashion, especially if limited substitutes are available in the marketplace. In the

event that customer and company were to reside in the same community, the incentives to cooperate financially would be even more powerful.

Other Benefits Offered by the CSOP and Customer Ownership in General

Customer ownership from a corporate perspective.

The loyalty of the consumer as investor has impact both in the capital and consumption realms. Every time the product or service was consumed, there would be a dual benefit for the customer, both on the consumption and investment sides of the equation. While loyal employees increase the marginal productivity of labor, or the cost side of the equation, customer loyalty positively impacts the revenue side, where customer ownership may result in less price sensitivity and/or more consumption.

When companies have customers as owners, the relationship between the company and the customer deepens. A closer relationship is financially beneficial to the corporation on multiple fronts, with an especially important one being product development. Companies already want to get closer to customers, so that they can tailor products and services to their customer's needs and wants. But to have customers invested in the innovation and development cycle of the company, as committed early adapters, is a key competitive advantage. Furthermore, in owning a part of the company, customers become more easily retained throughout the entire product lifecycle, which is by nature a bumpy ride.

Customer ownership from a customer perspective.

Up to this point, we have discussed the advantages of the CSOP predominantly from the corporate perspective. The argument to be made from the customer's perspective is not as compelling, because a fundamental aspect of the ESOP, namely that

it is recognized and supported by IRS policy, is not the case with the CSOP. Corporations get favorable tax treatment for funding an ESOP with contributions of stock to employees. This is why it is very rare to see an ESOP where the employee buys stock to participate.

With the CSOP, there is no incentive to contribute stock to customers. Even the employer tax benefit associated with the 401(k), the ability to do tax-free matching of company stock, is not available to the CSOP. The net result is that unlike the ESOP, the CSOP in its current iteration is not a source of credit, because the customer has to raise equity to participate. Nevertheless, the absence of specific financial incentives does nothing to prevent customers from buying stock on the open market if the business partner company is public.

Today's Alternative to the CSOP—the Direct Public Offering

In the event that the company is private, customers can participate in ownership via the financial instrument termed a direct public offering. In a direct public offering, customers or consumers are given a special opportunity to purchase stock ownership in a corporation. This purchase opportunity is not offered to the general public through the traditional Wall Street public-equity markets, therefore it is termed "direct". The prospects are qualified with the criteria that participants must be true stakeholders. Thus, the potential problem of owners creating anti-competitive effects is averted.

By floating a direct public offering, a company can raise equity capital directly from those who already consume the good or service, or are stakeholders of the company. As with the ESOP, this source of equity finance brings capital that should be reasonably committed to the long-term well being of the company. Again, the customer and

company are positively linked in a cooperative financial relationship, made stronger if the customer and company are in the same geographic area and the product or service is has few substitutes.

Drew Field, an industry specialist in the direct public offering area, nicely sums up the benefits of the direct public offering on his dfdpo.com website: with publicly-traded shares, the business is "owned by customers of securities firms". "With increasing *financialization* of investments, these owners may have no interest in the business, its markets, products, services, local economy or *management* — their only interest is in an expected short-term increase in the security's price." (Field, p.1).

Pearson also makes the connection between a direct public offering and the microcredit model pioneered outside the United States. In the "initial *microcredit* model, Grameen Bank, founded by Nobel laureate Muhammad Yunus, required a borrower to be in a community of about five other borrowers, with responsibilities to each other. After the start-up or *seed capital* stage, the next level for growing businesses is to expand its community of owners to customers, neighbors, vendors, employees and others who believe in what the business is doing." (Field, p. 1).

Like the ESOP, the direct public offering is a successful, working model. It is a financial vehicle that enables companies to raise low-cost capital, while providing customers with the opportunity to reap financial rewards that would otherwise be reserved for institutional investors. Unlike the CSOP as proposed, however, the direct public offering does not have a means for a customer without savings or foundational assets to participate. Nor does the direct public offering have the special ESOP-like tax treatment, with its powerful set of corporate incentives.

Although the direct public offering as it is implemented today provides clear and distinct benefits to corporations, the CSOP is a conceptual model that incorporates tax incentives making customer finance as desirable as the ESOP. Because corporations habitually approach Wall Street to raise capital, using alternative methods of raising capital requires a major change of attitude and behavior, even in the event that the associated costs are lower, and the likelihood of actually obtaining finance capital is higher. Migration of the direct public offering to an IRS-qualified CSOP-like plan would make this approach even more desirable, giving it additional traction and scalability so that more widespread adoption can occur.

Chapter Seven: Ownership of Natural Monopolies and Regulated Industry

An Opportunity to Participate Becomes a Right to Participate

In the prior chapter we covered the financial instruments that corporations can use to raise equity capital, while at the same time building assets for its employees and customers. Regarding both the ESOP and the other employee pension plans, participation in ownership, or the sharing of profits and financial benefits, has been justified on the basis of contribution to productivity. In the case of the CSOP, the customer relationship is reason enough for participation; yet, any special treatment or recognition of the CSOP would also involve justification through contribution--to sales, revenue, and overall company success.

Now we turn our attention to applying asset distribution methods that apply to the development, ownership, and direct financial benefit associated with goods and services that are naturally monopolistic or delivered through regulated industries. Whereas the ownership of assets up to this point has been discussed within the context of contributions to productivity, these goods and services present a new dimension to the argument. Community ownership of the commons, including the land, resources and infrastructure that provide for the basic needs of everyone within a community, recognizes that citizens, community members, and taxpayers can improve economic efficiency by directly participating in the creation of value. Sharing assets that are developed with the

participation of the community provides the incentive to participate, where there is financially-oriented reward.

Unless participation is made mandatory, however, not all community members will participate or contribute to the process. This brings up the point that there are situations where the right to ownership can be more clearly justified, without the litmus test of participation and contribution. Passive ownership is about fairness; community ownership with participation encompasses the principles of efficiency *and* fairness.

Kurland, Brohawn, and Greaney (2004) identify natural monopolies and regulated industries as attractive opportunities for community member ownership, specifically mentioning electric utilities, mass transit and cable systems (Kurland Brohawn, and Greaney, 2004). In these industries, there are a limited number of private, public, or cooperative providers that are granted a license, operations agreement, or land use contract.

In these particular examples, government intervention and participation on some level is operationally necessary. Because monopoly industries lack the natural market incentives that drive efficiency and quality, government imposes rules and standards. A major efficiency-related problem in these markets is price distortion. Some of these markets operate like set-aside contracts, with little or no competition. To preserve the interests of the consumer, government counteracts monopoly profit-taking. Other monopoly markets provide services that can not be financially supported in traditional markets. In this case, government subsidized service to guarantee access.

The important distinction in these industries is the presence of active government intervention. Through its government, the public is directly involved in its provision of

financial support. This current involvement strengthens the justification for public ownership.

I suggest that other types of government-provided infrastructure are good candidates, including water, garbage, sewage and other recycling systems. Other excellent candidates include green projects and clean energy, where government is currently providing financial incentives or subsidies.

In some cases, especially in the electricity market, stakeholder ownership already exists. It is the cooperative form of ownership that has given community members, as customers of a particular enterprise, this opportunity.

The consumer cooperative.

The consumer cooperative is an enterprise that disperses pre-tax profits, or surplus earnings, to its customers. Each consumer receives a rebate, the size of which is determined by consumption; the larger the usage, the larger the rebate. Although the cooperative does not pay taxes on these allocations, the individual beneficiaries are subject to personal income taxes.

When extended product or service provision is required to meet the needs of a particular customer, this customer is often required to provide the capital for the expansion. This capital is used to develop a product, service, or network that will be made available not only to the customer demanding and paying for it today, but to anyone who needs it in the future. This up-front cost incurred by the customer, used in the development of a natural monopoly or good/service that can be accessed by all, is returned in rebates over time.

A well-known example of this practice is the rural electric cooperative, which was created during President Roosevelt's tenure as a means of providing electricity to underserved rural communities. The Alaskan pipeline is another example.

While the cooperative structure effectively distributes profits to stakeholders, it is missing a fundamental component of the ESOP-like financial approach—the ability to directly link ownership with capital investment and expansion. To accomplish this task, a CSOP could be implemented.

The CSOP with an Expanded Role.

Expanding the earlier conception of the CSOP, Kurland, Brohawn, and Greaney (2004) offer the following definition of the CSOP:

> An expanded capital ownership vehicle for providing self-liquidating, productive credit to the regular customers of public utilities, marketing cooperatives, mass transit systems, family health care system(s), etc., linking them as owners to the enterprise's future investment opportunities and capital growth. For her patronage, the regular customer would get back ownership rights, represented by shares released to her CSOP account as the CSOP's debt is repaid with pre-tax earnings paid in the form of tax-deductible dividends on CSOP-held shares. Released shares would be allocated among users according to their relative patronage of the system. Future dividends on CSOP stock would be used to offset each user's monthly bill. The CSOP would also create an internal market for repurchasing shares when there is no public market for the shares (Kurland, Brohawn, and Greaney, p. 124, 2004).

The new elements added to this iteration include the allocation of shares is dependent upon usage, and the distribution of the proceeds used as an offset to consumption. If the CSOP were to obtain preferable tax treatment like the ESOP, the distributions, like dividends, would be tax free.

Like the cooperative, the CSOP distributes financial gains to community members, who as customers, purchase public goods and services. Different than the

consumer cooperative structure rooted in consumption and designed to recover costs incurred by customers financing expansion, the CSOP is an investment vehicle for all stakeholders affected by the enterprise. Within the CSOP, a stakeholder can be a customer, supplier, provider, producer, employee, or community member. Because the CSOP is flexible enough to accommodate a diverse range of constituents, it can be applied in a variety of situations.

The CSOP is more than customer ownership.

One will notice that in the legal description of the CSOP, there is a reference made to "family health care systems" as one type of application for the CSOP. School systems have been discussed as well. Kurland, Brohawn, and Greaney (2004) provide more detail:

> CSOP's could also be combined with ESOP's for establishing for-profit comprehensive health care delivery systems whose ownership and control would be shared by all doctors, other healthcare providers and employees and subscribers, supplemented by health care vouchers for subscribers with incomes below the poverty line. For-profit educational systems owned by teachers, other school employees, and parent-subscribers, could be similarly financed and organized (Kurland, Brohawn, and Greaney, 2004, p. 37).

Goods and services that are needed or consumed by all, especially in the cases where the current systems have been challenged to deliver quality service at a cost-justifiable price, are all areas of opportunity for the CSOP. Regarding the delivery of critical public services, the CSOP solves a common problem by mitigating the tension between those who strongly favor either a private or a public solution, where each side perceives that the answer is all or nothing. The CSOP focuses consumers on the arrangements that deliver the best quality of service, which may well be a hybrid set of

providers. Consumers as owners also have the incentive to manage costs, which can be significantly impacted when the system is used prudently.

It was proposed in the early discussions regarding health care reform that cooperatives be central in the delivery of health care. Neither the pro-government nor pro-business lobbies were proponents, because neither type of competing bureaucratic form stood to uniquely benefit from the cooperative approach. Although both the cooperative and the CSOP are corporations, their internal power structure is necessarily altered to give the consumer both a stake and a voice. In the cooperative, it is one person, one vote; in the CSOP, it is a representative form of corporate governance that mirrors the ESOP.

Today there are already consumer cooperatives that deliver health care and other public services. The difference is that cooperatives don't have the corporate-level tax advantages that contemporary ESOP's enjoy. Therefore, the cooperative is unable to finance investment with future earnings, and is also denied the tax deductibility of both principal and interest. If the CSOP can adopt the legal status of the ESOP, capital credit will be more readily available and cost effective, for both initially funding the stock ownership plan and satisfying the need for future expansion.

Legal recognition is certainly a critical factor if the CSOP, or any ESOP-like financial structure, is to be adopted in the community realm. In this community domain, there is another ESOP-like financial instrument that has been proposed but is yet to be formally recognized. Whereas the CSOP is designed to democratically distribute the financial gains from the use and operation of public goods and services, the CIC, or

Community Investment Corporation, is designed to share the profit from new development with the community.

Stakeholder Ownership of Land and Development

The CIC (Community Investment Corporation).

Whereas the CSOP is especially useful in spreading ownership to customers of natural utilities or to providers and consumers of essential services like health care and education, the CIC addresses the ownership of land and property. Property development that occurs on publicly-owned land, or receives public subsidy such as TIF (Tax Increment Financing) dollars is an ideal candidate for the CIC.

The CIC is a corporate structure that facilitates shared financial ownership, allowing constituents and future residential and commercial occupants to invest in development together. The assumption of the CIC is that tenants and community members have a natural stake in the investment. The stake of community members is validated because the project involves, or requires, public participation. This participation can be observed in developer tax breaks, economic subsidies, or in a public good claim to the land. Future residential or commercial occupants have a vested interest in the property as users of the development. If commercial tenants are businesses that serve the community, customers benefit as owners also.

The definition of the CIC, according to Kurland, Brohawn, and Greaney (2004) is a "for-profit land planner and private sector real estate developer geared to rational innovation and change at the community level" (Kurland, Brohawn, and Greaney, 2004, p. 36). The goal of the CIC is to benefit the community on two levels. First, the

community has a say in how the land is developed, and the community has a voice in determining what types of goods and services are provided in the development.

From a legal perspective, the idea for the CIC comes out of Revenue Act of 1978. Added as Subchapter U within this legislation, the GSOC (General Stock Ownership Corporation) forms the legal underpinnings of the CIC. Kurland, Brohawn, and Greaney (2004) write about the difficulty of adopting the GSOC framework, writing that "(a)s enacted, all citizens of a State could become stockholders of such massive projects as the Alaskan gas pipeline. Subchapter U proved so unwieldy that no State adopted a GSOC despite its many attractive ownership incentives. (Kurland, Brohawn, and Greaney, 2004, p. 37).

Because the legal provisions that activate the CIC have yet to be adopted at the state level, the predominant community development model is the Community Development Corporation (CDC).

The CDC (Community Development Corporation)

The key organizational distinction between the CDC and the CIC is that the CDC is a not-for-profit entity, thus it does not offer the opportunity for equity participation. The Democracy Collaborative(2005) provides the following definition of the CDC:

> Community Development Corporations are typically neighborhood-based, 501I(3) non-profit corporations—with a board composed of at least one-third community residents—that promote the improvement of the physical and social infrastructures in neighborhoods with populations significantly below the are median income (The Democracy Collaborative, 2005, p. 26).

The genesis of the CDC was as an affordable housing developer in blighted urban areas. This mission has expanded to include development of infrastructure and services, including job training facilities, shopping centers, health care facilities and day care

centers. By attracting and funding business enterprises within a community, the CDC broadens the sales and property tax base, and creates new job opportunities within the community.

The CDC has been most visible in areas lacking in social and civic institutions, or where government has not been accountable or effective. In this environment, the CDC looks like an arm of municipal government. Yet, there is a key distinction: residents have more democratic control over the CDC than they have in local government, given that the CDC's board is composed of at least one-third community residents.

Although some CDC's actually own businesses and properties, a major source of funding in the past has been in the form of government subsidy. In some cases, funds that would otherwise been channeled through government agencies have been redirected to CDC's. Christopher Walker of the Urban Development Institute comments that "over the past 30 years, the most promising alternative model to direct government administration of community development programs has been that of community development corporations." (The Democracy Collaborative, 2005, p. 29). The primary reason for this optimism has been the increase in housing values that has been observed in certain markets where CDC's have been active.

While government funding remains an important component of the CDC model, private funding has been rapidly increasing, which has culminated in better overall capitalization for CDC's. According to the Democracy Collaborative (2005), securing additional private funding has qualified CDC's for tax breaks created by the New Market Tax Credits Bill. This legislation gives CDC's the ability to sell tax credits similar to those offered by the Low Income Housing Tax Credit. The Democracy Collaborative

(2005) concludes that these tax credits have increased CDC affordable housing development in markets where future residents earn 50-80% of the AMI (Area Median Income). Nevertheless, this model has been less effective in generating CDC-developed housing for potential residents earning less than 30% AMI. Within this seriously underserved market, there are only 43 units for every 100 people. (The Democracy Collaborative, 2005, p. 31).

For CDC's to be successful in the residential and commercial property development business, they must work with a variety of constituents, including private developers and local government. In developing these partnerships, many CDC's have become involved in political activism and community organizing. While these efforts have built the financial base and created business opportunities, it is a delicate balance. Even though the CDC's express purpose is to serve the best interest of the community by listening to its members and responding to their needs, the CDC can only fulfill these needs by assembling resources from a multitude of areas. How these partnerships are forged determines how the participants are compensated and ultimately the benefit that the community receives. Navigating the competing priorities in these arenas of political and private action is the role of CDC, as an organization positioned to be a powerful intermediary.

Contrasting the CIC with the CDC.

The CIC is a very different organizational structure from the CDC, given that it is owned by the community. The developer is the community; the expertise and building resources are secured in a competitive, rather than a political process. Nevertheless, fundamental processes like zoning are inevitably political, and property development still

requires the cooperation of a multitude of participants. The difference though is that the overarching incentive for the CIC is to both to complete the project *and* make a profit, which promotes economic efficiency. Profits are turned into owner's equity, distributing a portion of the assets to all individuals that reside within the community. Because future residents are also homeowners, they participate in the asset distribution as well. Sharing the equity between the community and the residents provides representation for all stakeholders, an arrangement that is consistent with concerns about fairness.

To be effective, the CIC must balance the needs of the future residents in the CIC with the community members that reside in the project area. While profit is one objective, the current cost of providing services is an equally important consideration. For example, housing development that meets the needs of the lower end of the AMI spectrum may not be as profitable as a focusing upon the more financially feasible projects where CDC's are most successful, notably the 50-80% AMI resident. But a lack of housing for certain members of the community is already costing everyone in the community. If housing is not provided by the CIC, a likely alternative is subsidized housing which is funded by taxpayers. Subsidized housing is a temporary measure in comparison, and does little to improve the future prospects of the individual or the quality of life in the community. Both the CIC and the CDC offer opportunities for individuals to build assets by owning a home.

Both the CDC and CIC satisfy the demand for housing within a community by soliciting the input and participation of the community. In the case of the CDC, one-third of the board that is represented by appointed members of the community. The board of

the CIC reflects the composition of company ownership; to be an owner, one must have ties to the community.

With over 4,000 CDC's in over 50 states, the CDC has proven itself to be an effective economic development agent. Expanding its reach beyond commercial and residential real estate development, the CDC has become a community services provider, where the CDC's multi-faceted agenda has come to include "anti-crime projects, graffiti removal, policy advocacy, (and) retail promotion." (The Democracy Collaborative, 2005, p. 31). Irregardless of the project, its central role is the same: facilitating public/private partnerships to satisfy collective needs and solve shared problems. First and foremost it is an institutional framework that distributes assets within the community, with input and participation from the community. The benefits of these assets are measured in increased resident retention rates, reduced unemployment, improved school attendance and performance, and increased availability of goods, services, and housing. The financial impact is evidenced in the expansion of the tax base.

The CIC is different in that unlike the CDC, it is not an intermediary. The community works directly with industry to satisfy its needs, and in doing so, it builds assets that provide direct financial benefit to the community members, as individuals owning stock in the CIC. The needs of the community are best met when community members and businesses work effectively together to create the most efficient solutions. Affordable housing, infrastructure, commercial property and civic improvements are planned, developed and financed internally, by using the framework of the ESOP.

In the realm of residential real estate, the CIC is a shared equity model, where both the community and residents are asset owners. Another shared equity model is the land trust, the next topic of discussion.

The Community Land Trust—a hybrid solution.

The community land trust (CLT) is a special kind of Real Estate Investment Trust (REIT). The CLT is like a private community real estate market, where equity gains are shared in a pre-determined fashion by the homeowner and the trust, thus eliminating speculative market risk. This shared appreciation is conservative enough to preserve the affordability for the new owner, while allowing the seller to realize a modest return on investment.

In the CLT model, the resident owns the mortgage on the house, and the trust owns the land, which is leased back to the homeowner for a small fee. Because of this arrangement, the community and homeowner are inextricably linked. Both sides have the incentive to work with one another, to protect each other's interests. The commitment built into this relationship is one reason that the CLT has been successful. For example, the CLT and homeowner are both involved in the mortgage loan process, ensuring that the agreement is free of superfluous or egregiously high fees, confusing disclosures, or other unethical provisions.

Making sure that the mortgage is both a fair and affordable agreement is the first thing that the CLT and homeowner do together. This financial partnership continues, however, in that any modification of the original mortgage, in the form of a refinance or home equity loan, can not be done without the involvement of the CLT. The CLT's role is to protect the long-term financial well-being of the home owner. To reduce reliance

upon second mortgages or home equity loans, some CLT's make internal funds available to homeowners for upgrades, expansion, and improvements.

This collaboration between the CLT and the homeowner is one reason that the rate of foreclosure is so much smaller in the CLT than in the larger population. As reported by Temple in 2010, research conducted in 2007 concludes that the CLT homeowner rate of foreclosure is 0.06%, 33 times less than the foreclosure rate for mortgages in the general population. Temple (2010) attributes 40% of these foreclosures to a refinance that makes homeownership unaffordable. Homeowners within a CLT must work closely with CLT management to take out a new or modified loan on their property (Temple, 2010).

The supporting structure of the CLT, from both a financial and management perspective, is a private/public partnership. Private financial support of CLT's is often in the form of land or real estate that is donated and qualifies for favorable tax treatment in return. On the public front, CLT's have multiple sources of finance, including state government loan programs and federal funding programs like the Neighborhood Stabilization Program (NSP). Under the auspices of the NSP, CLT's have worked directly with homeowners who are facing foreclosure because of an unaffordable mortgage. The CLT first purchases the home and then sells it back to the homeowner who takes out a new mortgage that is both traditional and conforming.

The management structure of the CLT reflects this combination of private and public support and funding. The board is comprised of one-third residents, one-third community members, and one-third elected or appointed government representatives.

The CLT is different from a housing cooperative in this respect, in that all coop board members are homeowners.

Because the management of the CLT determines market rules, including who participates in the exchange and the terms of the exchange, the speculative component of real estate investment is eliminated. Although it is difficult to measure the full effect that controlling speculative activity in the closed market of the CLT has upon open market value, a good reference point can be found in the form of property taxes. Higher property taxes discourage speculative investment, by making it less financially attractive for non-resident investors to purchase real estate. Studies have shown that communities with higher property taxes have experienced less erosion in residential real estate prices during the economic crisis, even in communities that have suffered disproportionately higher losses within industry and employment (Sullivan, p. 3).

Managing the financial risk associated with the real estate transaction is one reason that CLT's have helped individuals secure assets safely. One critique of real estate as a financially beneficial asset-building instrument comes from outside the transactional aspect of the purchase. In the case of the owner-occupier with few initial assets, the impact of the living situation—the surrounding environment—is very important. Securing the best available living situation means being aware of, and sensitive to, the specific location of the real estate. The conundrum is that the most affordable real estate is found in the least desirable locations, in marginal neighborhoods. Because a lack of affordable housing is the primary reason that CLT are formed in the first place, the CLT most often operates in communities with a naturally favorable location.

Living in a desirable area provides access to a set of assets that have long-term financial impact. These assets often include an effective educational system, developed physical infrastructure, and the provision of services that maximize health and safety. These assets are central to the creation of a cohesive community, which bodes well for both business and personal development. Upward mobility is most often attained through relationships, through personal connections and networks. Safe and physically appealing communities make it easier for people to know each other, learn from each other, and share ideas and information, whereas marginal neighborhoods can close residents off from one another and the outside world. Residing in a neighborhood with limited prospects for change and growth diminishes the quality of life today and the future potential of tomorrow. These negative impacts have the potential to offset equity gains.

If there are few strong institutions to buttress the community, real estate values are compromised from the start. As discussed earlier, value is created by participation and contribution that occurs and multiple fronts. Financial institutions, appraisers, regulators, public officials, individuals, and communities need more comprehensive tools to assess both the current condition and future prospects of a neighborhood and the real estate that resides within it. Doing this effectively requires measuring the long term value of investments that are capable of turning a marginal neighborhood around. On the surface, many of these investments look like nothing but a sunk cost, when in fact they have the potential in thoughtful execution to be precisely the opposite. A public library could be offered as one example. This asset has has positive spillover effects on the value of surrounding assets.

It was in the provision and preservation of public goods that the land trust found its initial inspiration. In responding to what was really a market failure, the conservation land trust provides a vehicle for managing public goods, in an environment where creating a viable long-term proposition for public use has been difficult. The profitability of the investment in this type of public good hinges upon realizing and distributing the equity gains fairly, which requires an acknowledgement that equity gains are in reality are most often the result of shared efforts. Both the conservation and community land trust models have responded to a significant observation: the synergy between individuals and the larger community has economic value, which is materially recognized in the appreciation of physical assets. The CLT is shared-equity model that is designed to accurately capture and distribute these returns.

In the open market, there is no shared equity model which mitigates risk yet provides for equity gains, nor are there other recognized methods within real estate markets that identify and minimize speculative risk. Without a CLT-like structure, home ownership involves risk. Other methods that offer more flexibility and a different risk profile are available. Another investment opportunity this is available to a select group of individuals is the IDA (Individual Development Account). The ISOP (Individual Stock Option Plan) is another type of individual account that has been proposed, with its foundation in the financial framework that comprises the ESOP.

Chapter Eight: Individually-owned Accounts that Facilitate a Broader-based Distribution of Assets

The IDA (Individual Development Account

The vehicle for individual asset formation, separate of any relationships with a particular corporation or service provider, is the (IDA), or Individual Development Account. Invented by Michael Sherradon, the IDA matches an individual's savings up to a certain limit. Account funds can be used for housing, education, or business development. (The Democracy Collaborative, 2005).

The goal of the IDA is to accumulate personal savings so that productive assets can be acquired. Even though the goals of the 401(k) and the ESOP appear to be the same as that of the IDA, the IDA has two fundamental distinctions. First, it has a shorter-term investment horizon, where one can use the account without penalty to acquire assets today. Although one can borrow against a 401(k) or apply for a hardship withdrawal and be approved under certain circumstances, the ultimate goal is to accrue tax-free funds for retirement. Such is the case with the ESOP as well. Unless there is a special ESOP diversification election or the employee leaves the company, the account can not be borrowed against or liquidated.

The second key difference is how the IDA is funded. The IDA is a subsidized account, where income levels required for qualification and percentage matching policies are controlled at the state level. Regardless of state policy, the target market for the IDA

is the working poor, whereas the 401(k) and ESOP are available to all employees, independent of income level.

The ISOP (Individual Stock Ownership Plan)

Dovetailing off of the ESOP and the CSOP is another financial instrument called the ISOP, or Individual Stock Ownership Plan. Although never formally recognized by the IRS, the ISOP was part of legislative proposal termed the Accelerated Capital Formation Act. As originally proposed in 1975, the purpose of the ISOP was to broaden access to capital. Unlike the ESOP or the CSOP, the ISOP was not predicated upon a prior relationship with a particular corporation, as either an employee or a customer. Nor did the ISOP require that a shareholder be a customer purchasing services from a natural monopoly or a community member with a public good stake in property or real estate development. A definition of the ISOP as provided by Kurland (1977):

> The ISOP is designed as a special kind of Individual Retirement Account (IRA) to be set up by each citizen at any bank or approved financial institution, for financing new stock issuances by any enterprise that can convince a commercial bank that it has a viable (i.e., self-liquidating) capital project (Kurland, 1977, p. 1).

Because the ISOP was designed to be structurally and relationally independent, it could function both as a long-term store of value for individuals and an ongoing source of equity finance for multiple corporations. This flexibility opened up further possibilities for the financial instrument, including the opportunity to serve as a central point for individuals to roll over shares from an ESOP or CSOP.

Given its flexibility and broad structural framework, the ISOP could be used to establish a diversified portfolio of assets for a broad range of people. It could also raise equity finance for both start-up companies and corporate expansion.

The ISOP becomes the CHA (Capital Homesteading Account)

To more clearly distinguish the scope of the opportunity and overall mission, the ISOP was renamed the CHA, or Capital Homesteading Account. The CHA now forms the cornerstone of a larger policy initiative, termed the Capital Homesteading Act. The Capital Homesteading Act would do for capital what the original Homesteading Act of 1862 did for land: democratize the access to productive resources to stimulate national growth and foster individual opportunity.

The CHA brings in an entirely new dimension to the stable of financial instruments modeled after the ESOP. Most notably, the CHA goes beyond the creation of equity finance in situations where there is either collateral or future earnings against which a corporation can borrow. Because of the increased risk profile associated with the CHA, there are more institutional components that are added to the mix to make the situation more feasible.

Supporting Structures for the CHA

The FCCC (Federal Capital Credit Corporation).

One institutional component of the capital homesteading infrastructure is a Federal Capital Credit Corporation, or FCCC. The FCCC serves not only as a clearinghouse for potential investment opportunities, but as body that is capable of evaluating potential risk, reward, and opportunity. Kurland, Brohawn, and Greaney (2004) offer the following explanation of the FCCC, an organization conceived by Dr. Norman Bailey, former Special Assistant to President Reagan for International Economic Affairs.

> The FCCC, which could be owned and controlled by CHA lenders and citizens, would package insured CHA loans, create software for helping lenders to scrutinize the feasibility of CHA loans, and set uniform standards for CHA insurers, re-insurers, and lenders. The FCCC and competitors qualified by the Federal Reserve would then bundle and take these securitized CHA loans to the discount window of the regional Federal Reserve Bank (Kurland, Brohawn, and Greaney, 2004, p. 39).

Within the proposed definition of the FCCC is found the genesis of another CHA-supporting organizational structure, one that serves as an insurer or re-insurer of CHA loans. This organization would be termed the FCIC, or Federal Capital Insurance Corporation.

The FCIC (Federal Capital Insurance Corporation).

To provide insurance for default risk, an FCIC, or Federal Capital Insurance Corporation has been proposed. The FCIC would fund itself by collecting a risk premium as part of the loan servicing fees. Individual financial institutions would collect these payments, which would then be consolidated into an FCIC insurance fund. Another possibility is the formation of a CCRC, or capital credit reinsurance corporation. The reserves for the CCRC could be provided by federal, state, local government or be raised from private sources.

Problems, Issues and Opportunities with the Supporting Structures

The supporting structures of the FCCC, FCIC, and CCRC have been proposed because the CHA is designed to offer finance and investment opportunities to the broadest possible population with the least tenable amount of risk. From the outset, although the mission is laudable, the institutional structure is understandably suspect. Of concern is that fact that the FCCC has a likeness to Fannie-Mae", given its bundling facility that would purchase loans from participating financial institutions. Also like

Fannie Mae, the FCCC would have procedures and regulations for qualifying applicants and financial institutions.

There are also perception and execution problems with the FCIC and especially the CCRC, which appear on a cursory overview much like AIG, the large re-insurer. If the credit corporation were to sell groups of loans and bundle them into complex financial instruments where the value is the underlying asset was divorced or no longer understood, this would be a problem. Given past problems, tying the FCIC directly to the companies it insures, and avoiding the association of the capital homesteading idea with the business of buying, selling, and insuring speculative financial instruments is important.

What is important to remember, however, is that the idea of the CHA with an insured component brings back some of individual financial surety that was lost in the move from defined benefit to defined contribution programs. In this context, the FCIC is not much different than the government-sponsored Pension Benefit Guaranty Corporation. The only difference is that individuals can naturally diversify their portfolios, and in the process, capital is directed into productive investment. Because of the equity finance component, business has much to like about the CHA, which in this realm mirrors aspects of the 401(k).

If executed with thought and care, the CHA has the potential to offer the best of both the defined benefit and defined contribution worlds. The critical and unique distinction that has been proposed, however, would be that the CHA architecture would be owned by CHA financial institutions and CHA account holders. This eliminates much conflict of interest by aligning motivation and incentives in the same way that the ESOP

when well-executed has done for employees and employers. The ultimate challenge for the CHA architecture would be to do what the current government organizations that promote homeownership have not been able to do: to democratically expand the ownership of capital, in the way that Fannie Mae and Freddie Mac were originally conceived to democratically expand homeownership.

Chapter Nine: Conclusion

This paper encourages the reader to think about the creation of economic value. It is hoped that this effort will expand points of view that are largely influenced by traditional economic models and standard policy approaches.

Simply on the premises of basic observation and experience, I have found economic models that address production and investment to be limited in their explanatory power, given their restrictive assumptions. These assumptions have imparted a false sense of certainty, allowing us to base our understanding upon an incomplete picture of what is really happening. The net result is that the sources of contribution to productivity, especially the human elements that create value, often fail to be fairly recognized or rewarded. Thus, the power of economic incentives to stimulate economic progress and innovation are compromised.

These unidentified contributions to productivity have observable effects upon the value of assets, the level of profits, and the return on investment. In each of these areas, there is an also an opportunity to correct the distortion of incentives. In this paper, I have highlighted a variety of options and methods, assessing their functionality and identifying their strengths and weaknesses.

While these methods first and foremost promote efficiency and fairness, the benefits are wide in both range and scope. They include the creation and preservation of employment, the augmentation of income, and the stimulation of individual productive

investment. Some of the methods discussed are expressly designed to mitigate financial and asset-market risk, having built-in incentives that favor productive rather than speculative investment.

The approaches that properly align individual incentives also solve problems for corporations and communities. From the corporate perspective, the asset-distribution methods alleviate the well-recognized problem of capital scarcity, which is affects both current business operations and the opportunities for expansion. I find that the ESOP (Employee Stock Ownership Plan), and other financial tools built on the foundation of the ESOP, offer both opportunity and future promise when implemented with care.

The ESOP carves assets out of current productivity and finances investment by anticipating the development of future productivity and capacity. Because this approach stimulates effective demand, a positive, macroeconomic spillover effect is created. These gains are not accomplished through the redistribution of assets, but through the sharing of financial gains. Either a contribution to productivity or a natural claim to surplus legitimizes the shared ownership. I hope that the justifiable nature of these distributions, along with the macroeconomic benefit that these distributions create, can more easily foster a consensus among policy-makers.

While these methods can be expanded to offer desirable benefits to a wide variety of stakeholders within the corporation and community, reaping substantial returns is dependent upon the participation and cooperation of all parties to the agreement. Productivity increases with participation, and the fruits of laboring together to accomplish a common goal can then be justly and fairly distributed. This is strong motivation to base

relationships upon sharing, commitment, and engagement. This atmosphere facilitates the free-flow of ideas and information, creating a desirable environment for innovation.

I hope that we are able to re-frame our conception of economics and the world to see the possibilities and potential—the stored value and energy that resides within people, natural resources, and financial capital—so that innovation will forward the goal of economic progress. Implementing financial and organizational structures that that incent, recognize, and reward contributions to productivity are a fundamental way of achieving these goals.

With its ability determine the fate of all people on earth, economics is all-powerful. This position implies ethical accountability. As virtual stewards of the world around us, our purview moves from what *is*, to what we *can* do, to what we *should* do. By utilizing the wide range of policy tools available to us today--options that do not involve the re-distribution of income, but justly and fairly expand the ownership, management, and development of productive assets--we come closer to the meeting the objective of making people's lives better.

I will end with the encouraging words of Alfred Marshall, printed in Principles of Economics textbook and quoted later by Bowles and Gintis (2000):

> Now at last we are setting ourselves seriously to inquire whether it is necessary that there should be any so called "lower classes" at all: that is whether there need be large numbers of people doomed from their birth to hard work in order to provide for others the requisites of a refined and cultured life; while they themselves are prevented by their poverty and toil from having any share or part in that life…the answer depends in a great measure upon fact and inferences that are within the province of economics; and this is it which gives to economic studies their chief and their highest interest (1930 (1980), pp. 3-4).

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