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THE PROPOSED ALASKA GENERAL STOCK OWNERSHIP CORPORATION (AGSOC)

A Preliminary Report to the Alaska State Legislature: Part I

Prepared Statement of Arlon R. Tussing
to the House Finance Committee

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SUMMARY

The Alaska General Stock Ownership Corporation (AGSOC) would be a state-initiated but privately owned and managed corporation, organized and operated so as to be eligible for the federal tax benefits provided in Subchapter U of the Internal Revenue Code. The AGSOC would finance its purchase of business property entirely from loans that would be paid off from the corporation's earnings.

This preliminary report examines the tax advantages and other provisions of Subchapter U, and finds that:

1. Earnings of a general stock ownership corporation (GSOC) are not directly subject to U.S. corporate income tax, and thus GSOC shareholders may enjoy substantially higher after-tax dividends than shareholders of an otherwise comparable ordinary business corporation, if all or most of the latter corporation's earnings are exposed to the highest federal tax rates;

2. The tax savings for shareholders from organizing a business as a GSOC are greatest in the lowest tax brackets, and may be insignificant for upper-income taxpayers;

3. Ordinary business corporations can be organized so as to shelter much of their income from the corporate income tax through the way in which they arrange their accounts and their financing --- thus the actual tax advantage of organizing a business as a GSOC can vary widely and in some cases may be insignificant;

4. All other things being equal, the three principal types of small business organization (proprietorships, partnerships, and Subchapter S corporations) are at least equal to, and are usually more efficient than, GSOCs as producers of after tax-earnings; and

5. GSOCs must pay dividends every year sufficient to offset the added personal tax liability that ownership of GSOC stock creates for their shareholders --- this requirement severely restricts the kinds of investments GSOCS can safely make, and the ways in which those investments can be financed.

The investigator concludes that a GSOC may be a suitable form of organization to broaden the distribution of private capital ownership amomg Alaskans in some specialized instances, but other forms of business organization are likely to be superior in many other cases. Alaskans should first decide what they want to do, and then choose the organizational forms and financing plans that accomplish those goals most effectively: "To set up a very specialized corporate organization designed to conform to a very specialized provision of the tax law, and then to let it loose looking for something to do, is simply topsy-turvy."

A supplement to this report will consider AGSOC financing proposals, appropriate and inappropriate investments for GSOCs (with special attention to the suggested purchase of BP's interest in TAPS), and issues of AGSOC control and management.

This report is preliminary and subject to revision; the tables were calculated manually, and are subject to correction.

INTRODUCTION

This preliminary report on the proposed Alaska General Stock Ownership Corporation (AGSOC), reflects one part of a study by Arlon R. Tussing and Associates, Inc. for the Finance Committee of the Alaska House of Representives, reviewing and analyzing measures that have been proposed to conserve, invest, distribute, or otherwise manage Alaska's surplus oil and gas revenues.

The geological accident at Prudhoe Bay has given the government of Alaska, and through it the state's four hundred thousand people, a source of income that will far exceed anyone's notions of the funds needed for ordinary public services. The expected cash surplus also surpassses the capital requirements for all but the most far-fetched state economic development schemes.

Most Alaskans give some support to the idea of saving part of this treasure against the day that current oil revenues no longer can provide the citizens with a high level of government services, lavish transfer payments and generous promotional programs for developing (or distressed) industries, at practically no cost to them in personal or business taxes. But savings plans that will benefit mostly strangers ten, twenty, or more years in the future, probably can not match the attraction of programs that will, one way or another, get money into the state's economy now.[1]

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1) As I have commented elsewhere, some proposals that are purportedly aimed at diversifying Alaska's economic base are best understood as disguised programs to "privatize" a part of the oil revenues. [See Arlon R Tussing, "Investing in Economic Development." Statement at Workshop of Alaska Growth Policy Council, Anchorage, October 20, 1979.]

Thus, it is not surprising that the state's citizens should consider ways in which to turn at least part of this government windfall directly into private income or wealth. Some current proposals, such as Governor Hammond's energy credit plan and his "Alaska,Inc.," are openly intended to serve this aim.

AGSOC resembles these plans in some respects, and not in others. It is clearly intended to distribute privately-owned wealth broadly among individual Alaskans. But, according to the inventor of the concept, San Francisco financial consultant Louis Kelso, and AGSOC's most prominent Alaska advocate, Senator Mike Gravel, the Corporation will be capitalized entirely by borrowing against its own property. Thus, the sponsors assert, any wealth distributed to Alaska residents in the form of AGSOC shares will neither come from, nor depend upon, the state's oil wealth.

We shall nevertheless treat AGSOC as one option for managing Alaska's oil and gas wealth, because most legislators and concerned members of the public regard it as such, and more importantly, because we can evaluate the General Stock Ownership Corporation (GSOC) as a form of business organization quite separately from the way in which it is originally capitalized. Stated differently, AGSOC may merit consideration as a vehicle for privatizing and distributing oil and gas revenues, whether or not that was Senator Gravel's original idea in proposing the plan.

The AGSOC concept as presented by Mr. Kelso and Senator Gravel has three elements that are separable from one another, as well as from Kelso's distinctive social and economic theories.

Under this plan:

1. The state legislature would charter a private corporation entitled to certain federal tax benefits under Subchapter U of the Internal Revenue Code, and distribute one share in the corporation free of charge to each Alaska resident.

2. AGSOC would purchase one or more existing profit-making enterprises: British Petroleum's interest in the Trans Alaska oil pipeline (TAPS) is the most frequently suggested example.

3. AGSOC would purchase these enterprises with borrowed money, using its profits to amortize its debt.

This preliminary report considers the business advantages and disadvantages of GSOCs, as they are determined by the Internal Revenue Code. A supplementary report will treat AGSOC financing proposals, and appropriate and inappropriate investments for a GSOC (with special attention to the BP interest in TAPS), and issues of AGSOC control and management.

THE GENERAL STOCK OWNERSHIP CORPORATION (GSOC): TAX ADVANTAGES

The General Stock Ownership Corporation (GSOC) is a creature of United States tax law. Its singular advantage, indeed its only advantage, over an ordinary business corporation is the fact that Subsection U of the Internal Revenue Code exempts the profits of a GSOC from being taxed twice, first as corporate income and once more as dividends to the shareholder.

The ability to avoid double taxation under federal law can give AGSOC shareholders a real advantage over shareholders of other corporations that do not qualify under Subsection U. With a top rate of 46 percent, the federal corporate tax can leave as little as 54 cents out of each profit dollar to be reinvested or distributed as dividends. A shareholder who is subject to a 30 percent marginal tax rate on his personal income could thus end with after-tax benefits of only about 38 cents per dollar of earnings:

$$\underline{\$1.00 \text{ profits}} < \begin{matrix} - \underline{\$.46 \text{ corporate tax}} \ (46\%) \\ = \underline{\$.54 \text{ after-tax profit}} \ (54\%) \end{matrix} < \begin{matrix} - \underline{\$.162 \text{ personal income tax}} \ (30\%) \\ = \underline{\$.378 \text{ net personal income}} \ (70\%) \end{matrix}$$

State corporate and personal income taxes will of course reduce the shareholder's after-tax benefits even further. The earnings of a GSOC, in contrast to ordinary corporate profits, are taxed only once at the federal level --- as personal income to the shareholder. Thus, a GSOC shareholder in the 30 percent federal income tax bracket might be able to benefit from as much as 70 percent of his GSOC profit dollar:

$1.00 GSOC profits ----- $1.00 dividend (100%) < - $.30 personal income tax (30%) = $.70 net personal income (70%)

The GSOC is not the only form of business organization that can avoid having its earnings taxed twice. This ability is shared by single-owner businesses (proprietorships), partnerships, small business corporations under Subchapter S of the Internal Revenue Code, regulated investment companies (mutual funds), cooperatives, and thrift institutions. The previous comparison, moreover, tends to exaggerate the tax advantage of GSOCs over ordinary business corporations, because:

1. Most corporations can arrange their affairs so that they do not in fact pay the maximum rate of the corporate income tax;

2. The larger part of shareholders' earnings on common stock is not dividends but capital gains, which are taxed only when the stock is sold and even then at rates that are normally one-half of the rates that apply to ordinary income; and

3. Subchapter U creates tax disadvantages as well as advantages:

   a) GSOC dividends do not receive the $100 exclusion that applies to ordinary dividends;

   b) A GSOC may not benefit from the investment tax credit (ITC) --- ITC benefits, if any, have to be claimed by shareholders on their personal income tax returns;

   c) GSOC shareholders are liable for personal income taxes on their share of GSOC earnings, whether or not the GSOC distributes sufficient dividends to cover this added tax liability;

d) While GSOC shareholders are liable for taxes on their share of its earnings, they may not claim GSOC losses as deductions on their personal income tax returns; and

e) A GSOC that distributes less than 90 percent of its taxable income in any year is subject to an additional 20 percent tax penalty.

One way to consider all these factors together may be to look at the total tax burden on the profits from an identical investment under various forms of business organization. The actual burden in any real-world instance depends upon a large number of factors, and the reader should realize that the figures that follow are only illustrations, and not predictions about the performance of any particular enterprise.

The chief assumptions in the calculations of tables 1 through 8 are that:

1. A company is formed with a net investment of $1,000 per shareholder;

2. The company is capable of earning 25 percent before taxes on that investment, and also on any funds that it may reinvest;

3. Each year's depreciation is 10 percent of the previous year's cumulative net investment, and all depreciation allowances are reinvested; and

4. The company earns a 10 percent investment tax credit (ITC) on its initial investment and on all reinvested funds.

The tax rate on corporate profits is assumed to be 45 percent, and after-tax benefits to shareholders are calculated for the 20, 30, 40, and 50 percent marginal tax rate brackets, with capital gains taxed at half the rate on ordinary income.

Our first comparison is between a GSOC and an ordinary business corporation, both of which distribute 90 percent of their net earnings as dividends. I have chosen this assumption because the tax law penalizes a GSOC that distributes less than 90 percent of its earnings directly to shareholders.

Table 1 shows the after-tax benefits to a taxpayer in the 20 percent income tax bracket. Compare the first two columns, GSOC, and ordinary business corporation, for year 5. The GSOC pays dividends worth $207 after taxes, while the ordinary corporation's dividends are worth only $140 --- a difference of 48 percent. This difference is due to the GSOC's shareholder's avoidance of double taxation. The GSOC thus holds a considerable after-tax advantage in every year on the table.

year	GSOC	ordinary corporation	ratio
5	$207	$140	148%
20	$297	$197	151%

Look at the fifth and sixth columns, comparing the GSOC and the conventional company in terms of the after-tax value of all company earnings, including appreciation in the book value of the shares. Again, the GSOC shareholder enjoys a substantial advantage. In the fifth year, GSOC dividends plus appreciation are worth $232, while the corresponding total for the ordinary corporation is only $168, a difference of 38 percent.

year	GSOC	ordinary corporation	ratio
5	$232	$168	138%
20	$336	$238	141%

As we go up the income scale, however, the picture changes. Look at table 4. To a taxpayer in the 50 percent marginal income tax bracket, the advantage of a GSOC over an ordinary corporation is much weaker. Until about the eighth year, the after-tax performance of the two kinds of company is almost the same. Even in the twentieth year, GSOC after-tax dividends are only 15 percent higher than those of the ordinary company, and total earnings are only 8 percent more.

year	GSOC	ordinary corporation	ratio
5	$124	$125	99%
20	$184	$160	115%

The main reason the ordinary corporation is relatively more attractive to higher-bracket taxpayers is that the personal income tax is a greater part of their total tax burden. Here, the exclusion of the first $100 of ordinary corporate income (an exclusion not available for GSOC dividends) makes a noticeable difference, as does the fact that capital gains are taxed at a much lower rate than ordinary income.

These comparisons probably overstate the tax advantage of GSOCs over ordinary corporations, because the framework of corporate accounting and the tax laws offer many ways to reduce the burden of double taxation. Thus the examples in the second and fifth columns of each table tend to be "worst-case" examples --- cases of companies without

clever managers or tax advisors. The columns titled ordinary business corporation - leveraged illustrate the effect of just one possible corporate tax-avoidance device --- and it is one that might well be used by an Alaska state-sponsored enterprise taking a conventional corporate form.

In the case of the "leveraged" business corporation, the shareholder's original $1000 in common shares is replaced by $100 in common shares, plus $900 in "junior debt" --- in effect a second mortgage on the corporation's assets. This debt is more risky than the company's regular bonds, because it would be the last to be serviced if earnings were insufficient to meet all the firm's obligations. Hence it is reasonable that this junior debt earn a higher rate of return than ordinary corporate bonds --- say 20 percent. In place of dividends alone, the shareholder now receives a combination of dividends and interest.

Interest, however, is not subject to the corporate profits tax, but is taxed only as income to the utimate recipient. Thus, under our "leveraging" plan, the same corporate revenues suffer a substantially lower tax burden before they reach the investor.

Compare now the after-tax dividends (in this case "dividends" includes some interest) and total earnings of the leveraged corporation with those of the GSOC. In the lowest tax bracket, according to Table 1, the GSOC retains some dividend advantage, but its edge is very much diminished: In the fifth year, GSOC payments are worth $207 after taxes, while the ordinary corporation now produces 97 percent of that figure, or $200.

year	GSOC	leveraged corporation	ratio
5	$207	$200	104%
20	$297	$244	122%

Total earnings including the increase in book value are $232 and $217 repectively, a difference of 6 percent. The GSOC's advantage increases somewhat over the years, but is still substantially less than it was in our earlier comparison with a conventional business corporation.

year	GSOC	leveraged corporation	ratio
5	$232	$217	107%
20	$336	$270	124%

At higher incomes, the GSOC's advantage in after-tax earnings disappears, and table 4 shows that a taxpayer in the 50 percent bracket may receive more dividends after taxes by holding an interest in an ordinary corporation than by owning GSOC shares.

year	GSOC	leveraged corporation	ratio
5	$124	$146	85%
20	$184	$190	97%

The increase in after-tax total earnings shows a similar picture:

year	GSOC	leveraged corporation	ratio
5	$145	$160	91%
20	$210	$212	99%

As noted earlier, a GSOC is not the only kind of business organization that can avoid double-taxation of its earnings. Proprietorships, partnerships, and Subchapter S small business corporations (which are taxed essentially as if they were partnerships), are also permitted to flow their profits through to their owners untaxed.

The Internal Revenue Code provides similar treatment for these three kinds of business organizations, and our tables lump them all together under the heading small business. One essential difference in accounting and tax treatment between GSOCs and small businesses does concern us here: Subchapter U does not permit a GSOC to benefit from investment tax credits (ITC); any ITC benefits are claimed by the GSOC shareholders on their individual income tax returns.

While the owners of small businesses may (and often do) use the ITC as a tax-shelter for income from other sources, there is nothing in the tax code that prevents them from plowing it back into their businesses; and this is by far their most common use for the ITC. The tables assume therefore that small businesses reinvest any ITC they earn, (together with their depreciation allowances and 10 percent of their taxable income). Any ITC earned by a GSOC, however, is treated as an offset to shareholder tax liability --- that is, as part of shareholder after-tax earnings.

As a result, tables 1 through 4 show that a given investment in a small business will yield at least as much current after-tax income and at least as much after-tax total earnings from a given investment as will a GSOC, in all tax brackets. In most cases, the small business form of organization is substantially more effective in sheltering earnings from the federal tax collector.

The fifth-year figures in table 1 show, for example, that a small business can give a low-income taxpayer 9 percent more current after-tax income than a GSOC; the advantage is 29 percent in the 20th year. (In this case, the heading "dividends" may cover proprietor's income or partnership income.) The small business has a 16 percent edge in total after-tax earnings in year 5, and a 38 percent edge in year 20.

year	GSOC	small business	ratio
5	$207	$226	92%
20	$297	$384	77%

Table 4 shows a similar patterns for high income individuals in the 50 percent tax bracket.

year	GSOC	small business	ratio
5	$145	$166	87%
20	$210	$276	76%

REINVESTMENT OF GSOC EARNINGS

A business corporation normally does not distribute the bulk of its net earnings as dividends, but keeps them inside the firm to finance new investment. This arrangement is in the interest of both the company and its shareholders: On the one hand, internally-generated funds are usually the cheapest source of new equity capital for the firm. On the other hand, the shareholders are able to take most of their profits in the form of long-term capital gains, which are taxed at lower rates than dividend income --- if at all.

Many highly profitable corporations pay at most token dividends. Indeed, the more profitable the company and, especially, the greater its opportunities for growth, the more its shareholders tend to benefit from a policy of keeping dividend payments to a minimum.

Congress, when it enacted Subchapter U, clearly intended that GSOCs <u>not</u> reinvest the bulk of their earnings. Indeed the chief rationale for exempting GSOCs from corporate income taxes was the idea that they would be direct conduits for earnings like mutual funds, and <u>not</u> accumulators of capital.

Despite this explicit intent, the penalty in tax code on a GSOC that accumulates internal capital is remarkably mild: a 20 percent tax on undistributed earnings exceeding 10 percent of taxable income in any one year. This penalty is still less than half the top tax rate --- 46 percent --- on the income of ordinary corporations, whether that income is distributed or retained. Thus, frequent assertion that Subsection U <u>prohibits</u> GSOCs from reinvesting their earnings is inaccurate, and we shall see below what happens to the after-tax dividends and total after-tax earnings of a GSOC that reinvests a substantial part of its profits.

Tables 5 through 8 compare the after-tax earnings on a $1000 net investment by (1) a GSOC; (2) an ordinary business corporation, all of whose income is exposed to the top rates of the corporate tax; (3) an ordinary business corporation in which the owners each contribute $100 as common equity and $900 as junior debt at an interest rate of 20 percent, in lieu of $1000 equity; and (4) a small business taxed as a proprietorship, a partnership, or a Subchapter S corporation. Tables 5 through 8 assume that each firm reinvests 50 percent of its net earnings, in addition to its depreciation allowances and (except for the GSOC) its ITC.

In most respects the results are just what we would expect from Tables 1 through 4. In general, GSOCs produce more after-tax income and grow faster on the same initial investment than ordinary business corporations, and small businesses earn more and grow faster than GSOCs. The contrasts between the figures in Tables 5-8 and those of Tables 1-4 reflect the general principle that reinvesting means sacrificing current income for future income or capital gains. Comparing Table 5 with Table 1, for example, it is not surprising that reinvesting 50 percent of earnings yields a lower after-tax dividend in year 5 than reinvesting only 10 percent, except in the case of the "leveraged" corporation.

reinvestment	GSOC	ordinary business corporation	"leveraged" corporation	small business
50%	$119	$103	$200	$139
10%	$207	$140	$200	$226
Ratio:	57%	74%	100%	62%

With time, however, the pattern is reversed, and the contrast in year 20 is a dramatic illustration of the power of compound interest. The reason the leveraged corporation shows the best dividend performance in its early years and the weakest in its later years is the large fixed payout ($180 per share) in the form of interest, and thus the relatively lower proportion of total earnings (profit plus interest) that is reinvested.

reinvestment	GSOC	ordinary business corporation	"leveraged" corporation	small business
50%	$698	$306	$247	$1,083
10%	$297	$197	$244	$ 384
Ratio:	235%	155%	122%	282%

The impact on after-tax total earnings of a high reinvestment rate is even greater than its effect on after-tax dividends. In the 20 percent tax bracket the difference is notable even in year 5.

reinvestment	GSOC	ordinary business corporation	"leveraged" corporation	small business
50%	$299	$220	$250	$383
10%	$238	$168	$217	$270
Ratio:	126%	131%	115%	142%

The higher reinvestment rate of course has an even more dramatic impact on total earnings in the 20th year.

reinvestment	GSOC	ordinary business corporation	"leveraged" corporation	small business
50%	$1,658	$708	$466	$2,990
10%	$ 336	$238	$270	$ 462
Ratio:	493%	297%	172%	647%

THE DANGER OF CASH DEFICIENCIES

Table 8 contains one especially striking feature: A GSOC or a small business that invests 50 percent of its earnings generates no after-tax income at all for a shareholder in the 50 percent tax bracket. In a sense its situation is equivalent to that of an ordinary corporation that retains and reinvests 100 percent of its net income.

In contrast to owners of ordinary common stock, however, a GSOC shareholder is liable for personal income taxes on his or her share of the GSOC's earnings whether or not the GSOC distributes dividends, and totally without respect to any dividends that the GSOC does distribute.

In table 8, therefore, we see a major danger to shareholders arising from the very aspect of the GSOC that makes it an attractive form of business organization, --- "tax integration" ---, together with a serious limitation on their management and investment flexibility.

In at least one combination of circumstances, the sum of GSOC dividends and ITC are barely enough --- or not quite enough --- to cover the additional personal tax liability that GSOC earnings have created for at least one class of taxpayers. This situation can be expected to arise, under the assumptions used in this analysis, any time reinvestment of earnings approaches 50 percent.

Actually, Table 8 understates the problem because:

1. The table assumes that the GSOC passes on to its shareholders substantial ITC benefits every year, which can be used to offset additional tax liabilities. It is quite probable, however, that a large part of GSOC investment will be in assets --- land, existing plant and equipment, and working capital --- that do not generate any ITC.

2. The table assumes there are no claims against GSOC earnings other than reinvestment and payment of dividends --- specifically that depreciation allowances will always generate enough cash to amortize any outstanding debt.

3. There is nothing in the GSOC scheme that rules out a situation in which the corporation earns a taxable income --- and thus creates a tax liability for its shareholders --- and yet is unable to pay them sufficient dividends to offset that tax liability.

It will be intolerable if any group of shareholders is put into a negative cash position as a result of owning GSOC stock. Such a situation clearly can come about, however, with reinvestment rates considerably less than 50 percent, and there are plausible circumstances in which it might arise even if there were no reinvestment at all.

Consider, for example, a GSOC that had to pay off initial borrowings of $1,000 per share out of earnings in ten years. Assume that it earns only 15 percent, or $150 per share, instead of the 25 percent projected by its organizers (which would have permitted the GSOC to pay sufficient dividends to cover the additional tax liabilities for all classes of shareholders). Only $50 per share remains for distribution as dividends --- and to pay the 20 percent added tax Subsection U imposes on undistributed earnings in excess of 10 percent of taxable income. Maximum dividends would therefore be $28.75.

Taxable income	$150.00
(Less) amortization	100.00
(Less) penalty tax	21.15*
Available for Distribution	$ 28.75

*[20% x (90% x $150.00 - $28.75)]

The shareholders' tax liability does not depend upon the dividends they actually receive, however, but upon their share of taxable income, which is $150 per share. Thus, owning a GSOC share will increase each shareholder's tax bill. A taxpayer in the 20 percent bracket will have to pay an additional $30.00 in personal income taxes, while a taxpayer in the 50 percent bracket will have to pay $75.00. Both of these figures and all the figures between them exceed the comparable GSOC dividend payout.

marginal tax bracket	increased tax liability	income deficiency
20%	$30.00	$ 1.25
30%	45.00	16.25
40%	60.00	31.25
50%	75.00	46.25

In this quite plausible instance, therefore, ownership of GSOC shares has put taxpayers of every bracket into a negative cash position. This scenario is not the worst possible one; the reader can surely conceive of even more troublesome situations.

There is little doubt that a GSOC can, in principle, be capitalized and operated so as to avoid any danger that the personal tax liabilities of any shareholder group would ever exceed its dividend distributions. To be quite safe, however, such a GSOC probably:

1. Has to limit its borrowing --- either for its initial capitalization or for expansion --- to levels at which all debt could be paid off out of depreciation allowances alone, without relying on taxable income;

2. Must begin with and keep a substantial equity cushion in the form of initial paid-in capital and surplus, or retained depreciation allowances and profits, to cover any short-term losses and to pay sufficient dividends in every year to cover each shareholder's tax liabilities if, for any reason whatsoever, there is not sufficient cash flow from current operations; and

3. Cannot expect to finance its expansion with retained earnings.

A GSOC's tax advantages, in brief, come at a very high price to the corporation in flexibility regarding the kind of business it can operate, the ways in which it can initially be capitalized, and in its ability to respond to new investment opportunities. In many instances, surely, these costs will more than offset the benefits of operating under the provisions of Subchapter U. At this point in our study, we cannot be certain that there is in fact any kind of investment in Alaska, or any strategy for distributing private wealth more broadly among individual Alaskans, for which a GSOC is really the most suitable form of business organization.

SUMMARY AND CONCLUSIONS

Thus far, our examples have had five main implications:

1. A GSOC can create significant tax savings for shareholders, compared to an ordinary business corporation, if all of that corporation's earnings are exposed to the highest federal tax rates;

Hence, if Alaska wants to establish a corporate entity for the purpose of "privatizing" surplus oil revenues, organizing it as a GSOC is clearly one option to be considered.

2. The tax savings for shareholders from organizing a business as a GSOC are greatest in the lowest tax brackets, and may be insignificant for upper-income taxpayers;

Hence, the case for using a GSOC in place of an ordinary business corporation is stronger if Alaskans desire to use the corporation to accomplish a relatively "progressive" distribution of wealth.

3. Ordinary business corporations can be organized so as to shelter much of their income from the corporate income tax through the way they arrange their accounts and their financing: by their scheduling of depreciation, for example, or by converting profits to deferred capital gains and interest;

Hence, the actual tax benefits of organizing a subsection U corporation are unclear, and may not be sufficient to overcome the greater accounting, investment, and managerial flexibility of a shrewdly capitalized and managed conventional corporation.

4. All other things being equal, the three principal types of small-business organization are at least equal to, and are usually more efficient than, GSOCs as producers of after-tax earnings.

Hence, state loans, loan guarantees, or venture capital investments for Alaska small businesses may be more effective investments than GSOCs, dollar for dollar, as a means of dispersing private capital ownership.

5. The need to pay dividends every year sufficient to offset the personal tax liability GSOC ownership creates for individual shareholders severely restricts the kinds of investments that GSOCs may safely make, and the ways in which those investments can be financed.

In summary, the general stock ownership corporation organized under Subchapter U of the Internal Revenue Code is a very specialized creature, and it is probably adaptable only to a narrow range of investment opportunities and business strategies. In subsequent parts of this study, we will examine some of the specific investments and strategies that have been suggested for AGSOC.

Alaska's new oil and gas wealth gives state government the capacity to help "Alaskanize" existing big businesses operating in the state --- the oil pipeline, fish processing companies, or scheduled airlines, for example. Also, the state now has the ability to give real support to financing of the natural gas transportation system through its investment in the pipeline proper, a gas conditioning plant, or both. And state financial initiatives may be crucial in establishing new industries or for the growth of existing industries: agriculture, fisheries, tourism, chemicals,

or petroleum refining, or for building needed transportation, utility, and communications facilities. Any or all of these initiatives can be structured in ways that distribute ownership and control of the investments broadly among the state's residents.

But AGSOC enthusiasts have their priorities backward. Alaska's citizens, through their legislature and governor, first need to decide which existing industries they want to Alaskanize, what new industries they want to promote, whether or not they want a state investment in the gas pipeline, and what balance they want between private and public management of the state's wealth.

It is only in connection with these decisions that it makes sense to choose a kind of business organization or a financing plan. The ability to shelter benefits from the federal tax collector is obviously an important consideration in this choice, but it is by no means the only consideration, and may not always be the dominant one. A GSOC may well make sense for some investments --- for many others it surely will not. An approach that calls on the state to set up a very specialized corporate organization designed to conform to a very specialized provision of the tax law, and then to set it loose looking for something to do, is simply topsy-turvy.

TABLE 1: COMPARISON OF AFTER-TAX EARNINGS IN 20 PERCENT MARGINAL TAX BRACKET
90 percent of taxable earnings distributed as dividends; 10 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation	"leveraged"	small business	GSOC	ordinary business corporation	"leveraged"	small business
1	275	119	215	175	298	222	309	288
2	230	130	192	197	253	163	215	237
3	196	134	194	205	219	160	214	245
4	201	137	197	218	225	163	214	261
5	207	140	200	226	232	168	217	270
6	212	143	202	235	238	172	220	281
7	218	147	205	243	245	176	224	292
8	222	150	207	252	250	181	226	302
9	228	153	210	261	256	185	230	312
10	234	157	212	270	262	188	232	323
11	239	160	215	280	269	192	236	335
12	245	164	218	290	276	197	240	348
13	251	168	221	300	283	202	242	359
14	257	171	224	311	290	207	246	374
15	263	175	227	322	297	212	250	385
16	270	179	230	334	304	217	253	402
17	277	183	233	346	312	222	257	415
18	283	188	237	358	320	228	262	431
19	290	192	240	371	328	233	265	447
20	297	197	244	384	336	238	270	462

Notes: Initial equity investment $1,000 per share, except leveraged corporation;
Leveraged corporation initial investment per share $100 equity, $900 junior debt;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent;
ITC 10 percent of last year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

TABLE 2: COMPARISON OF AFTER-TAX EARNINGS IN 30 PERCENT MARGINAL TAX BRACKET
90 percent of taxable earnings distributed as dividends; 10 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation	"leveraged"	small business	GSOC	ordinary business corporation	"leveraged"	small business
1	250	116	161	150	271	213	249	256
2	192	127	174	169	214	158	196	206
3	170	129	176	175	192	154	195	213
4	174	132	179	187	209	158	195	228
5	179	135	182	194	213	161	196	236
6	183	138	184	201	220	165	201	253
7	188	141	187	208	226	169	205	262
8	192	143	189	216	232	172	207	271
9	197	146	192	223	238	176	211	280
10	202	149	194	231	244	180	213	290
11	207	152	197	240	250	183	217	300
12	212	155	200	248	256	187	220	310
13	217	159	203	257	263	192	223	320
14	223	162	206	266	269	196	227	332
15	229	166	209	276	276	201	230	343
16	235	169	212	286	283	205	234	355
17	240	173	215	296	290	210	238	367
18	246	177	219	306	297	213	243	379
19	252	180	222	317	304	219	246	393
20	259	185	225	328	312	225	250	406

Notes: Initial equity investment $1,000 per share, except leveraged corporation;
Leveraged corporation initial investment per share $100 equity, $900 junior debt;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent;
ITC 10 percent of last year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

TABLE 3: COMPARISON OF AFTER-TAX EARNINGS IN 40 PERCENT MARGINAL TAX BRACKET
90 percent of taxable earnings distributed as dividends; 10 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation	"leveraged"	small business	GSOC	ordinary business corporation	"leveraged"	small business
1	225	114	143	125	245	206	226	225
2	140	123	156	141	169	152	177	176
3	144	125	158	146	165	148	176	182
4	147	128	161	156	169	152	176	194
5	147	130	164	161	170	155	179	200
6	148	132	166	168	171	159	182	209
7	152	134	169	174	175	163	186	216
8	155	137	171	180	180	167	188	224
9	160	139	174	186	185	172	192	231
10	164	142	176	193	190	176	194	239
11	168	144	179	200	195	181	197	248
12	173	147	182	207	200	186	201	256
13	177	150	185	214	205	191	204	265
14	182	153	188	222	210	196	208	174
15	187	156	191	230	216	201	211	283
16	192	159	194	238	221	207	215	293
17	197	162	197	247	227	213	219	303
18	202	166	201	255	233	218	223	314
19	207	169	204	264	239	224	226	324
20	213	173	208	274	246	230	231	339

Notes: Initial equity investment $1,000 per share, except leveraged corporation;
Leveraged corporation initial investment per share $100 equity, $900 junior debt;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent;
ITC 10 percent of last year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

TABLE 4: COMPARISON OF AFTER-TAX EARNINGS IN 50 PERCENT MARGINAL TAX BRACKET
90 percent of taxable earnings distributed as dividends; 10 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation	"leveraged"	small business	GSOC	ordinary business corporation	"leveraged"	small business
1	200	112	125	100	219	198	203	194
2	114	119	138	113	134	147	158	146
3	118	121	140	117	138	143	157	151
4	121	123	143	124	141	146	157	160
5	124	125	146	124	145	148	160	166
6	127	127	148	134	149	151	163	172
7	132	129	151	139	152	153	166	178
8	137	131	153	145	156	156	169	184
9	141	133	156	150	160	159	172	190
10	144	135	158	156	164	162	175	197
11	147	137	161	162	168	165	178	204
12	151	140	164	168	173	168	182	211
13	155	142	167	174	177	171	185	218
14	159	145	170	181	181	175	188	225
15	163	147	173	188	186	178	192	233
16	167	150	176	195	190	181	196	241
17	171	152	179	203	195	184	200	250
18	175	155	183	210	200	187	203	258
19	180	157	186	219	205	191	208	267
20	184	160	190	227	210	194	212	276

Notes: Initial equity investment $1,000 per share, except leveraged corporation;
Leveraged corporation initial investment per share $100 equity, $900 junior debt;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent;
ITC 10 percent of last year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

TABLE 5: COMPARISON OF AFTER-TAX EARNINGS IN 20 PERCENT MARGINAL TAX BRACKET
50 percent of taxable earnings distributed as dividends; 50 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation "leveraged"		small business	GSOC	ordinary business corporation "leveraged"		small business
1	155	79	181	75	268	222	288	278
2	84	81	189	84	211	178	233	251
3	95	87	193	106	237	185	235	292
4	106	96	196	121	266	203	241	334
5	119	103	200	139	299	220	250	383
6	134	110	203	160	335	237	259	439
7	151	118	207	181	376	256	267	504
8	170	127	212	206	421	276	277	578
9	191	136	216	235	472	298	286	663
10	205	146	222	266	524	322	296	760
11	241	157	227	303	593	348	304	871
12	272	169	234	344	665	376	312	999
13	306	182	240	391	746	407	320	1146
14	344	195	247	444	836	440	328	1314
15	387	210	255	504	937	458	337	1507
16	435	226	264	573	1050	476	360	1728
17	490	244	271	650	1177	573	384	1982
18	551	263	279	739	1320	628	409	2273
19	620	284	288	839	1479	689	437	2607
20	698	306	297	1083	1658	708	466	2990

Notes: Initial investment $1,000 per share;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent; 20 percent tax on undistributed GSOC earnings in excess of 10 percent;
ITC 10 percent of previous year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

TABLE 6: COMPARISON OF AFTER-TAX EARNINGS IN 30 PERCENT MARGINAL TAX BRACKET
50 percent of taxable earnings distributed as dividends; 50 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation		small business	GSOC	ordinary business corporation		small business
		"leveraged"				"leveraged"		
1	130	79	163	50	236	231	264	241
2	56	81	171	56	176	173	213	214
3	63	87	175	71	197	180	215	247
4	71	96	178	81	222	197	220	282
5	79	103	182	93	249	213	228	323
6	89	109	185	106	279	229	237	370
7	100	116	189	122	313	247	245	425
8	113	124	194	140	350	265	254	487
9	127	132	198	160	392	285	264	559
10	143	140	204	184	440	307	276	641
11	181	150	209	211	493	331	286	735
12	181	160	217	242	552	357	299	843
13	203	171	222	277	619	385	313	967
14	229	183	229	318	693	415	327	1109
15	258	193	237	364	777	447	342	1272
16	290	210	246	418	870	484	359	1458
17	326	226	253	479	975	523	378	1673
18	367	243	261	549	1092	565	397	1918
19	413	261	270	630	1224	610	418	2200
20	465	280	279	722	1372	660	439	2523

Notes: Initial investment $1,000 per share;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent; 20 percent tax on undistributed GSOC earnings in excess of 10 percent;
ITC 10 percent of previous year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

TABLE 7: COMPARISON OF AFTER-TAX EARNINGS IN 40 PERCENT MARGINAL TAX BRACKET
50 percent of taxable earnings distributed as dividends; 50 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation	"leveraged"	small business	GSOC	ordinary business corporation	"leveraged"	small business
1	105	79	127	25	205	222	222	205
2	27	81	125	31	140	167	174	180
3	31	87	139	35	157	174	177	201
4	35	96	142	40	177	191	182	230
5	39	102	146	46	209	206	190	263
6	44	108	149	53	233	221	198	302
7	49	114	153	60	260	237	207	346
8	55	120	158	69	290	253	215	397
9	62	127	162	80	323	271	224	455
10	69	134	168	91	360	291	234	522
11	77	142	173	105	402	313	246	549
12	87	151	180	120	448	337	258	687
13	97	161	185	137	500	362	272	788
14	109	171	193	158	557	390	285	903
15	122	182	201	181	521	419	300	1036
16	137	195	209	207	693	452	315	1188
17	154	208	215	238	772	488	331	1363
18	173	222	221	272	861	526	348	1563
19	194	238	227	312	960	567	366	1792
20	217	254	234	361	1071	612	384	2056

Notes:
Initial investment $1,000 per share;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent; 20 percent tax on undistributed GSOC earnings in excess of 10 percent;
ITC 10 percent of previous year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

TABLE 8: COMPARISON OF AFTER-TAX EARNINGS IN 50 PERCENT MARGINAL TAX BRACKET
50 percent of taxable earnings distributed as dividends; 50 percent reinvested

YEAR	AFTER-TAX DIVIDENDS				TOTAL AFTER-TAX EARNINGS (including increase in book value)			
	GSOC	ordinary business corporation "leveraged"		small business	GSOC	ordinary business corporation "leveraged"		small business
1	80	79	102	0	173	213	198	169
2	-1	81	117	0	105	162	154	140
3	-1	87	121	0	118	162	156	155
4	-1	96	124	0	132	185	137	178
5	-1	102	128	0	149	200	169	203
6	-1	134	131	0	167	213	177	233
7	-1	146	135	0	186	227	185	267
8	-1	147	140	0	208	242	193	306
9	-1	153	144	0	233	258	202	351
10	-1	158	150	0	261	275	211	402
11	-2	195	155	0	292	294	223	462
12	-2	203	102	0	326	316	235	530
13	-2	211	168	0	365	339	248	608
14	-2	219	175	0	408	364	262	697
15	-2	228	183	0	456	390	276	800
16	-2	239	191	0	511	420	290	917
17	-3	250	196	0	571	452	305	1052
18	-3	262	200	0	639	486	320	1206
19	-3	274	206	0	714	523	336	1383
20	-3	288	212	0	799	563	353	1587

Notes: Initial investment $1,000 per share;
Pre-tax return 25 percent on net assets;
Depreciation 10 percent of last year's net assets, all reinvested;
Corporate income tax rate 45 percent; 20 percent tax on undistributed GSOC earnings in excess of 10 percent;
ITC 10 percent of previous year's gross investment, reinvested except GSOC;
$100 dividend exclusion in personal income tax on ordinary business corporation;
Capital gains taxed at one-half ordinary income rate.

Rep Duncan

THE PROPOSED ALASKA GENERAL STOCK OWNERSHIP CORPORATION (AGSOC)

PREPARED BY ARLON R. TUSSING & ASSOCIATES, INC.

For the House Finance Committee

ALASKA STATE LEGISLATURE

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PREFACE AND SUMMARY

The geological accident at Prudhoe Bay has given the government of Alaska, and through it the state's four hundred thousand people, a source of income that will far exceed anyone's notions of the funds needed for ordinary public services. The expected cash surplus also surpasses the capital requirements for all but the most far-fetched state economic development schemes.

Most Alaskans give some support to the idea of saving part of this treasure against the day that current oil revenues no longer can provide the citizens with a high level of government services, lavish transfer payments and generous promotional programs for favored industries at practically no cost in personal or business taxes. But savings plans that will benefit mostly strangers ten, twenty, or more years in the future, probably can not match the attraction of programs that will, one way or another, get money into the state's economy now.[1]

For many decades, moreover, residents of Alaska have deplored or resented the fact that outside capital dominated its major industries --- mining, fisheries, and now petroleum. In the 1980's, Alaskans have a chance to dilute this outside control, if they wish to use part of the state's oil wealth for such a purpose.

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1) As I have commented elsewhere, some proposals that are purportedly aimed at diversifying Alaska's economic base are best understood as disguised programs to "privatize" a part of the oil revenues. [See Arlon R. Tussing, "Investing in Economic Development." Statement at Workshop of Alaska Growth Policy Council, Anchorage, October 20, 1979.]

Thus, it is not surprising that the state's citizens should consider ways in which to turn at least part of the current government windfall directly into private income or wealth. Some current proposals, such as Governor Hammond's energy credit plan and his "people's portfolio" are openly intended to serve this aim.

AGSOC resembles these plans in some respects, and not in others. Like them, it intends to distribute privately-owned wealth broadly among individual Alaskans. But, according to the inventor of the concept, San Francisco financial consultant Louis Kelso, and its most prominent Alaska advocate, Senator Mike Gravel, the Corporation's capital will come from borrowing in private financial markets. Thus, the sponsors assert, any wealth distributed to Alaska residents in the form of AGSOC shares will neither come from, nor depend upon, the state's oil wealth.

Notwithstanding these claims, our report treats AGSOC as one option for managing Alaska's oil and gas wealth, for four reasons: First, until about one year ago, even Mr. Kelso and Senator Gravel presented AGSOC as a wealth-distribution plan. Second, most legislators and concerned members of the public regard it as such a plan. Third, and more important, we can evaluate the General Stock Ownership Corporation (GSOC) as a form of business organization quite separately from the way in which it is originally capitalized. Finally and most significantly, our investigation concludes that there is almost no hope that an Alaska GSOC could be financed entirely with "non-recourse" borrowing --- that is, without a direct state appropriation or loan guarantee.

The Kelso-Gravel program for AGSOC, which is reflected in the variants on H. B. 240 and S. B. 170, has three elements that we can consider separately:

1. The Alaska legislature would charter AGSOC as a private corporation entitled to certain federal tax benefits under Subchapter U of the Internal Revenue Code, and distribute one share in the Corporation free of charge to each Alaska resident.

2. AGSOC would purchase one or more existing profit-making enterprises: AGSOC sponsors have devoted the greatest attention to British Petroleum's interest in the Trans Alaska oil pipeline (TAPS).

3. AGSOC would finance these purchases with borrowed money, using its profits to pay off the debt.

Part I of this report examines the tax treatment of general stock ownership corporations (GSOCs) under Subchapter U and finds that:

1. A GSOC can create significant tax savings for shareholders, compared to an ordinary business corporation, <u>if</u> all of the latter corporation's earnings are exposed to the highest federal tax rates; but

2. Ordinary business corporations can be (and usually are) organized so as to shelter much of their income from the corporate income tax by their scheduling of depreciation, for example, or by converting profits to deferred capital gains and interest;

3. GSOCs are not the only kind of business organization that avoids double taxation of profits: cooperatives, mutual funds, and small businesses (proprietorships, partnerships and Subchapter U corporations), for example, are treated similarly. All other things being equal, the three principal types of small-business organizations are at least equal to, and are usually more efficient than, GSOCs as producers of after-tax earnings;

4. Any tax savings for shareholders that result from organizing a business as a GSOC are greatest in the lowest tax brackets, and may be insignificant for upper-income taxpayers; and that

5. The need to pay dividends every year sufficient to offset the personal tax liability that GSOC ownership creates for individual shareholders severely restricts the kinds of investments that GSOCs may safely make, and the ways in which those investments can be financed.

Thus, the ability to shelter benefits from the federal tax collector is obviously an important consideration in choosing the instruments by which Alaska tries to distribute capital ownership more widely among the state's residents, but it is by no means the only consideration and may not always be the dominant one. And, as we have seen, a GSOC is not even the most effective tax shelter in every instance.

The AGSOC idea may remain an enticing one even if its tax treatment is not an important advantage, because it seems to offer individual Alaskans stock in a profitable business at no cost to them or to state government for the Corporation's initial equity. Any promise of something-for-nothing depends, however, on the success of an unusual financing plan, whereby AGSOC would pay for its plant and equipment entirely by "non-recourse" borrowing. Part II of our report finds that the outlook for any such financing plan is extremely dim.

The only kinds of business that a GSOC would have much hope of financing with even 75 percent non-recourse debt (not to mention 100 percent debt) is one that has a guaranteed market at a guaranteed price. The industries that meet this test are mostly regulated utilities or facilities serving regulated utilities. But utility property as such is not a particularly promising investment for a GSOC, because the ratemaking process does not let tax-exempt businesses retain the benefits of their tax exemption.

The inability to profit from a GSOC's special tax treatment is the most serious of several flaws in the proposal that AGSOC buy an interest in the Trans Alaska

oil pipeline (TAPS). The most appealing investment opportunities are probably non-utility ventures whose product or services can be marketed or long-term cost-of-service contracts. Examples of such enterprises are the North Slope natural gas conditioning plant, a coal mining venture serving out-of-state electric utilities, or specialized ships built for chartering to oil companies or utilities.

As AGSOC is not likely to finance any major acquisition or investment entirely without state government aid, the form which that aid takes is of considerable importance. We conclude that a direct appropriation of equity is a more efficient and less risky way of arranging a GSOC's initial funding than state loans or loan guarantees.

Part III briefly reviews some of the provisions of the AGSOC legislation concerning shareholding and corporate governance. AGSOC is not a something-for-nothing money machine, as Senator Gravel and the AGSOC Educational Committee seem to imply. Nor is it the gateway to a radical reform of capitalism that Louis Kelso proclaims. And despite the fears of some, an Alaska GSOC is not likely to become a parallel government or a powerful political lobby, or otherwise subvert the integrity of democratic government. Even if GSOCs came to hold a significant block of capital assets in Alaska, their impact on the distribution of wealth and political power would be imperceptible.

A GSOC is one rather arcane form of business organization defined in the Internal Revenue Code, nothing more and nothing less. For each of AGSOC's purported objectives --- avoiding or reducing federal tax liabilities, broadening the ownership of corporate capital, redistributing wealth, privatizing a part of Alaska's oil wealth, or whatever --- there are several alternative measures, some of which may be more familiar, less complex, and more efficient.

AGSOC's enthusiasts have their priorities backward. Alaska's citizens, through their elected representatives, first need to decide what existing industries they want to Alaskanize, what new industries they want to promote, whether or not they want a state investment in the gas pipeline or the conditioning plant, and what balance they want between private and governmental management of the state's resource wealth.

It is only in connection with these decisions that it makes sense to choose a kind of business organization or a financing plan. A GSOC may make sense for some investments --- for many others it surely will not. An approach that calls on the state to set up a very specialized corporate organization, and then to let it loose looking for something to do, is simply opsy-turvy.

PART I. THE GENERAL STOCK OWNERSHIP CORPORATION (GSOC):

TAX ADVANTAGES

The General Stock Ownership Corporation (GSOC) is a creature of United States tax law. Its singular advantage, indeed its only advantage, over an ordinary business corporation is the fact that Subchapter U of the Internal Revenue Code exempts the profits of a GSOC from being taxed twice, first as corporate income and once more as dividends to its shareholders.

With a top rate of 46 percent, the federal corporate tax can leave as little as 54 cents out of each profit dollar earned by an ordinary corporation to be reinvested or distributed as dividends. (State corporate and personal income taxes will of course reduce the shareholder's after-tax benefits even further.) A shareholder who is subject to a 30 percent marginal tax rate on his personal income could thus end with after-tax benefits of only about 38 cents per dollar of earnings:

$1.00 profits < - $.46 corporate tax (46%) = $.54 after-tax profit (54%) < - $.162 personal income tax (30%) = $.378 net personal income (70%)

The ability to avoid double taxation under federal law can give AGSOC shareholders a real advantage over shareholders of other corporations that do not qualify under Subchapter U. The earnings of a GSOC, in contrast to ordinary corporate profits, are taxed only once at the federal level --- as personal income to the shareholder. Thus, a GSOC shareholder in the 30 percent federal income tax bracket might be able to benefit from as much as 70 percent of his GSOC profit dollar:

$1.00 GSOC profits ----- $1.00 dividend (100%) < - $.30 personal income tax (30%) = $.70 net personal income (70%)

The GSOC is not the only form of business organization that can avoid having its earnings taxed twice. This ability is shared by proprietorships (single-owner businesses), partnerships, small business corporations under Subchapter S of the Internal Revenue Code, regulated investment companies (mutual funds), cooperatives, and thrift institutions.[2] The previous comparison, moreover, tends to exaggerate the tax advantage of GSOCs over ordinary business corporations, because:

1. Most corporations can arrange their affairs so that they do not in fact pay the maximum rate of the corporate income tax;

2. The larger part of shareholders' earnings on common stock is not made up of dividends but of capital gains that are taxed only when the stock is sold, and even then at rates that are (at most) one-half of the rates that apply to ordinary income; and

3. Subchapter U creates tax <u>disadvantages</u> as well as advantages:

   a) GSOC dividends do not receive the $100 exclusion that applies to ordinary dividend income:

   b) A GSOC may not benefit from the investment tax credit (ITC) --- ITC benefits, if any, have to be claimed by shareholders on their personal income tax returns;

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2) In this context, we cannot ignore the alternative of state- or municipally-owned enterprises, whose earnings are tax free, and which can, in addition, borrow in the tax-exempt bond market. Some government enterprises (like the Alaska Marine Highway and the Alaska Power Authority) exist to provide services to the citizens at a low cost, and others (like the Anchorage Telephone Utility or the Washington State Liquor Board), are operated primarily as sources of revenue. New forms of state enterprise conceivably could be designed to channel income and wealth directly to individual citizens.

c) GSOC shareholders are liable for personal income taxes on their share of GSOC earnings, whether or not the GSOC distributes sufficient dividends to cover this added tax liability;

d) While GSOC shareholders are liable for taxes on their share of its earnings, they may not claim GSOC losses as deductions on their personal income tax returns; and

e) A GSOC that distributes less than 90 percent of its taxable income in any year is subject to an additional 20 percent tax penalty.

One way to consider all these factors together may be to look at the total tax burden on the profits from an identical investment under various forms of business organization. The actual burden in any real-world instance depends upon a large number of factors, and the reader should realize that the figures in this report are only illustrations, and not predictions about the performance of any particular enterprise.

The chief assumptions of the calculations of tables 1 through 7 are that:

1. A company is formed with a net investment of $1,000 per shareholder;

2. The company is capable of earning 25 percent before taxes on that investment, and also on any funds that it may reinvest;

3. Each year's depreciation is 10 percent of the previous year's cumulative net investment, and all depreciation allowances are reinvested; and

4. The company or its shareholders earn a 10 percent investment tax credit (ITC) on its initial investment and on all reinvested funds.

The tax rate on corporate profits is assumed to be 45 percent, and after-tax benefits to shareholders are calculated for taxpayers at 20 and 50 percent marginal tax rate brackets, with capital gains taxed at half the rate on ordinary income.

Dividend and total earnings after taxes: GSOC vs. an ordinary business corporation. Our first comparison is between a GSOC and an ordinary business corporation, both of which distribute 90 percent of their net earnings as dividends. I have chosen this assumption because the tax law penalizes a GSOC that distributes less than 90 percent of its earnings directly to shareholders.

Table 1 shows the after-tax benefits to a taxpayer in the 20 percent income tax bracket. In year 5, the GSOC pays dividends worth $207 after taxes, while the ordinary corporation's dividends are worth only $140 --- a difference of 48 percent. This difference is due to the GSOC's shareholder's avoidance of double taxation.

Table 1. Dividend Earnings After Taxes--
20 Percent Tax Bracket

year	GSOC	ordinary corporation	ratio
5	$207	$140	148%
20	$297	$197	151%

The total benefits of share ownership reflect total company earnings, which include appreciation in the value of the shares, as well as dividend payments. Again, the GSOC shareholder enjoys a substantial advantage. In the fifth year, GSOC dividends plus book value appreciation are worth $232, while the corresponding total for the ordinary corporation is only $168, a difference of 38 percent.

Table 2. Total Earnings After Taxes--
20 Percent Marginal Tax Bracket

year	GSOC	ordinary corporation	ratio
5	$232	$168	138%
20	$336	$238	141%

As we go up the income scale, however, the picture changes. To a taxpayer in the 50 percent marginal income tax bracket, the advantage of a GSOC over an ordinary corporation is much weaker. Until about the eighth year, after-tax performance favors the ordinary corporation. Even in the twentieth year, GSOC after-tax dividends are only 15 percent higher than those of the ordinary company, and total earnings are 1 percent less.

Table 3. Dividend Earnings After Taxes--
50 Percent Tax Bracket

year	GSOC	ordinary corporation	ratio
5	$124	$125	99%
20	$184	$160	115%

Table 4. Total Earnings After Taxes

year	GSOC	ordinary corporation	ratio
5	$145	$160	91%
20	$210	$212	101%

The main reason the ordinary corporation is relatively more attractive to higher-bracket taxpayers is that the personal income tax is a greater part of their total tax burden. Here, the exclusion of the first $100 of ordinary corporate income (an exclusion not available for GSOC dividends) makes a noticeable difference, as does the fact that capital gains are taxed at a much lower rate than ordinary income.

GSOCs vs. tax shelters for ordinary corporate earnings. The comparisons above probably overstate the tax advantage of GSOCs over ordinary corporations, because the framework of corporate accounting and the tax laws offer many ways to

reduce the burden of double taxation. Thus the previous cases tend to be "worst-case" examples --- cases of companies without clever managers or tax advisors. The following illustrates the effect of just one simple corporate tax-avoidance device --- but it is one that might well be used by an Alaska state-sponsored enterprise taking a conventional corporate form.

One way to shelter corporate earnings from double taxation is to treat them as interest rather than profits. In the case of the "leveraged" business corporation whose performance we summarize below, the shareholder's original $1000 in common shares is replaced by $100 in common shares, plus $900 in "junior debt" --- in effect a second mortgage on the corporation's assets. This debt is more risky than the company's regular bonds, because it would be the last to be serviced if earnings were insufficient to meet all the firm's obligations. Hence it is reasonable that this junior debt earn a higher rate of return than ordinary corporate bonds --- say 20 percent. In place of dividends alone, the shareholder now receives a combination of dividends and interest.

Interest, like the profits of a GSOC, is not subject to the corporate profits tax, but is taxed only as income to the ultimate recipient. Thus, under our "leveraging" plan, the same corporate revenues suffer a substantially lower tax burden before they reach the investor.

Compare the after-tax dividends plus interest, and the total earnings, of the leveraged corporation with those of the GSOC. In the lowest tax bracket, according to Table 5, the GSOC retains some dividend advantage, but its edge is very much diminished: In the fifth year, GSOC payments are worth $207 after taxes, while the leveraged corporation produces 97 percent of that figure, or $200.

Table 5. Dividends and Interest After Taxes--
20 Percent Tax Bracket

year	GSOC	leveraged corporation	ratio
5	$207	$200	104%
20	$297	$244	122%

Total earnings including the increase in book value are $232 and $217 respectively, a difference of only 6 percent between the GSOC and the leveraged corporation. The GSOC's advantage increases somewhat over the years, but is still substantially less than it was in our earlier comparison with a conventional business corporation.

Table 6. Total Earnings After Taxes--
20 Percent Tax Bracket

year	GSOC	leveraged corporation	ratio
5	$232	$217	107%
20	$336	$270	124%

At higher incomes, the GSOC's advantage in after-tax earnings disappears, and a taxpayer in the 50 percent bracket may receive more dividends after taxes by holding an interest in a leveraged corporation than by owning GSOC shares.

Table 7. Dividends and Interest After Taxes--
50 Percent Tax Bracket

year	GSOC	leveraged corporation	ratio
5	$124	$146	85%
20	$184	$190	97%

The increase in after-tax total earnings shows a similar picture:

Table 8. Total Earnings After Taxes--
50 Percent Tax Bracket

year	GSOC	leveraged corporation	ratio
5	$145	$160	91%
20	$210	$212	99%

GSOC's versus small business organization. As noted earlier, a GSOC is not the only kind of business organization that can avoid double-taxation of its earnings. Proprietorships, partnerships, and Subchapter S small business corporations (which are taxed essentially as if they were partnerships), are also permitted to flow their profits through to their owners untaxed.

The Internal Revenue Code provides similar treatment for these three kinds of business organizations, and here we can lump them all together under the heading small business. One essential difference in accounting and tax treatment between GSOCs and small businesses does concern us here: Subchapter U does not permit a GSOC to benefit from investment tax credits (ITC); any tax credits generated by the GSOC investment must be claimed by the GSOC shareholders on their individual income tax returns.

While the owners of small businesses may (and often do) use the ITC as a tax-shelter for income from other sources, there is nothing in the tax code that prevents them from plowing it back into their businesses; and this is by far their most common use for the ITC. The tables assume therefore that small businesses reinvest any ITC they

earn, (together with their depreciation allowances and 10 percent of their taxable income). Any ITC the GSOC earned, however, is treated as an offset to shareholder tax liability --- that is, as part of shareholder after-tax earnings.

As a result, tables 9 through 12 show that a given investment in a small business will yield at least as much current after-tax income and at least as much after-tax total earnings from a given investment as will a GSOC, in all tax brackets. In most cases, the small business form of organization is substantially more effective in sheltering earnings from the federal tax collector.

The fifth-year figures in table 9 show, for example, that a small business can give a low-income taxpayer 9 percent more current after-tax income than a GSOC; the advantage is 29 percent in the 20th year. (In this case, the heading "current income" may cover proprietor's income or partnership income.) The small business has a 16 percent edge in total after-tax earnings in year 5, and a 38 percent edge in year 20.

Table 9. Current Income After Taxes-- 20 Percent Marginal Tax Bracket

year	GSOC	small business	ratio
5	$207	$226	92%
20	$297	$384	77%

Tables 10 through 12 show similar patterns for after-tax current income in the 50 percent tax bracket, and for total income in both the 20 and 50 percent brackets.

Table 10. Current Income After Taxes--50 Percent Marginal Tax Bracket

year	GSOC	small business	ratio
5	$145	$166	87%
20	$210	$276	76%

Table 11. Total Income After Taxes--20 Percent Marginal Tax Bracket

year	GSOC	small business	ratio
5	$207	$226	92%
20	$297	$384	77%

Table 12. Total Income After Taxes--50 Percent Marginal Tax Bracket

year	GSOC	small business	ratio
5	$124	$124	100%
20	$145	$166	87%

REINVESTMENT OF GSOC EARNINGS

A business corporation normally does not distribute the bulk of its net earnings as dividends, but keeps them inside the firm to finance new investment. This arrangement is in the interest of both the company and its shareholders: On the one hand, internally-generated funds are usually the cheapest source of new equity capital for the firm. On the other hand, the shareholders are able to take most of their profits in the form of long-term capital gains, which are taxed at lower rates than dividend income --- if at all.

Many highly profitable corporations pay at most token dividends. Indeed, the more profitable the company and, especially, the greater its opportunities for growth, the more its shareholders tend to benefit from a policy of keeping dividend payments to a minimum.

Congress, when it enacted Subchapter U, clearly intended that GSOCs not reinvest the bulk of their earnings. Indeed the chief rationale for exempting GSOCs from corporate income taxes was the idea that they would be direct conduits for earnings like mutual funds, and not accumulators of capital.

Despite this explicit intent, the penalty in tax code on a GSOC that accumulates internal capital is remarkably mild: a 20 percent tax on undistributed earnings exceeding 10 percent of taxable income in any one year. This penalty is still less than half the top tax rate --- 46 percent --- on the income of ordinary corporations, whether that income is distributed or retained. Thus, the frequent assertion that Subsection U prohibits GSOCs from reinvesting their earnings is inaccurate, and we shall see in the following tables what happens to the after-tax dividends and total after-tax earnings of a GSOC that reinvests a substantial part of its profits.

Tables 13 through 16 compare the after-tax earnings on a $1000 net investment by (1) a GSOC; (2) an ordinary business corporation, all of whose income is exposed to the top rates of the corporate tax; (3) an ordinary business corporation in which the owners each contribute $100 as common equity and $900 as junior debt at an interest rate of 20 percent in lieu of $1000 equity; and (4) a small business taxed as a proprietorship, a partnership, or a Subchapter S corporation. In each case, a firm reinvests 50 percent of its net earnings, in addition to its depreciation allowances and (except for the GSOC) its ITC.

In most respects the results are just what we would expect from Tables 1 through 10. In general, GSOCs produce more after-tax income and grow faster on the same initial investment than ordinary business corporations, and small businesses earn more and grow faster than GSOCs. The contrasts between the figures in Tables 11 through 14 and those of Tables 1 through 10 reflect the general principle that reinvesting means sacrificing current income for future income or capital gains. Comparing Table 11 with Table 1, for example, it is not surprising that reinvesting 50 percent of earnings yields a lower after-tax dividend in year 5 than reinvesting only 10 percent, except in the case of the "leveraged" corporation.

Table 13. Current Income After Taxes, Fifth Year--20 Percent Marginal Tax Bracket

Reinvestment of percent earnings	GSOC	ordinary business corporation	"leveraged" corporation	small business
10%	$207	$140	$200	$226
50%	$119	$103	$200	$139

The contrast in year 20 dividends per share between a corporation which always reinvests half of its income and one that invests only 10 percent is a dramatic illustration of the power of compounding. The reason the leveraged corporation shows its best dividend performance relative to a GSOC in its early years and the poorest comparison in the later years is its large fixed payout ($180 per share) in the form of interest, and thus the relatively lower proportion of the leveraged corporation's total earnings (profit plus interest) that is reinvested.

Table 14. Current Income After Taxes, Twentieth Year--20 Percent Marginal Tax Bracket

reinvestment (percentage of taxable income)	GSOC	ordinary business corporation	"leveraged" corporation	small business
10%	$297	$197	$244	$ 384
50%	$698	$306	$247	$1,083

The impact on after-tax total earnings of a high reinvestment rate is even greater than its effect on after-tax dividends. In the 20 percent tax bracket the difference is notable even in year 5.

Table 15. Total Earnings After Taxes, Fifth Year--20 Percent Marginal Tax Bracket

reinvestment (percentage of taxable income)	GSOC	ordinary business corporation	"leveraged" corporation	small business
10%	$238	$168	$217	$270
50%	$299	$220	$250	$383

The higher reinvestment rate of course has an even more dramatic impact on total earnings in the 20th year.

Table 16. Total Earnings After Taxes, Twentieth Year--20 Percent Marginal Tax Bracket

reinvestment (percentage of taxable income)	GSOC	ordinary business corporation	"leveraged" corporation	small business
10%	$ 336	$238	$270	$ 462
50%	$1,658	$708	$466	$2,990

THE DANGER OF CASH DEFICIENCIES

Table 17 shows one especially striking implication of choosing to operate a company under Subchapter U of the tax code. A GSOC or a small business that invests 50 percent of its earnings generates no after-tax income at all for a shareholder in the 50 percent tax bracket. In a sense this situation is equivalent to that of an ordinary corporation that retains and reinvests 100 percent of its net income.

In contrast to owners of ordinary common stock, however, GSOC shareholders are liable for personal income taxes on their share of the GSOC's earnings whether or not the GSOC distributes dividends, and totally without respect to any dividends that the GSOC does distribute.

Table 17. Current Income After Taxes, 50 Percent Reinvestment--50 Percent Marginal Tax Bracket

year	GSOC	ordinary corporation	"leveraged" corporation	small business
5	-1	79	102	0
20	-3	288	212	0

In table 17, therefore, we see a major danger to shareholders arising from the very aspect of the GSOC that makes it an attractive form of business organization --- "tax integration" --- together with a serious limitation on the GSOC's management and investment flexibility.

In at least one plausible combination of circumstances, therefore, the sum of GSOC dividends and ITC are barely enough --- or not quite enough --- to cover the additional personal tax liability that the GSOC's earnings have created for its shareholders. This situation can be expected to arise, under the assumptions used in this analysis, any time reinvestment of earnings approaches 50 percent.

Actually, Table 17 understates the seriousness of this potential problem because:

1. The table assumes that the GSOC passes on to its shareholders substantial ITC benefits every year, which can be used to offset additional tax liabilities. It is quite probable, however, that a large part of GSOC investment will be in assets such as land, existing plant and equipment, and working capital which do not generate any ITC.

2. The table assumes there are no claims against GSOC earnings other than reinvestment and payment of dividends --- specifically that depreciation allowances will always generate enough cash to amortize any outstanding debt.

3. There is nothing in the GSOC scheme that rules out a situation in which the corporation earns a taxable income --- and thus creates a tax liability for its shareholders --- and yet is unable to pay them sufficient dividends to offset that tax liability.

It will be intolerable if any group of shareholders is put into a negative cash position as a result of owning GSOC stock. Such a situation clearly can come about, however,

with reinvestment rates considerably less than 50 percent, and there are plausible circumstances in which it might arise even if there were no reinvestment at all.

Consider, for example, a GSOC that had to pay off initial borrowings of $1,000 per share out of its earnings over a period of ten years. Assume that it earns only 15 percent, or $150 per share, instead of the 25 percent projected by its organizers (which would have permitted the GSOC to pay sufficient dividends to cover the additional tax liabilities for all classes of shareholders). Only $50 per share thus remains for distribution as dividends --- and to pay the 20 percent added tax Subsection U imposes on undistributed earnings in excess of 10 percent of taxable income. The maximum dividend payment would therefore be $28.75 per share.

Table 18. GSOC Income Available for Distribution (per share)

Taxable income	$150.00
(Less) amortization	100.00
(Less) penalty tax	21.15*
Available for Distribution	$ 28.75

*[20% x (90% x $150.00 - $28.75)]

The shareholders' tax liability does not depend upon the dividends they actually receive, however, but upon their portion of the corporation's taxable income, which is $150 per share. Thus, owning a GSOC share will increase each shareholder's tax bill. A taxpayer in the 20 percent bracket will have to pay an additional $30.00 per share in personal income taxes, while a taxpayer in the 50 percent bracket will have to pay $75.00. Both of these figures exceed cash flow available to the GSOC for payment of dividends.

Table 19. GSOC Dividends and Shareholder Tax Liability

marginal tax bracket	dividends	increased tax liability	income deficiency
20%	$28.75	$30.00	$(1.25)
50%	28.75	75.00	(46.25)

In this quite plausible instance, therefore, ownership of GSOC shares has put taxpayers of every bracket into a negative cash position. This scenario is not the worst possible one; the reader can surely conceive of even more troublesome situations.

There is little doubt that a GSOC can theoretically capitalized and operated so as to avoid any danger that the personal tax liabilities of any shareholder group would ever exceed its dividend distributions. To be quite safe, however, such a GSOC probably must ---

1. Limit its borrowing, both for its initial capitalization and for expansion, to levels at which the GSOC can meet its debt service obligations out of depreciation allowances alone in all events, without ever having to rely on taxable income;

2. Begin with and keep a substantial equity cushion in the form of initial paid-in capital and surplus, or retained depreciation allowances and profits; the GSOC will have to maintain such a reserve in order to cover any short-term losses and to pay sufficient dividends in every year to cover each shareholder's tax liabilities if, for any reason whatsoever, there is not sufficient cash flow from current operations; and

3. Give up any notion of financing its expansion out of retained earnings.

A GSOC's tax advantages, in brief, comes at a high price to the corporation in flexibility regarding the kind of business it can operate, in the range of prudent capital-

ization plans available to it, and in the ability to respond to new investment opportunities. In many instances, surely, these costs will more than offset the benefits of operating under the provisions of Subchapter U. Indeed, we cannot be certain that there is any kind of investment in Alaska, or any strategy for distributing private wealth more broadly among individual Alaskans, for which a GSOC is clearly the most suitable form of business organization.

PART II. AGSOC FINANCING AND INVESTMENT STRATEGY

HOW IS AGSOC TO BE FINANCED?

AGSOC's advocates intend that individual Alaskans will each receive at least one share of stock at no charge to them. Whether the AGSOC financing plan requires the use of state government revenues is not so easy to determine.

Until recently, state loan guarantees were clearly a crucial part of the AGSOC concept. For example, Senator Gravel's press release of March 29, 1978 stated:

> What [Mr. Kelso] has proposed, basically, is this: the people of Alaska could, through the offices of the state, form a corporation which would finance and own a portion of the new pipeline. The state would assist in securing the money which would establish the corporation, and the money would be paid back to the lenders out of the profits generated by the pipeline. [emphasis added]

Senator Gravel, in his April 10, 1978, Response to Several Questions Concerning the Alaska General Stock Ownership Plan, answered one question as follows:

> Up front cash, a question also raised, need not be required. The only State appropriation required would be for the study, so that the Alaskan GSOP could be properly launched. Any operating or investment monies that it needs could be borrowed. The loans in question, at the beginning, would have to have a State government guarantee, but not an appropriation. In fact, the Alaskan GSOP could even repay the moneys expended by the State in setting it up. The guarantee, if the investment is sound, need pose little risk . . . [emphasis added]

Louis Kelso, et al., in a February 1979 report, Design of an Alaskan General Stock Ownership Plan, included a proposed "Act Establishing Alaska General Stock Ownership

Corporation." Section 11 of the draft provided for special sessions of the legislature and special elections to approve state treasury backing for AGSOC projects:

> Section 11. SPECIAL SESSION TO APPROVE FINANCING. It is the intent of the legislature that at such time as AGSOC comes forward with a request for project financing that the Governor shall call a special session of the legislature to consider such request. . . In the event that the legislature shall determine that financing or the guaranty of financing for an AGSOC project is necessary or desirable, the legislature shall at the earliest convenient time call a special election . . . for voting on the approval of the extension of credit to AGSOC by the State of Alaska, or the guarantying [sic] by the State of Alaska or by any agency or instrumentality thereof of the credit of AGSOC.

In support of the bill, the Kelso report offered the following "Analysis Recommended for Inclusion in the Legislative Financial Committee Report to Accompany the AGSOC Bill:"

> The average citizen does not have effective access to credit for capital formation because he does not have existing wealth to guarantee the lender's risk. However, joined together with his fellow citizens through his State government he has tremendous borrowing power. The security of a State guarantee can perform the same guarantee function for the average citizen which existing capital does for the wealthy. Through the power of State government the typical citizen can leverage himself into a capital asset which will pay for itself and throw off income to him and his neighbors and his children. [emphasis added]

Recently, however, publicity efforts in favor of AGSOC have begun to downplay or disavow any notion that a GSOC would require state financial support (other than for its initial organizing expenses). At a hearing of the House Finance Committee on November 2, 1979, for example, Senator Gravel argued at length that AGSOC had nothing in common with Governor Hammond's proposed energy credits or Alaska, Inc., because AGSOC was not a plan to distribute benefits of

the state's oil wealth among private citizens. AGSOC, Senator Gravel insisted, did not depend on state revenues in any way, and he specifically objected to the assumption that AGSOC would require state loan guarantees for its initial capitalization: "It is a concept just as valid for Chad as for Alaska."

The AGSOC Educational Committee's recent campaign brochure, "It's Time to Take Stock in Alaska", is categorical on this point:

> Once AGSOC was formed, it would operate independently of the state.
>
> AGSOC would borrow money from banks, insurance companies and other large institutional investors. These lenders would loan their money on the strength of investments proposed by AGSOC and eventually on the financial strength of AGSOC itself.
>
> If any AGSOC investment should fail, the lenders would not be able to recover any money from the shareholders. They could only look to the AGSOC itself for AGSOC debts. [emphasis in original]

Senator Gravel's current campaign for AGSOC and the propaganda of the AGSOC Educational Committee thus clearly reject the notion that the Corporation's financing will depend upon a state equity contribution or state loan guarantees. But the question is not thereby laid to rest. In the following pages, we shall examine whether or not 100 percent non-recourse debt financing is a realistic hope for AGSOC under any circumstance, and if so, for what kinds of investments. To the extent that AGSOC can not be capitalized without a direct appropriation or guarantees from the state, however, we shall consider the implications of such assistance, both for the state budget and for AGSOC's shareholders.

PRINCIPLES OF FINANCING

All investments are risky, and some are riskier than others. Business risks include market setbacks that can be unique to a particular firm or reflect general economic conditions; increased costs for labor, materials or services; accidents, strikes, and disasters; management mistakes, incompetence or dishonesty; unpleasant surprises from new technologies or unfamiliar environments; cost overruns or delays in plant construction or in delivery of equipment; and changes in laws, regulations, or taxes.

The first principle of debt financing is that lenders do not voluntarily assume any of these risks. Of course, some borrowers do become delinquent or default on loans; the spread in interest rates charged to different borrowers reflects this experience. In order to minimize risk, however, business lenders invariably require one, and usually both, of the following assurances:

1. The venture's projected cash flow from current operations must be sufficient to make all scheduled payments of principal and interest on time --- even under the worst plausible circumstances, and with some margin to spare; and

2. The borrower or a creditworthy third party must pledge sufficient collateral in the form of saleable assets or unrelated income to pay off the entire loan plus accumulated interest, even if the venture in question fails totally, i.e., generates no cash flow.

These requirements are normally met by the borrower's equity in the venture. Investors expect the return of and on equity to provide the business with a substantial margin of cash flow in excess of its fixed costs, which include repayment of principal and interest on debt. Hence, profits

may fall drastically, or the business may even run considerable losses for a long time, before it can no longer cover its debt service obligations out of current revenues. The shareholders' equity itself provides collateral that lenders can attach and liquidate if necessary, should the business fail to generate enough cash to meet its obligations.

It follows, therefore, that the more equity there is in a company's capital structure, the less likely it is that revenues will fail to cover operating expenses and debt service. Conversely, the more leveraged a firm's capital structure, that is, the higher the percentage of debt, the greater the danger that, for some reason, revenues will not be adequate.

For this reason, the financing of business ventures with anything approaching 100 percent debt (as Senator Gravel now proposes for AGSOC acquisitions) is extremely rare. Most firms have a capital structure about evenly divided between equity and debt. The 1978 debt of the top 50 manufacturing companies in the Fortune 500, for example, was 51 percent of their total assets; only 7 of the 50 had debt ratios greater than 60 percent. Even for the 50 top utility companies, debt was only 62 percent of total assets, and among them there were just two that had debt ratios exceeding 75 percent.

In support of their claim that AGSOC could finance its acquisition of business plant and equipment entirely with non-recourse borrowing, Senator Gravel and other AGSOC advocates have cited examples of several kinds of financing that seem to contradict the principles we have outlined, but it is important to look carefully at such examples. The following cases illustrate most of the circumstances in

which individuals, firms, or governmental entities are able to make highly leveraged investments. In very few of the examples is the borrower truly exempt both from contributing substantial equity to the venture, and from pledging some other kind of security in place of equity.

PROJECT FINANCING: ELEVEN CASES

Case 1: Commercial real estate. An Anchorage businessman buys an office building for $1 million --- and a friendly local banker assigns the property a value of $1.4 million in order to lend the buyer $1.15 million. The building is fully leased, so that its cash flow can easily cover payments on a mortgage of this amount. Our businessman not only acquires an income-generating asset with no down payment, but walks away from the closing with $150,000 in cash!

Can the buyer truly finance such a purchase without any equity investment? Is the bank really assuming the risk that the building may be half-empty next year and thus fail to bring in enough cash to cover the mortgage payments? Not really, because the buyer, who has a net worth of $3.5 million, personally signed the note. The bank's security for its $1.15 million is, therefore, not a building worth $1 million, but $4.5 million --- the value of the building plus the owner's net interest in other properties.

Case 2: Commercial real estate. A Texas oil billionaire buys and finances an Anchorage commercial building on the same terms as the local businessman in Case 1, but in this instance the Texan does not personally sign the note.

Is this a case of 100 (or 115) percent debt financing? Not quite, because the oilman's total income and assets are implicit security for the loan, at least as good as the borrower's signature in Case 1. The bank has no reason to doubt the borrower's ability or his motivation to pay, even if the investment in question turned out to be a bad one: For him to renege on this relatively small loan would be a near scandal, and would cost the oilman more in damage to his business reputation and credit standing than he would save by defaulting on the debt.

Case 3: Oil pipeline. The oil companies that built the TAPS oil pipeline each financed its own share of the project with 90 to 100 percent borrowed funds.

Are the owner companies' equity contributions really less than 10 percent of the pipeline's total cost? This case is just like Case 1: Each of the companies put its entire worldwide assets at stake, so the 40 to 60 percent debt ratios of the parent companies are the real capital structure, not the apparent 90 to 100 percent debt covered on the books of their pipeline subsidiaries.

Case 4: Electrical generating plant. An electric utility builds a new generating plant, and sells bonds that pay the entire cost of the facility.

Is this a 100 percent debt financing? Once more, not really, because the debt is secured by the utility's other assets and its total income. The willingness of lenders to fund the new plant will not depend on the income from that facility alone, but rather on the projected coverage ratio for the utility's entire operations. Each future year's cash flow available for debt service must be some multiple of --- usually at least twice --- its anticipated debt service requirement.

Case 5: Electrical generating plant. A consortium of electric utilities has formed a joint venture to build a new generating plant. The plant is project-financed: The utilities establish a new corporate entity financially independent of all the sponsoring companies. The new corporation then borrows 100 percent of its long-term capital needs on a non-recourse basis, meaning that the parent companies do not guarantee the debt.

Surely this is a true 100 percent debt financing? Yes and no. Lenders have no direct recourse against the sponsoring utilities' other assets in event of default, but project financing is possible only because the utilities have signed all-events, minimum-bill contracts to buy the project's electrical output.

In some instances, lenders prefer this form of project financing to conventional balance-sheet financing, because regulatory commissions and bankruptcy courts will allow the parent utility to continue paying its operating costs which include current costs for the purchase of electricity even if the parent utility's own bonds are in default. This arrangement in effect makes the cash outlay serving the project's bonds senior to all debt instruments previously issued by the sponsoring utilities.

An absolute prerequisite for this form of non-recourse project financing of gas or electric utility investments is perfect tracking --- arrangements guaranteeing that no regulatory commission will ever prevent the utilities who sign all-events, minimum-bill service agreements from passing these charges on to final consumers, no matter how many separate transactions and regulatory jurisdictions may be involved.

Case 6: LNG terminal. A group of gas utilities are jointly building a terminal to receive liquefied natural gas (LNG) by tanker and to regasify it for delivery into their gas distribution networks. Long-term financing will be 25 percent equity and 75 percent non-recourse debt, secured by full-cost-of-service-contracts signed by the sponsoring utilities and approved by the state and federal regulatory commissions that have jurisdiction over the utilities.

The commissions have turned down sponsors' requests to begin customer billing for servicing debt during the construction phase. Instead of putting construction work in progress (CWIP) into their present rate base the companies must capitalize the allowance for funds used during construction (AFUDC) --- the return to debt and equity accrued during the construction period --- and begin billing consumers only after the plant goes into service. Thus the lenders can be expected to insist upon external loan guarantees during the construction phase, though they may be willing to accept non-recourse financing terms once operations begin.

Case 7: Ship construction. A group of investors has formed a limited partnership to build and charter an oil-industry service vessel (a heavy-duty ocean-going tug for moving and servicing offshore drilling rigs). Financing for the $2 million vessel will consist of a conventional 12 year bank loan for 65 percent of the cost and a 5 year second mortgage from a finance company for 25 percent. Taking the 10 percent investment tax credit (ITC) into account, the investors will not have to make any long-term equity contribution, and they might even recover all of their organizational and promotional expenses out of the loan proceeds.

How can these investors manage without equity? Collateral for a 65 percent conventional loan is the value of the vessel itself. Since the ship's value is insufficient to serve as collateral on the second mortgage as well, a boat charter to a major oil company assures the necessary cash flow for a period of three years to cover payments on both loans. The holder of the second mortgage insists, however, on some security for the fourth and fifth year payments on his loan; to accomplish this, he requires the owners (during the three year charter period) to set aside a certain part of their profits in a sinking fund which can meet the fourth and fifth year payments if necessary.

Case 8: Ship construction. A transportation company built a $50 million U.S. flag tanker with an equity contribution of only $2.5 million, without a charter and indeed without any clear idea of where the tanker will be used.

How? Seventy-five percent of the total price was borrowed from financial institutions on the strength of a U.S. Maritime Administration (Marad) loan guarantee under Title XI of the Merchant Marine Act. Another 10 percent was a direct loan by another federal agency that was trying to preserve shipyard jobs in a community with high unemployment rates. Addition of the 10 percent Investment Tax Credit left the owners with a need to supply only five percent of the project cost from their own resources.

Case 9: Public works. A school district plans to sell bonds for a construction program and to finance the construction entirely out of the bond proceeds.

Is this 100 percent debt financing? Once more, yes and no. Because the bonds are "general obligation" bonds, they are backed by the school district's taxing authority. The marketability of the bonds depends upon the lenders' assess-

ment of the district's tax base, its other debt service obligations, and its legal and political capacity to levy whatever taxes are necessary to service the debt.

Case 10: Public works. A state toll road authority sells bonds to finance turnpike construction, and pays for that construction entirely out of loan proceeds.

Is this 100 percent debt financing? Maybe. The bonds are revenue bonds, secured completely by tolls without recourse to the state's general fund. The ability of the authority to sell these bonds, however, depends upon convincing lenders that tolls from the project will be sufficient to cover all debt service obligations with some margin of safety and that the authority is legally and politically capable of increasing tolls on this project or on others in order to make up any deficit.

Case 11: Housing.

(a) In the late 1960's and early 1970's some prominent banks formed real estate investment trusts (REITs) to develop rental housing and condominiums. The REITs were 80 to 100 percent capitalized by loans from a variety of financial institutions and individuals. In the mid-1970's, however, cost overruns, construction delays, and high vacancy rates caused a number of REITs to fail, costing the lenders hundreds of millions of dollars.

(b) The government of an eastern state formed a public corporation to build middle-income housing. Construction was funded entirely by sale of bonds that were to be serviced from rent receipts. Here again, cost overruns, construction delays, high vacancy rates, and tenant resistance caused the housing corporation to become delinquent in its debt service payments, creating substantial losses for the bondholders.

Why did the lenders make such poorly-secured loans? In each case, they thought that the debt carried an implicit guarantee from a creditworthy sponsor as in Case 2. In the first instance, the association of prominent banks with the REITs led lenders into assuming these banks would take responsibility for REIT debts. In the case of the state housing corporation, the governor (who was himself a financier of sorts) had styled the corporation's debt as "moral obligation bonds," despite the fact that the bonds themselves provided no explicit recourse against the "full faith and credit" of the state. Ironically, some of the same banks that walked away from the debts incurred by their REITs were fooled into believing that the state government would stand behind its own housing subsidiary.

. . . AND THEIR IMPLICATIONS

The preceding examples show that it is indeed possible to borrow all or almost all the funds needed for a business venture, but only if:

(1) The debt is secured by recourse against other assets or income of the borrower, either express (cases 1 and 3) or implied (cases 2 and 11), or by a guarantee from a creditworthy third party (such as the federal government in case 8);

(2) The debt service is assured by a contract that commits creditworthy purchasers to pay the venture's full cost of service, or at least to pay a minimum bill that covers its fixed costs "in all events," or "come hell or high water" (cases 5 and 6); or

(3) The borrower is (a) a regulated utility, fully assured that the regulatory authorities will allow it whatever rates may be necessary to service its debt (case 4), or (b) an unregulated monopoly or a governmental body with the power to set its prices or levy taxes, at whatever level may be necessary to service its debt (cases 9 and 10).

While these three conditions do not absolutely rule out any possibility of financing AGSOC ventures without either a state appropriation or a state loan guarantee, they do stringently narrow the investment options for any state-sponsored enterprise that starts without equity and without the ability to pledge the state's credit.

Our cases illustrate at least two more principles relevant to the outlook for financing AGSOC investments:

(1) With a governmental loan guarantee, it is possible to borrow even on a patently unsound business enterprise, like the shipbuilding venture in case 8 (or the Chrysler Corporation's 1981 model year). The state's credit is thus capable of making almost any AGSOC enterprise financible, but it does not thereby make it a sound venture.

2) It is sometimes possible to persuade lenders that an implicit loan guarantee from government exists for bonds that are really only revenue bonds, or that an implicit guarantee from a creditworthy entity attaches to loans that on their face are non-recourse debt.

Conceivably, therefore, AGSOC could borrow more money for one of its business ventures than would normally be prudent for either AGSOC or the lenders, but only on the condition the loan were guaranteed by the state treasury, or where the lenders believed that AGSOC's political influence (or the state government's fear of damage to its own credit standing) would force the state to cover AGSOC's debts even in the absence of a legal obligation to do so.

Notwithstanding the <u>possibility</u> that AGSOC's initial investments could be financed with 100 percent non-recourse debt on the strength of the state's "moral obligation" alone, the <u>probability</u> is very small --- because of recent experiences like those of case 11, because of the capital market's unfamiliarity with GSOCs as a form of business

enterprise, and because of the political controversy in which an Alaska GSOC would likely be born, and the controversy that would certainly surround it if it got into financial trouble.

PUBLIC UTILITY INVESTMENTS

The preceding discussion leads toward one strong conclusion about AGSOC financing: The only kind of business that a GSOC has much hope of financing with a capital structure containing even 75 percent (not to mention 100 percent) non-recourse debt, is one with a guaranteed market at a guaranteed price. This probably means either regulated utility property, or facilities serving regulated utilities through long-term, cost-of-service contracts.

The fact that almost every urban transit company and most of the major railroads in the United States have gone into bankruptcy at one time or another is ample evidence that regulated industries are not necessarily riskless enterprises. Electric, gas, and telephone utilities have tended to be relatively safe investments, however, because (until recently) they have enjoyed the lucky combination of rapidly expanding demand and falling real costs. Nevertheless, risks do exist even in these industries. While new project-financed gas or electric ventures secured by all-events, minimum bill service agreements have managed to obtain financing based on only 25 percent equity, the typical utility company has had to maintain about 40 percent equity in its overall capital structure. The various segments of the Alaska Highway gas transportation system, all to be owned by newly-created entities of utilities and others, plan ratios in the vicinity of 75/25.

Where a project's revenues are effectively guaranteed by regulation or by a long-term contract with a regulated utility, lenders are much less concerned about the project's capital structure. Instead, they scrutinize its coverage ratio --- the cash flow available for debt service as a multiple of the total debt service obligation. Here, a GSOC might appear to have a distinct advantage over a conventional firm; the following discussion will show why.

Implications of GSOC's tax exemptions. As we noted in Part I of this report, the singular advantage of a GSOC over an ordinary business corporation is the fact that Subchapter U of the Internal Revenue Code exempts the GSOC's profits from being taxed twice, first as corporate income and once more as dividends to shareholders. To the extent AGSOC does not pay federal income taxes, more cash should be available out of a given stream of revenues to service debt than would be the case for a fully taxable company.

Consider, for example, a project-financed investment with a cost of $1 billion undertaken by a conventional corporation and a GSOC respectively. Assume that:

(1) Either venture would produce a contractually-guaranteed net operating income (revenues less operating costs) of $250 million;

(2) Interest is 10 percent annually, and debt is amortized on a straight-line 20 year schedule; and

(3) The GSOC pays no corporate income taxes, while the ordinary corporation's earnings are taxed at 45 percent.

Suppose that lenders demand a coverage ratio (a ratio of current cash flow to debt service requirements) of 1.9 or higher on this kind of project. The table below shows that

an ordinary corporation would be able to borrow about 75 percent of its capital requirements and a GSOC about 85 percent, without bringing their respective coverage ratios below 1.9.

Table 20. Cash Flow: GSOC Versus An Ordinary Corporation (millions of dollars)

			ordinary corporation	GSOC
a	Equity		$250	$150
b	Debt		$750	$850
c	Net operating income	$250	$250	$250
d	(Less) depreciation	$100	100	100
e	(Less) interest	10% of debt	75	85
f	Taxable income	(c - d - e)	$ 75	$ 65
g	(Less) corporate tax	45% of f	33.75	0
h	Net income	(f - g)	$ 41.75	$ 65
i	Debt amortization	5% of debt	$ 37.50	$ 42.50
e	Plus interest	10% of debt	75.	85.
j	Total debt service	(i + e)	$112.50	$127.50
d	Depreciation	$100	$100	$100
e	Plus interest	10% of debt	75.	85
h	Plus net income	(f - g)	41.75	65
k	Available cash flow	(d + e + h)	$216.75	$250
l	Coverage ratio	(k/j)	1.92	1.96
m	Return on equity	(h/a)	16.5%	43.3%

Note that the GSOC's preferential corporate tax treatment results in an after-tax rate of return to shareholder equity almost three times that of the conventional corporation, but that the GSOC is still unable to get by completely without equity of its own. In the real world, a GSOC's advantage would probably be much less than the illustration above suggests, because:

1) As noted in Part I, few conventional corporations are actually taxed at the maximum rates of the corporate income tax.

2) A conventional corporation can benefit directly from the investment tax credit (ITC), while a GSOC can not. (Any ITC earned by a GSOC must be claimed by its shareholders on their personal tax returns.) This feature alone may completely negate the apparent advantage the GSOC's corporate tax exemption gives it in financing!

3) The GSOC's appparent advantages in Table 20 both in financing and in return to equity, depend entirely upon the questionable assumption that the state or federal regulatory commission having jurisdiction over a GSOC-owned utility project would permit it to retain its tax savings rather than requiring them to "flow-through" for the ratepayers' benefit.

Considering only the role of the ITC, the effective sources of investment funds for the two firms described previously will be changed to the following:

Table 21. Financial Requirements, GSOC Versus Ordinary Corporation

		ordinary corporation	GSOC
a	Equity	$150 Mil.	$150 Mil.
a'	Investment tax credit	100	0
b	Debt	750	850

All other figures on the two income statements would remain the same except the bottom line. The GSOC's financial advantage has disappeared, but it still has an edge in rate of return to shareholder equity (though considerably reduced):

h	Net income	(f-g)	$ 41.75	$ 65
m	Return to equity	(h/a)	27.8%	43.3%

Allowed earnings of regulated utilities. The reasoning and behavior of regulatory commissions are neither wholly uniform nor wholly predictable, and the various state and federal regulatory commissions differ greatly in their treatment of tax issues, for example accelerated depreciation. But it is quite unlikely that any commission having authority over a utility investment in Alaska would leave AGSOC's federal tax savings intact.

Most commissions (including the Federal Energy Regulatory Commission [FERC] in its jurisdiction over wholesale electricity transactions and the interstate transportation of natural gas, and the Alaska Public Utilities Commission [APUC], in its jurisdiction over the distribution of locally-produced gas and electricity in Alaska) treat income tax liabilities as a specific component of the utility's cost of service. Thus, if the utility's tax liability is reduced or eliminated, its rates will be reduced by exactly the same amount.

Suppose, for example, AGSOC were to own a major hydroelectric or coal-fired generating plant in Alaska. The Alaska Power Administration (federal), the Alaska Power Authority (state), the Anchorage and Fairbanks municipal utilities, or the Golden Valley and Chugach Electric Associations (cooperatives) are also tax-exempt. None of these utilities charges its ratepayers for non-existent corporate taxes. None of them computes the interest on its tax-exempt bonds or low interest loans from the United States Treasury at the rates they would have had to pay private lenders in the taxable corporate bond market. How then, could APUC justify allowing an AGSOC-owned utility project to add taxes that it does not pay to the bills its sends Alaska consumers?

Consider, alternatively, a project whose ultimate ratepayers are mainly consumers outside Alaska, as would

be the case with an AGSOC investment in TAPS or the Alaska Highway gas pipeline. Once again, FERC builds up a regulated firm's allowable rates out of specific cost elements, including corporate income taxes.

Treatment of ITC. While regulatory commissions normally require a flow-through of any tax exemption to the ratepayers, the Internal Revenue Code virtually prohibits a flow-through of the investment tax credit. The law denies ITC to any utility if the regulators reduce either the size of its rate base or the rate of return to that rate base on account of the ITC. In the incentive rate of return (IROR) proceeding for the Alaska natural gas transportation system, for example, FERC interpreted the tax law as compelling it to ignore the ITC totally in setting the pipeline tariff. Thus, the joint effect of utilities law (flow-through of tax exemptions) and the tax code (no flow-through of ITC) may be fatal to AGSOC as a vehicle for investment in regulated industries.

Assume, for example, that FERC or APUC allowed an AGSOC-owned project to collect the only same 16.5 percent rate of return to equity it found fair and reasonable for the conventional private utility whose accounts are summarized in Table 20 and repeated in the first column of Table 22 below. The second column shows that the GSOC could not actually borrow 85 percent of its capital requirement as we assumed in Table 20, because its resulting debt service coverage ratio would be only 1.65. Thus, the GSOC's borrowing capacity would be only 75 percent of its total investment, just like that of the ordinary corporation.

But, as we can see in the third column below, the GSOC's effective loss of the corporate tax advantage with respect to utility investment would leave it with an earnings capability even less than that of an ordinary corporation.

TABLE 22. Effect of Flow-Through and Investment Tax Credit on GSOC and Ordinary Utility Cash Flow

(millions of dollars)

			ordinary corporation	GSOC 85% debt	GSOC 75% debt
a	Equity		$150	$150	$250
a'	Investment tax credit		100	0	0
b	Debt		750	850	750
c	Net operating income	$250	$250	$209.75	$216.75
d	(Less) depreciation	$100	100	100	100
e	(Less) interest	10% of debt	75	85	75
f	Taxable income	(c - d - e)	$ 75	$ 24.75	41.75
g	(Less) corporate tax	45% of f	33.75	0	0
h	Net income	(f - g)	$ 41.75	$ 24.75	$ 41.75
i	Debt amortization	5% of debt	$ 37.50	$ 42.50	$ 37.50
e	Plus interest	10% of debt	75	85	75
j	Total debt service	(i + e)	$112.50	$127.50	$112.50
d	Depreciation	$100	$100	$100	$100
e	Plus interest	10% of debt	75.	85	75
h	Plus net income	(f - g)	41.75	24.75	41.75
k	Available cash flow	(d + e + h)	$216.75	$209.75	$216.75
l	Coverage ratio	(k/j)	1.93	1.65	1.93
m	Return on equity	(h/a)	27.8%	16.5%	16.5%

To summarize the preceding pages, it appears that:

1) The chance of AGSOC financing major investments with 100 percent non-recourse debt is virtually non-existent.

2) The only investments AGSOC is likely to finance with a high proportion (75 percent or more) of non-recourse debt are projects with a contractually-guaranteed market and price over the life of the debt;

3) Non-recourse financing will be available even under these circumstances only for completed projects, projects that have virtually no risk of prolonged delay, non-completion or premature abandonment, or projects in which the customers accept these risks; and

4) A GSOC's special tax treatment does not give it any advantage, and may in fact be a handicap, in financing regulated utility projects.

The preceding pages examined the opportunities and limitations for a GSOC with respect to general classes of investments and financing schemes. Now we shall look at the prospects for making specific investments, including those that have been proposed by the most prominent sponsors of the AGSOC concept.

BRITISH PETROLEUM'S INTEREST IN TAPS

The investment most often suggested by Senator Gravel and other advocates of AGSOC is the British Petroleum (BP) interest in the Trans Alaska pipeline system (TAPS). BP retains a 15.84 percent undivided interest in the pipeline, despite the fact that it has transferred its operating interest in the Prudhoe Bay field, and a 33.34 percent interest in TAPS to its affiliate, Sohio. BP officers have hinted that the company would be willing to sell its interest if the terms were right, and have held preliminary discussions with Senator Gravel, Alaska state officials, members of the legislature, and investment advisors regarding possible terms.

TAPS is an undivided interest pipeline, which is (curiously) the term for a joint-venture pipeline in which each of the several owners arranges its own financing, keeps

separate books, files its own tariffs, and accepts separate "tenders" (proposals to ship oil) from shippers, as if it owned and operated a physically separate pipeline. Alyeska Pipeline Service Company does not own TAPS, but is only a non-profit service corporation that schedules shipments, operates and maintains the system, and sends monthly bills to each of the eight TAPS owners for its proportion of the pipeline's operating costs.

If TAPS were a single corporate entity in which each oil company was a shareholder, rather than an undivided-interest venture, there would be no reason even to consider an AGSOC purchase of the BP share, as Subchapter U denies its special tax exemption to any dividends a GSOC might receive from another corporation. (It also forbids a GSOC to own more than 20 percent of any other corporation, but this provision is not at issue here, as BP's interest in TAPS is less than 20 percent.)

Financing the purchase. Senator Gravel and Louis Kelso [in Kelso & Co.'s December 7, 1978, memorandum to the state] assume that AGSOC's purchase of the pipeline share would be 100 percent debt-financed. AGSOC could either (1) buy the property for cash and arrange its own bond issue, or (2) assume BP's debt and issue new debt in AGSOC's name only to pay for BP's equity interest in the pipeline.

Either course would require the state to guarantee AGSOC's bonds: BP's present creditors would surely refuse to exchange the liens they now hold against the worldwide interests of British Petroleum for a practically worthless claim on AGSOC assets. The bondholders might be willing to accept the state of Alaska as a substitute guarantor in place of BP, but it would be unreasonable to expect BP to maintain its existing billion-dollar-plus guarantee on a pipeline that it no longer owned --- unless the state were willing to backstop this liability.

Assuming, however, that AGSOC could somehow refinance the pipeline, the proposed AGSOC purchase invokes some more fundamental problems:

Purchase price. What will the purchase price be? Kelso & Co. seem to assume that the price will be the pipeline's book value at the time of sale. This assumption, however, begs the question of what "book value" really means in this context. Is it the ICC valuation (which was used in fixing the initial tariffs), or BP's net pipeline assets according to generally accepted accounting practices (GAAP)? There is no reason, in fact, to assume that BP would be willing to sell at either price, or at any price that is even remotely related to either of them.

Tariff conditions. Moreover, until FERC decides what ratemaking methodology it will require oil pipelines to use in the future, it is impossible to estimate the pipeline's real worth to either party with much confidence. The Commission may retain the old ICC concept of valuation, under which pipeline rates can be expected to increase with inflation, as FERC's Chairman, Charles Curtis, has repeatedly suggested.

Under the latter method (whose advocates in the ICC and FERC proceedings included the U.S. Justice Department, FERC staff, and the state of Alaska), a 100 percent debt-financed pipeline would not be entitled to any profit at all, because it would have no equity in its rate base on which to earn a profit. Until FERC finally defines its oil pipeline ratemaking methodology, therefore, any estimate of the value of a share in TAPS is quite conjectural and, further, poses the danger that a highly-leveraged investment might all but destroy its profitablity.

Only after this proceeding is completed can one even begin to calculate the pipeline property's value to AGSOC or any prospective purchaser. This value is, of course, based upon the stream of net income the owner would expect to receive, discounted to the present. But, as we explained previously, it is extremely unlikely that FERC would allow a GSOC-owned pipeline to add non-existent corporate income taxes to its rates, regardless of which of the two basic ratemaking principles it finally adopts. Thus, in the most probable circumstance, there would be no real advantage to a GSOC investment in the line, and further inquiries into its worth from the buyer's standpoint would be futile.

If by chance, FERC did permit AGSOC to extract a larger net income from the pipeline tariff each year than BP, because of the Subchapter U tax exemption, the property would be worth more to AGSOC than to BP. Both companies could, therefore, benefit from the sale of the TAPS interest at any price less than its worth to AGSOC and more than its worth to BP. (That price must of course compensate BP for any capital gains taxes it has to pay as a result of the sale, as well as for the present value of future pipeline earnings.)

But <u>where</u>, within this range of prices will the deal be cut? There is no confident way to answer such a question: it is a matter for bargaining. BP, however, would tend to have the stronger hand because it has no compelling need to sell its interest in the pipeline, while AGSOC's management would be under pressure to buy something if only in order to justify its own existence. In any case, the final price is likely to be substantially higher than the pipeline's current worth as seen by BP: <u>the bargaining process will surely enable BP to extract from AGSOC some part of whatever added worth the latter's tax-exempt status might convey to the pipeline property</u>.

Risk. Thus, the BP pipeline purchase is at best a wild gamble for AGSOC. Granted, deals are in fact made in the face of great uncertainty --- oil and gas lease sales, for example --- but for this one, every omen is unfavorable. Kelso & Co.'s own cash flow scenarios [loc. cit.] make unreasonably optimistic assumptions regarding the purchase price and FERC's treatment of AGSOC's tax exemption, plus an additional unsupportable assumption that pipeline throughput will remain steady for 20 years at either 1.2 or 1.6 million barrels per day.[3] Despite these biases, many of Kelso's own scenarios show only trivial payouts to AGSOC shareholders, and others even show losses.

The purely financial risks to AGSOC in such a purchase are monumental, particularly if a large fixed debt-service obligation caused by 100 percent debt financing reduces the margin for error to the barest minimum. Senator Gravel has himself identified another notable risk, yet dismisses it with a most unusual argument:

> The guarantee, if the investment is sound, need pose little risk particularly so for the purchase of an interest in the TAPS line, since we are already dependent upon the oil line for our prosperity and for substantial State revenues. Whatever is at risk in the guarantee of the purchase of an interest in the TAPS line is very little risk indeed, since we are already at risk as a State on the economic success of that line. In the unlikely event that the TAPS line should fail, the State will suffer severe economic dislocation because of the loss of jobs and our inability to transport royalty oil. An Alaskan GSOP ownership interest in the line would not substantially compound the economic crisis resulting from a failure. ["Response to Several Questions Concerning the Alaska General Stock Ownership Plan," April 10, 1978.]

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3) Our projections show a probability of only 50 percent that total Arctic Slope oil production --- including production from new fields --- will exceed 1 million barrels per day in 1995, or 600 thousand barrels per day in 2000. See Arlon R. Tussing & Associates, Inc., Alaska North Slope Production Forecasts, 1980-2000 [October 8, 1979].

The illogic of this argument is so obvious that further comment would seem unnecessary. Senator Gravel appears to say that a failure of the Prudhoe Bay field or of the TAPS system would be so devastating to the state's economy that Alaskans would be indifferent to further disasters such as the loss of all value in their AGSOC shares and the drain of hundreds of millions of dollars on an already depleted state treasury in order to make good on pipeline loan guarantees. Most of our eggs are already in one basket. Therefore, he tells us, it is no matter if we put the rest of our eggs there!

Summary. BP's share of TAPS looks like an exceedingly questionable first investment for AGSOC:

Nobody knows what method FERC will ultimately use to set the TAPS tariff;

Until FERC does finalize its ratemaking methodology, moreover, the value of TAPS ownership will be pure conjecture, and bargaining will take place in the dark;

Whatever ratemaking method FERC adopts, it is unlikely to allow AGSOC to profit from its Subchapter U tax exemption; and

Even if AGSOC's tax position did make ownership of the pipeline more valuable to AGSOC than to BP, the latter would be able to bargain away some, and possibly the major part, of this additional value.

SOME AGSOC INVESTMENT POSSIBILITIES

The factors reviewed in this report --- both the tax and accounting considerations examined in Part I and the financial and regulatory principles reviewed just now --- drastically narrow the range of projects and investment strategies for which a GSOC has a decisive advantage over other forms of business organization. They do not, however, entirely eliminate AGSOC as a vehicle for citizen participation in the ownership of Alaska business, provided the legislature is willing to appropriate equity for AGSOC or to provide state guarantees for its financing.

The most promising opportunities for (1) financing AGSOC investments with a relatively high proportion of non-recourse debt, and (2) turning the provisions of Subchapter U to an advantage for the shareholders rather than a handicap or a hazard, are ventures that can operate under long term cost-of-service contracts to utilities or other large purchasers, but which are not themselves regulated utilities. The following pages examine three such ventures, their prospects for securing highly leveraged financing, and their ability to make effective use of a GSOC's special tax status.

The gas conditioning plant. One investment that may meet these standards is the Prudhoe Bay gas conditioning plant. This facility is an ideal subject for a highly leveraged project-financing (a debt ratio of 75 percent or more), because it will operate under long-term cost-of-service contracts either to the gas producers or to the shippers of gas through the Alaska Highway pipeline. But the conditioning plant will not itself be a regulated utility, and probably will not carry the severe disabilities for GSOC ownership that utility status creates.

FERC interprets the relevant laws (the Natural Gas Act [NGA], the Alaska Natural Gas Transportation Act [ANGTA], and the Natural Gas Policy Act of 1978 [NGPA]) to mean that the conditioning plant is not a gas transportation facility subject to FERC's direct regulatory jurisdiction, but is rather a part of the production process. Thus, the return to equity, the treatment of corporate and ad valorem property taxes paid or not paid, and other components of the conditioning charges need not conform strictly to utility law or to FERC's accounting practices.

The Commission does believe, however, that NGPA gives it the authority to decide what part of the gas conditioning costs may be passed along to gas consumers, and what part must be absorbed by the producers. Thus far, FERC has insisted that the producers bear all of the conditioning costs, but may modify this ruling during the current negotiations over pipeline financing. In any event, both FERC and the producers are likely to view the reasonableness of conditioning charges quite broadly. To the extent the alternative to AGSOC ownership is a conventional, taxable private corporation, neither the producers nor FERC is likely to insist that conditioning charges be reduced by the amount of AGSOC's tax exemption, as would be required by strict public utility rate-making principles.

A conventional, taxable private corporation is not necessarily the only feasible alternative to a GSOC for financing and operating the conditioning plant, however. For example, the state of Alaska, which is also exempt from corporate income taxes, and which in addition might be able to obtain capital for the project (at least indirectly) from the tax-exempt bond market, might build and operate the plant, taking advantage of its own favorable tax position to earn after-tax profits equal to a conventional corporation's taxable profits.

Still another possibility is that the producers themselves establish such a non-profit (and effectively tax-exempt) 100-percent-debt financed entity. Whatever entity ultimately owns and operates the gas conditioning plant, however, it can be project-financed only on the basis of guarantees from some party or group of parties that the plant and the entire Alaska gas transportation system will be completed and go into operation within a certain time and within a certain cost. It is still quite unclear who will provide these guarantees. Thus, we can not accurately assess the feasiblity, or the magnitude and distribution of benefits, of AGSOC ownership --- or of any other arrangement for financing, building, and operating the conditioning plant --- except as part of an overall agreement regarding financing of the entire gas transportation system.

Coal mining. Another kind of enterprise that might capitalize on AGSOC's tax advantages, and thereby enable financing with a high proportion of non-recourse debt, is a coal mining venture under contract to an electric utility company, in (say) California or Japan. Like the gas conditioning plant, such a venture would not be subject to strict utility-type regulation. The California Public Utilities Commission (CPUC), for example, would scrutinize any service agreement for the sale of Alaska coal to a California utility, but would bar the utility from executing a contract only if it seemed "imprudent" --- that is, if the terms were patently inferior to those obtainable from some alternative source of supply.

As was the case for the gas condtioning plant, the alternatives are likely to involve production of the coal by fully taxable private corporations. If the delivered price of coal from an Alaska GSOC were competitive, the CPUC probably would not veto a contract that let AGSOC capture all or most of its tax advantages.

Shipping. A GSOC might build or buy and operate tankers or offshore service vessels under charter to oil companies, or coal carriers under charter to a utility. Ships can easily be moved from one market to another, and though their resale prices are volatile, they can readily be sold or chartered to other parties. Ships also have much lower risks of prolonged construction delay, non-completion, or unserviceability than specialized, fixed installations such as Arctic pipelines, refineries, and electrical generating plants.

As a result, ships can often be conventionally financed with very low down payments, even during the design and construction periods. Title XI of the U.S. Merchant Marine Act provides federal loan guarantees of 75 percent for most kinds of U.S. ships, and up to 85 percent for ocean-going tugs and LNG tankers. Thus, it is not unknown for ships to be privately financed 100 percent (or more) with non-recourse debt.

In general. As we have seen, there are many factors that determine whether a particular business enterprise organized as a GSOC would actually produce more after-tax income for its owners than some other kind of business organization, and whether Subchapter U of the Internal Revenue Code would be an advantage or a handicap. Likewise, uncertainties plague any judgment about whether an otherwise sound GSOC financing plan might actually require some shareholders to pay out more in additional income taxes than they receive in GSOC dividends.

While other equally worthwhile investments surely exist, the three specific cases examined here (the gas conditioning plant, a coal mining venture under contract to an outside utility, and ships built or bought for charter to outside companies) offer the best prospects for GSOC success. Nevertheless, even these ventures may not turn out to be

particularly prudent, profitable, or otherwise appropriate GSOC investments. Among them, only the shipping venture offers more than the slimmest possibility of 100 percent debt-financing without state loan guarantees.

Finally, no matter how compatible with the GSOC form of organization and highly-leveraged financing a class of projects seems to be, the state government should not encourage the purchase or construction of any kind of facility until the prospective cash flow and risks of a particular project have been carefully scrutinized.

STATE APPROPRIATIONS, DIRECT LOANS, AND LOAN GUARANTEES

Promoters of the AGSOC concept originally described it as a means to transfer the state's oil wealth to private citizens (through a state government equity contribution or guarantee for borrowed money). Interestingly, they have now abandoned that rationale, and seem to imply that AGSOC is a means of creating wealth virtually out of thin air, solely by capitalizing on a GSOC's federal tax exemption.

We have seen, however, that there is little chance a major GSOC investment can be financed 100 percent with non-recourse debt. If a GSOC is to become a reality in Alaska, it must therefore get its initial funding and its ability to attract additional private capital from some infusion of surplus state revenues. And, if the state's treasury or credit is involved, it is only prudent for the legislature to weigh the merits of AGSOC against other vehicles for transfering state oil wealth to individual Alaskans. Whatever organizational vehicle may be chosen, the three methods by which this transfer can be accomplished are state equity contributions, direct loans, or loan guarantees.

State equity contributions. The most straightforward and efficient way to transfer wealth from the state government to individuals is by direct appropriation. If the legislature wants to capitalize the excess revenues of state government and distribute them as income-earning shares in a GSOC or some other kind of state-sponsored enterprise, the most straightforward and efficient, and the safest method is to grant it a direct appropriation of equity capital.

With an equity appropriation, the citizens and the legislature will know just how much they are putting at risk. They will also have a clear standard for comparing

alternative investment opportunties: what rates of return do they expect to earn on each project? Finally, they will have a clear measure by which to judge the results of actual investments and to assess the performance of a project's managers: what rate of return has the equity in fact earned?

An appropriation of state equity, coupled with debt furnished by financial institutions and other private lenders under market terms without a state guarantee, is also the most prudent capitalization strategy for a state-sponsored enterprise. The private capital market can thereby be expected to serve as a check against over-leveraged capitalization schemes --- capital structures in which the debt service burden can exceed the venture's cash flow if something goes wrong.

Direct loans. There is, however, little point for state government to lend money to AGSOC or any other state-sponsored business enterprise at market rates and terms. Such loans only displace outside private capital that the enterprise otherwise would be able to borrow. After all, the market rate is simply the rate at which money is actually available for a certain purpose, and subject to a certain level of risk. A direct loan from the state can, however, be tailored to create more favorable business prospects for a GSOC than would a conventional private loan:

1 The state may charge AGSOC a lower interest rate than private lenders would demand for investments of similar risk. The reduced service obligation might make an otherwise submarginal venture competitive, or leave a greater part of a profitable venture's total cash flow in the form of earnings that can be distributed as dividends.

Like a state appropriation of equity capital, an interest subsidy in a direct state loan allows citizens and the legislature to know exactly how much they are contributing to AGSOC. The cost-effectiveness of an interest subsidy is much harder to judge, however, than that of an equity appropriation. And "soft loans" often tend to make bad investments and bad management look much better than they really are.

2. The state might lend AGSOC a greater proportion of the capital it needs than private lenders would deem prudent --- as much as 100 percent. State loans would thus reduce AGSOC's need for equity and permit it to earn a higher rate of return on that reduced equity commitment --- provided, of course, that everything goes well.

3. The state might grant AGSOC a direct loan, subordinated to loans from private parties, and in doing so allow AGSOC to begin with a highly leveraged capital structure that it would otherwise be unable to attain.

In both of these cases, it would be impossible to measure the true size of the subsidy. Instead of a clearly discernible interest rate discount relative to private market rates, the state's contribution would be to assume part or all of the risk that is normally borne by equity capital. No direct cost to the state will appear until something goes wrong, but at that time, the cost can be far greater than any interest discount ever would have been.

Loan guarantees. A state loan guarantee can serve the same function in capitalizing a GSOC as a direct state loan:

1. State credit backing may allow the GSOC to obtain lower interest rates in the private capital market than would otherwise be available. Again, the reduced debt service obligation may make an other-

wise submarginal venture competitive or leave a greater part of a profitable venture's total cash flow in the form of earnings that can be distributed as dividends.

2. A state loan guarantee can induce financial institutions to lend AGSOC a greater proportion of its needed capital than they would normally deem prudent --- even as much as 100 percent. Such loans will thus reduce AGSOC's need for equity and permit it to earn a higher rate of return on the reduced equity commitment.

In either case, the state's contribution to AGSOC would be to assume all or a part of the risks that are normally borne by equity capital. Here the citizens and the legislature would have no way whatsoever to measure their contribution to AGSOC, because no burden will become apparent until something goes wrong. Once more, the cost to the state in case of trouble might be far greater than if it had simply granted the GSOC a direct equity contribution or an interest subsidy. What may not be readily apparent, however, is that the use of state loans or loan guarantees to create a highly leveraged capital structure for AGSOC makes trouble more likely. The following pages explain why this is so.

Assumption of risk and creation of risk. Government loans or loan guarantees are needed in an Alaska GSOC's capital structure only to the extent that private lenders are not convinced that its cash flow will cover its debt service under every plausible circumstance, or that the value of the GSOC's assets would offset its debts should it become insolvent. Thus, state credit or credit backing to a venture that otherwise could not be financed bears an equity risk --- it consists of funds that in fact may not earn their specified return or be repaid. But it also carries a debt service burden --- the return of and return on debt capital is a fixed cost that must be paid in good times and bad if the business is to remain solvent.

The adverse impacts of soft credit. It is a truism that direct state loans or loan guarantees can make even the poorest business venture financible by reducing or eliminating the risks to private lenders. It is not so widely realized that they can also make the most promising venture unsafe by encouraging over-leveraging.

If financial institutions refuse to supply as much debt capital as AGSOC seeks unless the state backs the loans, they are saying that AGSOC's proposed capital structure is over-leveraged, undercapitalized, and therefore unsafe. A capital structure that is unsafe for private lenders will also be unsafe for the state as a lender or guarantor.

It is, moreover, unsafe for AGSOC's shareholders, because it carries the danger that their equity could be wiped out by a relatively small business setback. When private lenders insist that each project have enough paid-in equity that its debt service obligations will never exceed the cash available to meet those obligations, they are guarding not only their own investment from default but that of the shareholders from insolvency and liquidation. Alaskans should not ignore this free advice and protection, except for the most compelling reasons.

Shareholder tax liability. In addition to the dangers of insolvency, the extension of state credit or guarantees in order to create an over-leveraged capital structure poses another risk to AGSOC shareholders. Under Subchapter U of the Internal Revenue Code, the income of a GSOC is taxable to its shareholders in proportion to their ownership, without regard to the dividends the GSOC actually pays.

Part I of this report showed that there were a number of plausible circumstances in which ownership of GSOC shares would create personal tax liabilities that exceeded the

shareholder's dividend receipts. The likelihood of such a situation increases with the amount of debt in the GSOC's capital structure and its resulting need to use net earnings to retire debt rather than to pay dividends. The danger is thus an additional reason to avoid using the state's credit strength for the purpose of arranging a highly leveraged AGSOC capitalization.

Today's Alaskans and future Alaskans. The various measures for capitalizing AGSOC affect present and future Alaskans quite differently.

Subchapter U of the Internal Revenue Code and the AGSOC bills before the legislature require AGSOC to be a closed corporation, in which the only Alaskans to receive shares without charge will be those who reside in the state at a specific time. While these initial shareholders may not transfer their shares to nonresidents, they would be allowed to take their shares with them if they moved out of Alaska. Any person who moved to Alaska after the distribution date and wished to own AGSOC shares would have to buy the shares either from an out-migrant or (after five years) from another resident shareholder. Individual Alaska residents could each accumulate up to ten shares from the original distribution or by inheritance, gift or purchase.

As of the time of initial distribution, therefore, the ownership of AGSOC shares would be almost identical with the state's population. But as time passed, the distribution of stock ownership in any one GSOC would diverge substantially from the state's population at that time.

An appropriation of current funds by today's legislature, which represents today's Alaskans, for the purpose of funding a private corporation that benefits all of today's Alaskans is one thing: The population making the appro-

priation, the population whose revenues are appropriated, and the beneficiary population are identical. Once the legislature makes such an equity grant, moreover, the state treasury will bear no further obligation to the GSOC or because of it.

Direct loans and guarantees for AGSOC are quite another matter: Once again it would be today's Alaska population that commits the state's credit and receives an equal distribution of whatever benefits it conveys. But the risk of default on loans or loan guarantees granted by a past legislature will be borne by a quite different group of people. That is, the GSOC formed today, will in the future be owned much less equally by a group composed of some (but not all) Alaska residents together with some non-residents. The propriety, fairness, and legality of such an arrangement is certainly worth questioning.

Summary. The outlook for financing AGSOC's initial investments entirely by borrowing as described by Senator Gravel and the AGSOC Educational Committee is extremely slim unless the state of Alaska lends or guarantees some or all of the debt. Direct loans from the state or state loan guarantees for this purpose, however, have little to recommend them:

1. The true cost of direct loans or loan guarantees is impossible to measure accurately;

2. The cost-effectiveness of a state financed contribution to AGSOC in the form of direct loans or loan guarantees cannot be estimated with any confidence;

3. Soft loans or state-guaranteed loans make it harder to monitor the quality of AGSOC investments or the performance of management;

4. Loans or loan guarantees that one used to increase the leverage of a GSOC's capital structure also increase the likelihood of insolvency and business failure;

5. Loans or loan guarantees that increase a GSOC's debt ratio increase the danger that the shareholders' personal tax liability on GSOC earnings would exceed their dividend receipts; and

6. The Alaskans who will bear the costs of state loans or loan guarantees for AGSOC will be a quite different population from those who benefit from the state's financial aid.

State loans and loan guarantees are thus an undesirable means of capitalizing AGSOC. An Alaska GSOC should carry no more debt in its capital structure than financial institutions would regard as prudent for a conventional private corporation in similar circumstances.

To the extent the legislature wants to provide financial assistance to an Alaska GSOC, state participation should take the form of an appropriation of equity capital. This route is straightforward; its costs and risks are measurable, it preserves the ability to judge the quality of investments and AGSOC management, and the people who bear its costs are the same as those who benefit. An equity appropriation is, in short, the honest, direct, and efficient way of financing AGSOC.

PART III: AGSOC SHAREOWNERSHIP AND MANAGEMENT

Kelso's ideology. Louis Kelso, originator of the GSOC concept, is the leading spokesman for a distinctive, radical social philosophy whose details need not concern us here. In general, however, Kelso's ideology combines an emphasis on capital (as opposed to labor) as the principal source of prosperity, with a deep hostility to the private enterprise system as it actually exists. The chief evil of contemporary capitalism, according to Kelso and his followers, is the concentration of wealth and economic power in the hands of a few wealthy individuals. This concentration, he believes, results in:

> " . . . endemic poverty . . . misuse of technology, resource waste, despoilation of the environment, declining personal freedom, increasing lawlessness and civil disorder, the waning of liberal education, the civil rights impasse, the youth revolt, urban concentration, rising public and private debt, public loss of confidence in leadership and the seemingly irreversible advance toward a totalitarian society." [Kelso, et al, "Design of an Alaskan General Stock Ownership Plan" Volume I, p.16.(February 15, 1979)]

Restrictions on shareownership, transfer, and voting. Instead of welfare measures or state socialism, however, Kelso advocates an equal or more nearly equal distribution of capital in the form of shares in new kinds of corporate enterprise, one of which is the General Stock Ownership Corporation (GSOC). The special restrictions on share ownership, transfer, and voting rights incorporated in Subchapter U of the federal tax law, and in the proposed Alaska GSOC legislation, stem directly from Kelso's theories and social philosophy. These restrictions include the following:.

1. The original distribution of shares is limited to residents of the state, and no shareholder may transfer stock to a non-resident (even by inheritance);

2. Only natural persons (not corporations or associations) may own GSOC stock;

3. No resident shareholder may transfer his stock (except by inheritance) for 5 years after its issue;

4. No person may acquire more than ten shares in total through original distribution, inheritance, purchase, or otherwise; and

5. Proxy and cumulative voting are prohibited.

The first four provisions are required by Subchapter U, and the last is a feature of the proposed Alaska legislation. The purpose of these restrictions is to preserve the identification of the GSOC with its home state, to prevent the concentration of control in the hands of a few large shareholders, and to deter "speculation" in GSOC stock (as opposed to its retention for income). These are elements of the new economic order that Mr. Kelso and Senator Gravel would create.

Will the example of a new, broadly-based form of business enterprise revolutionize the economic system or the social order?

If state-sponsored GSOCs were to acquire substantial productive assets, they would indeed have some impact on the overall distribution of wealth. But that influence, for good or evil, is not likely to be profound, and in many cases its direction will be quite different from that envisioned by Kelso or other GSOC boosters. On the other hand, fears that AGSOC could become a "rival government" or a pernicious economic and political power, are probably unjustified. The following pages review a few of the implications of existing federal and proposed state legislation governing GSOC shareholding and management.

The experience of the cooperative movement. It is useful to consider another form of broadly-based business enterprise with which we have already had extensive experience. Cooperatives on the Rochdale model have existed in Western Europe and the United States for more than 140 years, and have deep cultural roots in the farmer, labor, and socialist movements. In our judgment, at least, their philosophical bases are more respectable intellectually, and they are certainly more acceptable to more people than Mr. Kelso's "two-factor" theory.

The federal tax treatment of cooperatives is, interestingly, much more liberal than that which applies to GSOCs, and the legal restrictions on their membership and their investment strategy are considerably less onerous. A cooperative does not need a special state charter, for example; any group of citizens (or non-citizens, for that matter) may establish one. A large body of experience with successful (and unsuccessful) cooperatives in different economic sectors exists to guide those who would set up a new enterprise. Successful cooperatives exist in retailing, in the marketing of agricultural and fishery products, in finance (credit unions), and in health (HMOs). Cooperatives predominate in the electric utility business in Alaska, for example.

Yet despite successful precedents in all these fields, despite the tax advantages of corporations over ordinary corporate enterprise, despite the attractiveness of economic democracy and broad-based shareholder participation, the cooperative movement has not swept the nation, nor has it perceptibly changed the distribution of economic or political power.

Mutual savings banks and savings and loan associations are also successful vehicles for widening the ownership of financial capital. The thrift institutions are theoretically owned and governed by their depositors, just as mutual insurance companies are theoretically owned and governed by the policyholders. Federal and state laws grant such collectivist enterprises certain tax and other advantages over commercial banks and stock insurance companies, respectively, but their impact on the distribution of wealth and power is no more evident than that of the cooperatives.

Despite their origins in radical or reform movements, cooperatives and mutual enterprises are really specialized parts of a highly pluralistic capitalist economy, distinguished from other corporations by somewhat different rules regarding their financial structure, government, and accounting systems. In practice, they neither reform nor subvert the economic and social system. There is little reason to believe that the influence of GSOCs --- if they ever managed to overcome the handicaps we have enumerated --- would be any more profound.

Management incentives. Viewed from the standpoint of the business enterprise itself, the Kelso formula for economic democracy probably does not lend itself to effective management and business performance. Broadly-based enterprises like cooperatives and mutual aid societies have been most often successful where they are specialized, single-purpose ventures with relatively standardized operations and in which the shareholder-member can easily measure management performance: How do the premiums and benefits of a specific mutual insurance company compare with its competitors? What interest rate does this credit union charge, and what does it pay as dividends on share deposits? How long is the wait to see a doctor at the Group Health Association? Etc.

Though important exceptions do exist, the most successful cooperatives and related organizations are not usually those with an active and involved membership --- but rather those with a competent and usually self-perpetuating professional business management. The coop member's most effective remedy for poor performance is to shop or bank, or sell his crop elsewhere. Thus, those associations that fill an appropriate niche in the economy and are well-managed thrive, while those who do not meet both specifications flounder and disappear.

These are exactly the means by which customers and shareholders alike exact performance from ordinary business corporations. Very few customers or shareholders want to become involved in the governance of the enterprises that serve them, or in which they invest, and very few take advantage of the opportunity to participate in management even when it is offered to them. The dissatisfied customer goes elsewhere, and the small investor sells his stock.

This option on the part of shareholders is the ultimate discipline on corporate management and the most fundamental incentive for economic efficiency, and against sloth, gold-plating, pyramid building, and management self-dealing. The net worth of efficient and profitable corporations appreciates (whether or not they pay dividends) --- these are the corporations whose management have access to both the internal and external funds needed for rapid growth.

In addition to the ability of the shareholders to "vote" on management in the stock market, the most important protection that small shareholders have is the large shareholder.

One or one hundred shares in a company usually does not make it worthwhile for a shareholder to learn much about a corporation or become active in its affairs. The fact that there are wealthy individuals, banks, or other large institutions for whom business is a profession, and for which the corporation's efficiency and profitability makes a difference of millions --- means that someone is almost always looking out for the interests of the "little guy" and of the legendary "widows and orphans."

In their naive hostility toward the capitalist system as it operates today, and in their idealistic desire to protect the little guy, AGSOC advocates like Mr. Kelso and Senator Gravel would substantially dilute forces that create efficiency incentives, and the value of shareownership:

1. By requiring a GSOC to flow-through as dividends at least 90 percent of its taxable income, Subchapter U limits the GSOCs ability to generate capital gains --- which in the long run constitutes the largest benefit from owning common stock;

2. By restricting the sale of shares in various ways, the federal and state GSOC legislation limits the growth of a market for GSOC shares, and further reduces the shareholders' ability to benefit from appreciation of stock values;

3. By restricting shareholders to natural persons, the law effectively prevents individual shareholders from borrowing money on their stock, and thus from using their GSOC wealth as a foundation for additional investments. (This is a particularly ironic restriction, in light of Kelso's belief that it is the access of the wealthy to credit that is the root of their economic power);

4. By limiting an individual to ten shares, the law guarantees that no shareholder will have a sufficiently large stake in the GSOC to make it worthwhile for him or her to pay careful attention to the quality, conduct, or performance of the directors or management.

We can not predict with any confidence what the net impact of the dispersal of AGSOC ownership and voting rights on business performance would actually be.

1. As we noted earlier, some broadly-based organizations --- specialized cooperatives, thrift institutions, and insurance companies, perform as well as their conventional corporate rivals. In most successful instances, however, the membership seems to be apathetic (or just content?) and the management is more-or-less permanent.

2. In other cases, including, for example, many non-profit hospitals and nursing homes, some labor unions or professional organizations and their welfare funds, a large and inactive membership coexists with an incompetent, indifferent, or corrupt management.

3. Finally, there are still other instances where broad-based economic organizations have a relatively large group of active members, but where the organization is constantly convulsed by turmoil and factional warfare, a situation that is hardly conducive to achieving the organization's economic objectives.

All three models and all gradations between them, are visible among Alaska Native corporations today. Of all the types of organizations with which Alaskans are familiar, the Native corporations are probably the most similar in objectives and structure to a GSOC, and their history and performance are probably good predictors of the outcome of a GSOC experiment in Alaska. It is anybody's guess, however, which kind of Native Corporation AGSOC would most closely resemble.