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Socializing the Surplus: A System of Life Estates

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SOCIALISM AND SURPLUS

Among the venerable components of socialist thought has been a conception of economic systems potentially producing a surplus in excess of the requirements of reproduction of the existing stock of non-human productive resources and of consumption at current levels of the productive population. This surplus is then conceived as divided between two uses: expansion of the stock of non-human productive resources and additional consumption.

When one attempts to spell out this conception in precise detail there are several areas of difficulty. Especially problematic is making defensibly precise the distinction between consumption from the surplus as opposed to the "necessary" consumption of the productive population.

However these difficulties might be resolved, the gist of the socialist critique of capitalism formulable in terms of this conception is straightforward. Under capitalism the division of the surplus between investment and consumption is determined by processes not subject to democratic control and, especially pointedly, the portion of the surplus devoted to consumption is distributed not according to any defensible principle but rather roughly in proportion to ownership of the stock of productive resources.

A socialist alternative is democratic control of this surplus. That is, both the division of the surplus between investment and consumption, and the distribution of the consumed

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surplus are to be decided democratically. The first decision determines the growth rate of the stock of productive resources. The second decision reflects in part principles of distributive justice.

Some, though by no means all, proposals for a socialist society directly address the question of how these decisions might take institutional form. A prominent example is the version of market socialism propounded by John Roemer (Roemer 1994a).

Roemer proposes a system in which all large firms are corporations whose stock is owned by mutual funds. Stock prices are denominated in coupons which can only be converted into conventional money by corporations at the state treasury. Mutual fund shares, also priced only in coupons, are then held by the citizenry who receive equal coupon endowments at adulthood. When citizens die their mutual fund shares are sold for coupons which revert to the state. Citizens receive conventional money distributions on the mutual fund shares they hold, distributions of (money) profits flowing through the mutual funds from the corporations they own. " Thus the coupon system is meant to endow each adult citizen with a stream of income during his lifetime, his transient property right in the nation's 'public' firms" (Roemer 1994b: 462).

Roemer had not yet offered detailed exposition of the financial economic workings of this proposed coupon system, and is in fact evidently open to alternative suggestions for how these details might be spelled out.[1]

One matter Roemer has briefly considered is how to prevent mutual funds from catering to fund holders' predictable desires to turn the value (directly denominated in coupons) of the principle of their holdings into money by investing in "cash cows," i.e., firms which liquidate their assets by paying dividends in excess of earnings. Here Roemer suggests that mutual funds be required to have "a balanced age distribution of owners" (Roemer 1994b: 463). In the absence of more detail it is not at all clear that such a requirement would solve the problem foreseen. To be sure it is plausible that motives for converting principle value into cash will grow more powerful with age. But on the face of it such motives will be substantial

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[1]There are significant differences between the coupon systems described in Roemer 1994a, and Roemer 1994b.

at any age, even more so in so far as individuals can invest outside the coupon system. In any event such motives will be qualitatively stronger than under conventional capitalism in so far as the conditions for applying the Miller-Modigliani dividend policy irrelevance theorem apply.[2] Roemer's mutual fund holders would not be rationally indifferent between unrealized coupon capital gains and realized cash distributions.

This particular question of the (cash money) distribution policy of firms and in turn of the mutual funds which own them is part of a broader question which Roemer has as yet not treated. How is the share of the profits of firms to be distributed as cash to citizens determined? That is, in so far as corporate profits comprise a surplus above costs, what share of this surplus is to be retained for investment and what remaining share is to be made available to individuals to do with whatever they might like?

I will not argue the point here, but in fact developing an answer to this question is not best facilitated by the coupon structure Roemer proposes in which cash is provided to mutual funds by the firms whose stock they own, presumably only in the form of dividends on stock. Capital gains on the other hand would then show up only in increases in coupon value per share. If firm shares are then only traded among mutual funds in coupon terms, there is no evident way for capital gains to be realized. It would seem to follow that mutual fund cash distributions to fund share holders must consist precisely of cash dividends paid by firms to the mutual funds which own them. It is evident that in this institutional setting dividends and capital gains are not at all substitutable for each other, let alone (more or less) perfect substitutes as under Miller-Modigliani conditions. It follows that under the coupon proposal, the dividend policies of firms and the distribution policies of the mutual funds which own them determine the share of surplus retained for investment.

Of course, while retaining the coupon system conception, one can consider instituting constraints and requirements on dividend policies of firms and distribution policies of mutual funds with the purpose of controlling the division of profits between retained earnings for investment and distribution as

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[2]Miller & Modigliani 1961. For a standard textbook exposition see Brealey & Myers 1991: .422ff.

cash to individuals. A bit of reflection on such mechanism design project strongly suggests that plausibly effective constraints and requirements are likely to be complex and will threaten to be unwieldy, involving regulation of firms' financing decisions of a fundamentally different kind than under capitalism and with potentially substantial consequences for efficiency.

Rather than attempt such a construction, I am proposing here instead consideration of an institutional structure alternative to Roemer's coupon system which is designed to realize the same objective of granting citizens "transient property rights" in public productive assets, represented in a share of the flow of profits on these assets, while allowing the financing decisions of firms and the distribution policies of mutual funds to proceed without any special constraints being required to realize this objective. That alternative institutional structure is a system of life estates.

SURPLUS AND LIFE ESTATES

A life estate conception less general than the notion to be spelled out here already exists in the law where a life estate is "[a]n estate whose duration is limited to the life of the party holding it, or some other person." It is "[a] legal arrangement whereby the beneficiary (i.e., the life tenant) is entitled to the income from the property for his or her life. Upon the death of the life tenant, the property will go back to the holder of the remainder interest or to the grantor by reversion" (Black 1991: 636). A life tenant holds a "life interest" in the estate, "[a] claim or interest in real or personal property, not amounting to ownership, and limited by a term of life" (Black 1991: 637). The holder of a life estate does not hold this estate "in fee simple," but rather under special restrictions. In general, the holder of a life estate has claim only to the "usufruct" of the estate, "[t]he right of using and enjoying and receiving the profits of property that belongs to another" (Black 1991: 1073).

The received legal category of life estates is only suggestive of the institutional structure here being proposed which is qualitatively more flexible and potentially comprehensive. The name "life estate" is retained because it remains appropriate and for lack of a better alternative.

What is here proposed is a specific institutional structure of life estates which in some realizations would entirely regulate

the disposition of social surplus. The structure proposed is substantially more supple than coupon systems in combining the goal of achieving an egalitarian distribution of the non-invested surplus while blocking efforts to misdirect resources from investment to consumption. And, as laid out in the next section, the financial economic properties of life estate systems are open to straightforward formal investigation. For example, it can be demonstrated that even under very weak assumptions about preferences over the return and risk of investments, life estate holders will choose riskier investment strategies than investors who hold their portfolios in fee simple.

One defensive remark before proceeding to the more formal development is this. The notion of life estates has a heritage which long precedes the emergence of capitalism as a dominant mode of production. The very idea that a proposal somehow generalizing on this notion could offer an institutional structure in which one of the fundamental components of socialist striving might be realized can seem prima facie far-fetched. This proposal may even seem prima facie even less radical than that of a coupon system, a suggestion which many have already dismissed as an tacit renunciation of any ideal of socialism as a qualitatively different (and better) mode of production than capitalism.

There are two immediate responses to this skepticism. The first is that some instantiations of a system of life estates would in fact provide for an egalitarian distribution of the social surplus available for consumption, that this objective is a core component of the ideal of socialism as a mode of production progressing beyond capitalism, and the fact that a conceptual relative of this conception has roots in feudal societies is irrelevant to the evaluation of the conception. The second is that no estimable socialist critic of capitalism has ever thought that egalitarian access to the consumable surplus remotely exhausted or was even perhaps the most important component in the socialist ideal of a post-capitalist society. But it is an essential component and, as instantiated by means of a system of life estates, it is economically coherent.

A SYSTEM OF LIFE ESTATES

We can conceive of any particular life estate system as administered by an agency which regulates its component

individual life estate portfolios and the mutual funds offering shares for these portfolios.

The life estate agency opens, on behalf of each person newly becoming a life estate holder, e.g., by becoming an adult citizen, at time t, a life estate portfolio account to be comprised of a (fully insured) checking account and generally one or more mutual fund share sub-accounts. The agency deposits an initial amount W_t in the holder's portfolio checking account which pays a risk free interest rate on the balance. Other portfolio sub-accounts are share accounts created when holders buy mutual fund shares for their life estate portfolios. The number of shares held and their current redemption value is continuously recorded for each share sub-account. The sum of the values in the checking and share sub-accounts of a life estate portfolio account, i.e., the aggregate account balance, $W^{\dagger}_{t}$, is the value of its holder's life estate portfolio. (For anyone newly becoming a life estate portfolio holder at time t it is automatic that $W^{\dagger}_{t} = W_t$.) When a person ceases to be a life estate portfolio holder, e.g., by dying, all shares in the portfolio account are redeemed and the aggregate account balance escheats to the life estate agency.

Life estate portfolio holders can write checks on their portfolio checking account to eligible mutual funds to buy shares which are then held in life estate portfolio sub-accounts. The only deposits permitted by the agency into life estate portfolio checking accounts are distribution and share redemption payments from eligible mutual funds and deposits by the agency itself. Distribution and share redemption payments from mutual funds on shares held in life estate portfolios are permitted only to the portfolio holder's life estate checking account. With the exception of checks written to mutual funds in payment for shares and withdrawals by the agency, withdrawals from life estate portfolio checking accounts are only permitted if they do not draw the aggregate balance below the amount W_t.

The value W_t may be thought of as a "minimum balance requirement" for life estate portfolio accounts at time t. Of course life estate portfolio holders who enter the system before time t may fail to meet this requirement, i.e. their aggregate balance $W^{\dagger}_{t}$ may be less than W_t, due to inadequate past earnings on its components. Under such circumstances the holder can make no withdrawals from the checking account except to buy shares from eligible mutual funds.

The value W_t is recursively specified as follows: Where W_0 was the life estate portfolio endowment level at the point the life estate system was initiated, τ_i is an endowment level change (if any) at time i, and γ_i is the life estate system target growth rate at each time i, $W_t = W_{t-1}(1 + \gamma_{t-1}) + \tau_t$.

Here τ_i is conceived as an amount which may be a (lump-sum transfer) deposit to (if $\tau_i > 0$) or (lump-sum tax) withdrawal from (if $\tau_i < 0$) each life estate portfolio checking account by the agency, and γ_i is a rate specified by life estate agency fiat. If τ_i is positive, new funds are added to the life estate system by the agency. If γ_i is positive, additional funds are required from the investment earnings of life estate portfolios. Thus for a person who became a life estate portfolio holder at time s ≤ t, the cumulative life estate agency contribution to the value of W_t has been $W_s + \sum_{s+1}^{t} \tau_i$ while the remainder has come from investment earnings of the portfolio.

Each portfolio holder controls the investment of an amount equal to the holder's aggregate life estate portfolio account balance $W_t^\dagger$. This amount is invested at the holder's discretion in eligible mutual funds or left in the portfolio checking account. In the next period the aggregate total return on this investment is $W_t^\dagger(1 + r_t)$ where r_t is the actual average rate of return on the portfolio. The minimum balance requirement for the next period is $W_{t+1} = W_t(1+\gamma_t)+\tau_{t+1}$. Thus the portfolio holder will be able to withdraw value from the portfolio account, e.g., to fund consumption, only if $W_t^\dagger(1+r_t) > W_t(1 + \gamma_t)$, i.e., only if $(W_t^\dagger/W_t)(1+r_t) - 1 > \gamma_t$. A life estate system allows the portfolio holder conditional access to a portion of economic surplus to do with whatever is desired, but the system also requires that a certain other portion of the economic surplus be reinvested.

If the conditions for the application of the Miller-Modigliani dividend irrelevancy theorem are accepted, portfolio holders should be indifferent about the distribution policies of mutual funds. For any distributions, per share of mutual funds will be exactly offset by decreases in share prices (net asset values per share). Thus mutual fund distributions paid into life estate portfolio checking accounts are exactly offset by decreases in the value of life estate portfolio share accounts. If the minimum balance requirement is exceeded and a portfolio holder wishes to withdraw the excess for consumption or investment outside the holder's life estate portfolio, the excess can be made

available in the checking account by redeeming shares in share accounts if it is not already available in the checking account from mutual fund distributions.

A useful feature of this life estate conception is the flexible breadth of its potential range of application. At one extreme one can imagine a privately endowed life estate system, the aggregate asset value of which is a small portion of aggregate financial assets and/or whose portfolio holders are a small portion of the total population. For example the holders might be the descendants of the founder who endowed the system. (Such a founder might be especially revered by near descendants for pegging $\gamma_i = \bar{\gamma}$ at a low or even negative fraction $\bar{\gamma}$!)

At the other extreme, and here is where interest lies, one can imagine a life estate system in which the life estate agency is a public body, the aggregate value of the financial assets in the life estate system approaches the aggregate value of the productive assets of the whole society, and every adult citizen is a life estate portfolio holder. (Here the τ_i and γ_i values would acquire macroeconomic importance.[3]) So conceived a life estate system is a version of market socialism on all fours with Roemer's coupon system, but with salient advantages.

Although an examination of the financial economic properties of life estate systems is precluded here by lack of space, they are of substantial interest.[4] It can be shown, for example, that, for a given Capital Market Line of efficient portfolios, optimizing life estate investors with convex preferences in return and risk will bear more risk than conventional (in fee simple) investors with the same preferences, and thus, in general equilibrium, the Capital Market Line in an economy with an extensive life estate system will be characterized by a higher risk free rate of return and a lower risk premium. It can also be argued that, no less than in a system in which equity is held by mutual funds held by conventional in fee simple investors, managers of both mutual funds and corporations they own will strive to maximize asset value in a life estate system. In particular, no incentive to run funds or firms as cash cows is created by life estates.

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[3]For example, an adherent of the Solow growth model would recommend pegging $\gamma_t = \bar{\gamma}$ at the rate which produces the Golden Rule level of capital accumulation. More generally, in a comprehensive life estate system, the savings rate is a policy variable, democratically determinable.

[4]Thompson 1995.

Whether some conception of a system of life estates should be promoted as a part of a feasible and desirable vision of socialism is a question this short essay seeks only to pose, not to answer. Much more thinking about both the politics and the economics is needed.

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