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Kelsoism, GSOC, and AGSOC

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by

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Executive Summary

This report is divided into three parts: the Kelso framework; the GSOC; and the AGSOC.

The Kelso Framework. Central to the analysis of capitalism by Kelso and his associates is the alleged existence of a massive maldistribution of income: capital accounts for 90 percent of the economy's output but gets only 30 percent of that as income while labor produces only 10 percent and gets 70 percent. There is also said to be a maldistribution of wealth; 10 percent of the households own all of the capital assets. They argue that these two maldistributions are inherently contradictory and, unless corrected, Mixed Capitalism (i.e., the type of capitalism that exists in the U.S. today) will collapse into State Capitalism (i.e., the type of capitalism that exists in Russia today).

To prevent these developments, Kelso and his associates advocate a capitalist revolution--the creation of Universal Capitalism by the adoption of a gigantic capital diffusion program that would make new capitalists of the 90 percent of households that now own no capital. This revolution would require that corporations no longer retain earnings for purposes of internal financing, thereby compelling them to pass profits through to stockholders as dividends; would eliminate collective bargaining by unions; and would abandon the full employment and welfare transfer policies of the federal government. The magnitude of these changes would be huge; these changes, designed

to reduce the alleged maldistribution of income, would require that wages decrease by 85 percent and that the returns to capital increase by 600 percent. Similarly, the rate at which the economy would have to grow in order to effect this transfer would also be very large, given historic comparisons; they would have to be "several" times four percent.

We suggest that, even if this analysis by Kelso and his associates were correct, it is doubtful that such a program of action is feasible. If the economy were to expand to the extent and as rapidly as projected, we would expect inflation to be a major problem and that the levels of concentration and centralization in the economy would increase significantly from their present levels. More important, however, is the high probability that present economic/physical constraints on resources, especially energy, would not allow the necessary rapid rates of growth. The scope and speed of the proposed reform are beyond current economic/physical resource capabilities.

More determinative of the relevance of the Kelso framework, however, is the fact that the alleged massive distribution of income does not exist. Kelso and his associates provide no quantitative support for the existence of the 90-10/30-70 breakdown. It appears to be the result primarily of casual observation. Their version of such an income maldistribution has no known support among professional economists. It is argued below that, in alleging the existence of such a maldistribution, Kelso and his associates made a basic theoretical error. They overlooked the fact that entry and the competitive market dis-

tribute the results of particular productivity improvements, whether made by capital or labor, primarily to consumers in the form of lower prices rather than to capitalists and labor in the form of persistently higher profits or wages. Given this historic process, there is no justification for allocating exclusively to capital a persistent and high rate of return for having initiated a productivity improvement.

Although a capital diffusion plan is central to the analysis of capitalism made by Kelso and his associates, the invalidity of that analysis does not necessarily make capital diffusion also invalid. Such programs should be considered on their own terms and rated up or down on the basis of their own merits. This is true of both GSOC and AGSOC.

GSOC. The most important feature of the federal law that created the opportunity for states to create GSOCs was the refusal by Congress to grant two very significant tax exemptions that were initially sought. The failure to obtain these exemptions had three effects. First, the probability of a negative cash flow during the first years of a GSOC was increased. Second, this adverse effect on cash flow will increase the probable need and duration to finance losses during the early years of a GSOC. And, third, the possibility is increased that during these initial years a GSOC will not be able to pay dividends to its stockholders but will pass through to them a tax liability. During these years, the stockholders would be net losers.

AGSOC. We analyzed three administrative and organizational

features of AGSOC, as currently proposed: the guarantee issue, the issue of the investment decision-making process, and the holding v. operating company issue.

In connection with the guarantee issue, we concluded that a loan guarantee fund would undoubtedly be required by private creditors of an AGSOC. The key to long term legislative control over an AGSOC lies in the enabling and appropriation acts with respect to successive loan guarantee funds. But the significance of the fund goes further: it can affect the nature of the investment decision-making process.

Five parties will be involved in the investment decision-making process: the seller of the asset, creditors, AGSOC management, AGSOC's Board of Directors, and the Legislature. Given the elective nature of both the Board and the Legislature, it is hard to escape the conclusion that the investment decision-making process will be subject to appreciable political influence. This means that Alaska will have to rely heavily on creditors to sift the good risks from the bad risks. In projects of the magnitude presently contemplated, it is doubtful wisdom for debtors to depend so heavily on creditors. Such dependence will, at best, come at a price.

The general principle with respect to investment is that, if markets work efficiently and if the buyer functions only as a non-speculative and non-operating investor, the price paid (i.e., the amount borrowed) plus interest paid on the debt will just equal the income generated by the asset over its life. This principle applies to assets with either a finite or perpetual life.

Given the above principle, how can a buyer borrow, invest, pay back the loan, and still make money? A buyer can, for example, make money if he has better information than the seller, is a better negotiator than the seller, is both more risk prone and lucky, or is able to increase the annual income generated by the asset. Income can be increased (1) if the buyer were to become an operator as well as an investor and if he is more efficient as an operator than the seller or (2) if the buyer got a tax break not previously available to the seller. This analysis suggests that, failing to get their desired tax breaks, AGSOC proponents will begin to promote AGSOC as an operating company rather than as a holding company. AGSOC as an operating company, however, would break the Kelso conception as to the nature of investment in capital diffusion programs. The expected result of such a change in function would be to increase significantly both the risk characteristics and the degree of uncertainty associated with the AGSOC. There would undoubtedly be an adverse effect both on the ability to secure 100 percent debt financing and on the probability of a reasonable pay-out period.

Kelsoism, GSOC, and AGSOC

Introduction

The proposed Alaska General Stock Ownership Corporation (hereafter AGSOC) came to Alaska in three steps. The first step was the writings of Louis D. Kelso and his associates[1] in which they set forth a program of capital diffusion. The second step was the inclusion by Congress in the Revenue Act of 1978 of the General Stock Ownership Corporation (hereafter GSOC) provisions in which Senator Gravel played a major role. The final step was the introduction in the Alaskan Legislature of a bill proposing to create an AGSOC.

The present report follows this development. The first section is an economic analysis of the writings of Kelso and his associates. The second section discusses major characteristics of a GSOC with special reference to tax considerations. The third section analyzes important issues raised by the AGSOC proposal itself. The preceding executive summary will function as a conclusion.

The Kelso Framework

Kelso and his associates identified four types of capitalism. Primitive Capitalism was the "form of capitalism which existed in Great Britain during the nineteenth century and which persisted

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[1]These abbreviations will be used to identify the following three books. CM will identify The Capitalist Manifesto by Louis O. Kelso and Mortimer J. Adler (Random House, New York) 1958; TFT for Two Factor Theory: The Economic of Reality by Louis O. Kelso and Patricia Hetter (Vintage Books, New York) 1967; and PA for A Piece of the Action by Stuart M. Speiser (Van Nostrand Reinhold Company, New York) 1977.

in a waning state until the end of the First World War" (CM, p. 104). State Capitalism is the "form of capitalism that exists in Soviet Russia today" (CM, p. 105). Mixed Capitalism is the "form of capitalism which exists in the United States and Great Britain today and which has been developing since the end of the First World War and the rise of labor unions to power with the help of the countervailing power of government" (CM, p. 105). Finally, Universal Capitalism or Capitalism "with a capital 'C'" is the "form of capitalism which will exist, probably in the United States first, after the capitalist revolution has brought into being the first justly organized capitalist economy" (CM, p. 107). Universal Capitalism is advocated by Kelso and his associates.

In brief, Kelso argues that Mixed Capitalism is doomed because of internal contradictions and will be replaced by State Capitalism unless the transition is made to Universal Capitalism. Universal Capitalism will be the product of installing capital diffusion policies--accompanied by other key changes in corporate conduct, labor unions, and government economic policies--on a sufficiently grand scale to give all citizens a second income that is derived from their ownership of capital and not from their labor. This section will briefly sketch out his argument with emphasis on the key role of his capital diffusion program. The General Stock Ownership Corporation (hereafter GSOC) and the Alaska General Stock Ownership Corporation (hereafter AGSOC) are directly derived from this capital diffusion program although, as will be duly noted, they differ importantly from the diffusion

institutions described in the writings of Kelso and his associates. As they see it, the game is big and the stakes are obviously high.

Mixed Capitalism and its Fatal Flaw. It is the position of Kelso and his associates that Mixed Capitalism contains a fatal flaw or internal inconsistency that, unless eliminated, will cause the collapse of Mixed Capitalism into State Capitalism. This fatal flaw consists of a massive maldistribution of wealth and of income.[2]

Maldistribution of wealth. According to Kelso and his associates "2.3% of America's households own about 80% of the economy's productive capital, and an additional 5 to 8% own the rest" (TFT, p. 40). In short, 7 to 10% of U.S. households own all productive assets. This massive maldistribution is said to be the result of the two conventional methods by which new productive capital is financed (TFT, p. 40, p. 79). The first method is the internal corporate financing of new investments by the use of retained corporate earnings. The second method is the insistence by creditors that debtors provide collateral that consists of existing capital owned by the debtors. The use of these two conventional financial processes assures that those who get more will be those who already have. In short, the rich get richer. Increasing centralization of capital is the result.

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[2] To this reader, Kelso and his associates use the concepts of wealth and income in an ambiguous manner. In that which follows, wealth is used as a stock concept and income as a flow concept. For an example of the ambiguity, see CM, p. 129.

This maldistribution is said to cause a shortage of purchasing power; "a few families have purchasing power in excess of their consumption needs, and the great majority have needs in excess of their purchasing power" (TFT, p. 40). According to Kelso and his associates, it is this excessive concentration in the ownership of capital and the resulting shortage of purchasing power "that is the basic cause of the economic dislocations or periodic 'depressions' in an industrial economy based on private property in capital and labor" (CM, p. 151). This condition is aggravated by the maldistribution of income.

The Maldistribution of Income. According to Kelso and associates, over "70 percent of the wealth produced (read "income") is distributed to labor, but over 90 percent of that wealth (again read "income") is produced, not by labor, but by capital instruments" (CM, p. 129). In other words, it is alleged that, while capital accounts for 90 percent of output, the owners get only 30 percent of that income. Labor, on the other hand, produces only 10 percent but gets 70 percent of the output. In Mixed Capitalism, labor exploits capital! The massive maldistribution of income claimed by Kelso and his associates is advantageous to labor and disadvantageous to capital. No wonder that Milton Friedman, Nobel Laureate in Economics, said of this theory: "It's Marx stood on its head" (PA, p. 124).[3]

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[3] More generally, Professor Friedman characterized the "two factor theory" of Kelso and his associates as "a crackpot theory" (PA, p. 124).

This alleged maldistribution of income (we shall assume for the time being that such a maldistribution of income exists. I personally do not believe that this type of a maldistribution of income exists.) is said to be the result of a conflict between a capitalistic mode of production and a laboristic mode of distribution (CM, p. 129). The capitalistic mode of production refers to the increasing use of capital and associated labor-saving improvements in technology to produce an ever increasing supply of goods while decreasing the demand for labor. The laboristic mode of distribution distributes the national income through wages paid in the process of employment. "The laboristic distribution which organized labor, with the help of government, has managed to effect has been achieved by the exercise of political and economic power, not by bargaining" (CM, p. 125). This laboristic mode has been supplemented by a "needistic" distribution based on welfare programs that transfer income from one group to another

The simultaneous use of capitalistic and laboristic modes increases the supply of goods to be distributed, thereby increasing the pressure on the distribution system, while decreasing the demand for labor, thereby decreasing employment and further eroding the basis of distribution. A gap is said to develop between society's ability to produce goods and its ability to distribute goods. As a consequence the government comes under increasing pressure to increase employment or to develop welfare-like transfer systems in order to generate sufficient purchasing power to move all that can be produced. The result has been

the expeditous adoption of a full employment policy and the development of a welfare system based on income transfers from the rich to the needy. These "laboristic" and "needistic" programs are at the heart of the policies of Mixed Capitalism.

The full employment policy, drafted as a partial solution to the conflict between the capitalistic mode of production and the laboristic mode of distribution, requires that the economy be continually stimulated. This stimulation leads to persistent inflation which, according to Kelso, is Mixed Capitalism's "insoluble problem" (CM, p. 129). "Inflation is a natural and necessary process in an economy that is capitalist in its mode of production and laboristic in its form of distribution" (CM, p. 129).

In addition, Kelso sees a potential conflict between the maldistribution of wealth and income: the "effective and highly concentrated ownership of capital in about 5 percent of the households of our economy is incompatible with the production of some 90 percent of the wealth (read income) by capital instruments" (CM, p. 136). As capital continues to produce more, the increasing concentration of capital decreases the ability of capital ownership to serve as a basis for distributing income, thereby creating increasing pressures to use labor and employment as the basis for distribution. Kelso and Adler reached this pessimistic conclusion:

> If mixed capitalism cannot check the inflationary process of the last thirty years, if it cannot resolve the conflict between its policy of full employment and the technological advances that lie ahead, if by the very nature of the elements in the mixture the laboristic

> aspect of the distribution tends to expand and the capitalistic aspect to contract..., then, perhaps, mixed capitalism...contains the seeds of its own destruction. (CM, p. 129)

The Kelso Program of Reform. The principal goal of the reform program of Kelso and his associates is to create Universal Capitalism whose essential characteristic is to make effective capitalists of those 90 percent of the households who own no capital. This transformation will provide the basis for a distribution system that is based predominately on capital ownership rather than on labor. This capitalistic mode of distribution will be able to absorb the output of the capitalistic mode of production. The gap that breeds inflation will allegedly be closed. And, according to the theory, this capitalist revoluation will correct the fatal maldistribution both of wealth and of income.

More particularly, the capitalist revolution consists of four steps. First, corporations will no longer be able to finance expansion internally from retained earnings; profits are to be paid to stockholders as dividends. This change will prevent further concentration of wealth and facilitate the creation of the New Capitalists by accelerating the repayment of funds borrowed to finance the purchase of their equity positions. Second, markets must be freed from the collective or "coercive" (TFT, p. 76) bargaining imposed by unions that has distorted the distribution of income to the advantage of labor. Collective bargaining

> introduces into the economy a governmental enfranchisement of unions to levy taxes upon employers, stockholders, and upon the economy as a whole. It sanctions a form of monopoly

> and conspiracy made effective by organized force which dwarfs any industrial monopoly ever contrived. It eliminates from the major area of the economy the use of objective, impartial, and free competition as a just determinant of economic values. (CM, p. 187)

A measure of the extent of the distortion Kelso and Adler attribute to labor unions is indicated by this passage.

> If a competitive evaluation of the contribution of labor were then to set wages at a level which labor could justly claim as a return for its services, labor's standard of living might dwindle to bare subsistence or even fall below it. (CM, p. 61)

Under Kelso's program unions would indeed be transformed; they would cease being an organization that exploited capitalists and become an institution whose function would be to protect the small and medium sized capitalists from all challenges. Under Universal Capitalism,

> ...the labor union will obviously not be needed as an instrument of power to effect a laboristic distribution of wealth (read income)....But to say that the union will not be needed to perform this function in a justly organized economy, with diffused ownership of capital and a capitalistic distribution of wealth (read income), is not to say that there will be no socially useful service for it to undertake. Voluntary associations of capitalist workers, operating through democratic processes of self-government, may serve their own members and the whole society by functioning as agencies for the economic education of the newly made capitalists, and as instruments for the protection of their property rights. (CM, p. 157)

Kelso recognizes that the reform of corporations and unions would be both necessary and difficult.

> The giant corporations which now exist and the giant labor union which has just come into existence represent enormous concentrations of power which have not as yet been made fully responsible for the use they make of their power. The most difficult task that government faces, in effecting the transition from our present mixed capitalism, is to tame and harness

> the power of these creatures of capitalism and, by making them responsible in the discharge of the limited functions they should perform, make them serve (Universal) Capitalism, or at least prevent them from despoiling either. (CM, pp. 156-157)

The third step is to create the class of New Capitalists who presently own no capital. This will be a massive undertaking because sufficient new capital must be created to give those 90 percent of households that own no capital a grubstake that will provide with them an important second income based on capital ownership. Some idea as to the magnitude of the change required can be obtained from the following considerations. Under Mixed Capitalism labor is the source of 70 percent of household income. Under Universal Capitalism and after correction of the maldistribution of income, labor would be the source of only 10 percent of that income--as determined by labor's 10 percent productivity. Capital ownership would have to become the source of that 60 percent difference. In short, during the transition from Mixed Capitalism to Universal Capitalism, wages would have to decrease 85 percent (6/7s) and the return to capital would have to increase 600 percent, assuming no increase in the standard of living.

This mammoth restructuring of both the production and distribution systems would apparently be accomplished by allowing these households to borrow from banks and to purchase stock in a limited set of well established, blue chip corporations; the investments of the New Capitalists are not to be in venture capital. The purchased securities would be held in escrow until they had been paid for by dividends received. The New Capitalists

would then receive their stock. Three programs would expedite this process. First, the corporations could retain no earnings; this would maximize the dividends to accelerate paying off the loan. Second, tax exemptions would further maximize the flow of earnings to repay the loan. Third, a Capital Diffusion Insurance Corporation would be created in order to encourage banks and other institutional creditors to engage in 100 percent financing by protecting them against losses. This last proposal would, in effect, base creditor protection on the collective credit worthiness of non-capitalist households rather than on assets owned by established capitalists.

Finally, the U.S. economy would have to grow at a much more rapid rate than it has in the past if the New Capitalists are to acquire a capital base sufficient to make a difference; the New Capitalists are not to be created at any significant expense to existing capitalists. The New Capitalists and their "Second Income" are to be created out of growth. For example, in the United States and Canada a growth rate will be required that is "several times the three and a half to four percent that is currently achieved in the U.S. and in most Western economies." (TFT, p. 9) The situation would be even more striking in less industrialized economies; their productive capacity "may have to be expanded fifteen, twenty or more times in order to build second economies capable of producing general affluence." (TFT, p. 47) It is evident that the arrival of Universal Capitalism will be heavily dependent upon realizing sustained rates of growth significantly greater than the world has as yet experienced in a sustained and general fashion.

Is the Kelso Program Workable? Let us assume for the sake of argument that the diagnosis of Kelso and his associates is correct and that their proposed remedies could solve the problems. Is the plan workable?

To answer this question, two economic features of the plan should be recalled. First, the plan envisions a huge increase in capital formation in order to create the capital base for an adequate second income for 90 percent of U.S. households. Second, in order to realize this great expansion within a reasonable period of time, the economy must grow at an unprecendentedly rapid, sustained rate of growth.

If we assume for the moment that such rates of growth are within our physical capabilities, we must examine the effects of such large and rapid rates of growth on the national economy. At least two consequences can be predicted with reasonable assurance: the program would be inflationary and would lead to an increase in both industrial centralization and concentration.

Kelso and Hetter have argued that his capital diffusion plan would be "deflationary" (TFT, p. 97) on the grounds that the new capital formation would lead to a larger supply of goods. They acknowledge, however, that the debt financing aspect of the program would increase significantly the supply of money. This would, of course, be inflationary unless the supply of goods could be increased simultaneously and commensurately. The increase in the money supply and hence demand would begin immediately with the start of the plan. The increase in the supply of goods would come more slowly and later. Because of

this lag, inflationary pressures would develop. History does not support Kelso's implicit assumption as to the almost spontaneous responses of supply to a sharp and sustained increase in demand. We could expect significant lead times, lags, and bottlenecks. The inflationary potential of the Kelso plan was recognized by a 1976 staff report of the Joint Econmic Committee of the U.S. Congress.[4]

The Kelso program would funnel much of this new capital expansion into established, well-managed firms (TFT, p. 97). This would increase their size relative not only to the economy as a whole but also to other less favored firms with which they compete in relevant markets. The first type of increase we customarily call centralization and the second type concentration. Because of this preference for blue chip firms, we can expect the capital diffusion plan of Kelso to increase both centralization and concentration.

A more important difficulty, however, than the likely inflationary and centralization tendencies of the Kelso program, is the great likelihood that the projected rates of growth are beyond our present economic/physical capabilities. It is increasingly apparent that we are entering a mandatory slow growth period, constrained by energy and raw material supplies. Growth targets have been reduced by both developed and developing countries. What might have been a potentially viable policy in the

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[4] See PA, p. 254-6 for a discussion of that report. The report did support, in general, efforts to diffuse capital ownership.

60's appears no longer to be viable, given the magnitude of the proposed change.

Implementation of the plan would also undoubtedly pose political problems. Two major economic institutions, both with political clout, would have to undergo basic changes. Management would lose the flexibility associated with internal financing. The impact on labor unions would be even more far-reaching. Not only are unions accused of exploiting capitalists (albeit apparently of willing capitalists) but the plan would dismantle collective bargaining as we know it. The new unions would function as the protectors of the interests of small capitalists.

Political problems could also be associated with the need for wages to fall some 85 percent during the transition to Universal Capitalism as the income to households from capital ownership rose 600 percent. Upheavals of this magnitude boggle the mind and challenge credibility, especially when the whole conception is based on an alleged massive maldistribution of income that does not exist.

Is There Really a Basic Maldistribution of Income? From the standpoint of a professional economist the most suspect aspect of the analysis by Kelso and his associates is their contention that, although labor gets about 70 percent of the economy's income and capital gets 30 percent, capital should get 90 percent and labor only 10 percent based on their comparative productivities. This contention was rather summarily dismissed by Professor Paul Samuelson, a Nobel Laureate in Economics, in a brief

report that he prepared on Kelso's ideas for the Puerto Rican government.

> Kelsoism is not accepted by modern scientific economics as a valid and fruitful analysis of the distribution of income, but rather it is regarded as an amateurish and cranky fad....Its central tenet (the 90-10/30-70 gap) is contradicted by the findings of economic empirical science: according to statistical study of macro-economic trends, by such distinguished scholars as Professor Simon Kuznets of Harvard (Nobel Laureate in 1971), Senator and Professor Paul H. Douglas (award winner for his Cobb-Douglas statistical measurement of the aggregate production function), MIT Professor Robert M. Solow, and numerous researchers at the National Bureau of Economic Research under the direction of Arthur M. Burns, chairman of the Board of Governors of the Federal Reserve System, economic adviser to Presidents Eisenhower and Nixon, the contribution of labor to the totality of GNP is in the neighborhood of 75 percent, with only 25 percent attributable to land, machinery and other property.
>
> ...this 75-25 percent breakdown is diametrically opposite to the Kelso presuppositions, which are purely speculative and not based on econometric analysis of the observed statistics of nations at different stages of development. (PA, p. 112)

According to Samuelson, the principal determinants of the distribution of income between capital and labor are changes in the relative supplies of labor and capital, changes in technology, trade union pressure, antitrust policies, and welfare transfers.[5] The process, however, is dominated by the first two determinants. The two have combined to stabilize the 75-25 (similar to Kelso's 70-30) distribution of income.

Professor Samuelson's comments do not quite get to Kelso's concern. I do not believe that Kelso's problem is that the 70-30 (or 75-25) breakdown fails to measure what capital and labor get.

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[5] Paul Samuelson, Economics (McGraw-Hill, New York) 1973, 9th edition, pp. 741-748).

His concern is that the distribution should reflect the relative contributions of capital and labor to national output. If capital produces 90 percent, it should get 90 percent. If labor produces only 10 percent, it should get only 10 percent. It is for these reasons that he contends "there is no longer any basis for believing that the available statistics give us an accurate picture of the relative economic productivity of capital and labor" (CM, pp. 260-261).

The real issue is the relative productivities of capital and labor. Kelso and his associates offer no empirical support for this important quantitative aspect of their analysis. It seems to be based on nothing more than casual observation. I believe that Kelso and his associates have made a fundamental theoretical error. The central question is simply stated: How is the productivity dividend to be distributed? Kelso's answer is straightforward: Capital, not labor, is responsible for the increased productivity; therefore, it is only just that capital should get it all. But, in a market system (and recall that Kelso is a strong believer in a market system) there are three claimants to a productivity increase: capital, labor, and the consumer. Kelso overlooks the critical role of the consumer. In a market economy, the initial, high return to capital for innovation is eventually eroded and prices fall as entry of new capacity, attracted by the profits, increases industry supply. New products have such a life cycle. The price experience of small hand-held calculators over the last five years is a good example. In short, the principal beneficiary of increases

in productivity in a market economy is the consumer and not the capitalist. The consumer benefits from the lower prices made possible by technological gains and enforced by a competitive market. It is the consumer, not capital or labor as factors, who is the principal beneficiary of productivity improvements. If the above analysis is accepted, there is no reason to accept Kelso's 90-10 breakdown or, more importantly, his claim of a massive maldistribution of income that is alleged to be a fatal flaw of Mixed Capitalism.

Does Capital Diffusion Make Sense Outside the Kelso Framework?

According to Kelso and his associates, the two fatal flaws of Mixed Capitalism were the maldistributions of wealth and income. Of these two, the maldistribution of income was both the more controversial and the more important. In my opinion, the maldistribution of income as described by Kelso, does not exist. It is not a fact. Is there, however, a maldistribution of wealth? In this instance, the facts are less controversial and reasonable people can disagree as to the desirability of the existing distribution of wealth. For those who would prefer a more even distribution of wealth, a capital diffusion program is one way to achieve it.

In 1976, for example, the Joint Economic Committee of the U.S. Congress stated in its Joint Economic Report:

> To begin to diffuse the ownership of capital and to provide an opportunity for citizens of moderate incomes to become owners of capital rather than relying solely on their labor as a source of income and security, the Committee recommends the adoption of a national policy to foster the goal of broadened ownership. (PA, p. 252)

In sum, a policy of capital diffusion should be evaluated outside the Kelso framework and its dire predictions of the collapse of Mixed Capitalism. Such a policy should be allowed to stand on its own feet and be voted up or down on its own merits. In this conclusion, I agree with Stuart Speiser, an admirer of Kelso, when he wrote concerning Kelso's two factor theory--the theory that is based on the existence of the massive maldistribution of income--that it is "an irrelevant issue that would be ruled out of the case if Kelso were trying it in court" (PA, p. 95) and "a millstone around Kelso's neck" (PA, p. 122). In addition, Speiser believes that this theory "has absolutely nothing to do with capital diffusion or universal capitalism" (PA, p. 95). I would, however, go one step further and argue that capital diffusion policies should be evaluated on their own terms and not even as a part of that broader program, Universal Capitalism. It is in this limited context that we proceed to an analysis of GSOC and AGSOC.

The General Stock Ownership Corporation

The General Stock Ownership Corporation (hereafter GSOC) plan, as initially conceived, had at its heart two elements: finance by borrowing and significant tax exemptions to facilitate that debt financing. Debt financing was at the ideological core of the Kelso program: individuals were to utilize their collective credit worthiness to finance their increased participation in the capitalist system. This was to be a "boot strap" operation--a painless way for all to become capitalists and ac-

quire a significant second income. Although we shall concentrate in this section on the tax exemptions, it is important to stress that their importance derives from the key role of debt financing.

The GSOC plan, as initially proposed in the U.S. Senate, sought two major tax exemptions. First, the corporation in which a GSOC acquired stock was to be allowed to deduct as an expense dividends paid to GSOC. This would approximately double the revenue to GSOC relative to other stockholders. Second, the bill proposed that GSOC be given tax-exempt debt financing. Not only would GSOC have been able to deduct the interest payments on its debt but it would also be able to deduct its payments against the principle. In other words, the principle debt was not to be paid out of taxable income as it normally is, for example, in a home mortgage; the mortgage payment would itself be tax deductible. This was a critical exemption and would have significantly facilitated debt financing.

In the final bill, Congress gave GSOC neither of these important exemptions. Instead GSOC was allowed to integrate its tax liability with its stockholders; the corporation was allowed to escape double or triple taxation by passing its income tax liability through to the stockholders. This is the same type of tax advantage that is routinely exercised by small business.

The refusal of Congress to grant the previous two major tax exemptions has three consequences with respect to the operation of a GSOC. First, by reducing the after tax income of the GSOC

Congress's refusal increased the probability and duration of a negative cash flow during the first years of the GSOC. Second, this adverse effect on the cash flow will increase the probable need and duration to finance losses during the initial period of a GSOC. In particular, it complicates attempts by a state legislature to guarantee the debt of the GSOC to its creditors either by a guaranteed loan or a loan guarantee fund.

The third consequence of Congress's refusal to grant the tax exemptions initially sought by the GSOC proponents is the taxable income issue. It will be recalled that under the only tax exemption granted--the tax integration exemption--GSOC's taxable income flows through to its stockholders. This tax liability flows through whether the stockholders receive any dividends or not. The source of the problem is twofold. First, although it is not inevitable, it is probable that a GSOC will initially generate a negative cash flow. It, therefore, will be unable to pay dividends because its expenses, including interest and payments against principle, will exceed its revenues. Second, despite the negative cash flow and consequent inability to pay dividends, the GSOC can generate a taxable income which passes through to the stockholders as a tax liability. This is a result of the fact that a payment against principle is included in taxable income because it is not deductible, thereby increasing taxable income, but is excluded from cash flow because it is paid to the creditors, thereby decreasing the cash flow. In sum, in the first years of a GSOC it is very probable that its stockholders will get no dividends but will receive an ad-

ditional tax liability. The cost to particular stockholders will depend on their tax status. In passing, we might note that at a hearing of the Alaskan House Finance Committee on November 2, 1979, Senator Gravel acknowledged the probability that the plan "can wind up having to saddle the people with a tax liability."

In conclusion, the proponents of the original GSOC went to Congress and asked for a silk purse. Instead, Congress gave them a sow's ear. And it is well understood that you cannot make a silk purse out of a sow's ear. Congress, however, could be asked once again for the silk purse--i.e., for the two major tax exemptions--in order to minimize the taxable income problem and to increase the financial viability of the GSOCs. Such action by Congress would create a new set of problems--equity problems associated with transfers from one set of taxpayers to another set.

It is convenient to distinguish between two types of tax subsidies: direct subsidies and indirect subsidies or tax expenditures. A direct subsidy involves taxing A to pay B; it is a direct transfer from A to B. A tax expenditure involves a more complex subsidy. One set of citizens (A) gets a tax break. Government revenue is reduced by this amount; consequently, in order to compensate for the revenue loss, B's taxes must be increased or C's benefits must be reduced. A transfer is involved: A benefits at the expense of B or C. Peter is robbed to pay Paul.

It is correct to note that these "silk purse" exemptions would not make a GSOC a Robin Hood. Robin Hood took from the rich to give to the poor. Such a GSOC would instead take from all (rich and poor) to give to some (rich and poor). Congress recognized that these "silk purse" exemptions were a potential threat to the corporate tax base at the national level. This erosion would increase as the use of GSOCs expanded. This is why Congress rejected these exemptions and will undoubtedly continue to reject them. Consequently, the future viability of GSOCs in general and of AGSOC in particular must be assessed on the basis of the very limited tax exemption given in the 1978 law.

AGSOC: Some Administrative and Organizational Features

We shall consider three important issues raised by the administrative and organizational features of the proposed Alaska GSOC (hereafter AGSOC): the guarantee issue; the issue of the investment decision-making process; and the holding v. operating company issue.[6]

The Guarantee Issue. An AGSOC will be limited to financing its investments by borrowing. There will be no initial payments for stock. There can be no relatively significant retained earnings by which an AGSOC could finance its own expansion. An AGSOC could borrow directly from the State of Alaska or from

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[6] Other important issues include the constitutional issue and the issue of stockholder control. These will not be discussed in this report; they have been the subject of other reports.

the private sector. I shall limit this discussion to efforts to borrow from the private sector.

In borrowing from the private sector (e.g., banks and insurance companies), an AGSOC would have three possible options: borrowing with no guarantee or collateral to protect the creditor; borrowing with creditor protection provided by a guaranteed loan; and borrowing with protection provided by a loan guarantee fund.

1. Borrowing Without Creditor Protection. It is very doubtful that this is a realistic option for at least four reasons. First, there is the need for 100 percent debt financing. As a result, there would be no margin for error; the creditor would be fully exposed. The creditors would not even have the minimal protection provided by an equity contribution to the original investment.

Second, the very large sums of money that are involved in proposed investments can be expected to assume that creditors will seek some type of protection. It is one thing to lend $1,000,000. It is quite a different order of magnitude to lend $500,000,000 or $1,000,000,000. Third, the probability of an initial negative cash flow which must be covered by borrowing raises further difficulties when financing must be 100 percent by debt. Losses are not assets that could conceivably protect the creditors.

Finally, Mr. Kelso and his associates have recognized the historical need for creditor protection. In conventional finance, based on the assets of individual debtors, "existing financial

or tangible capital is put at risk to insure against the possibility that newly formed capital either may not pay for itself within a reasonable time, or that if it does so, the wealth it produces may not be used to make that disbursement" (TFT, p. 93). They would substitute for that individual credit worthiness either the collective credit worthiness of all within a given jurisdiction or some insurance scheme. For example, a Capital Diffusion Insurance Corporation (CDIC), modelled after the Federal Housing Authority Insurance Plan, was suggested (CM, p. 241) in order to insure institutional creditors against losses in the realization of any capital diffusion plans. In brief, AGSOC will almost certainly have to offer its creditors some type of a guarantee against losses.

2. Borrowing With a Guaranteed Loan. It is quite certain that the Alaskan Legislature cannot constitutionally guarantee a loan to an AGSOC. Such a guarantee does not involve a capital improvement. The Alaskan Legislature can, however, protect AGSOC's creditors, if it so desires, by the creation of a guarantee loan fund.

3. Borrowing with a Loan Guarantee Fund. The creation of a loan guarantee fund would involve two legislative acts: an enabling act and an appropriation act. The enabling act is necessary to create the loan guarantee fund. Conditions that determine the reach and functions of the fund are in control of the Legislature. This would be an important statute. The appropriation act would provide the money required by the fund. The amount of the appropriation would depend on negotiations between AGSOC and the seller of the assets being acquired (this

determines the amount of money AGSOC would have to borrow) and between AGSOC and its creditors. The Legislature would be asked to appropriate the amount of money that AGSOC and its creditors negotiated as sufficient to protect the creditors, given the size of the loan. This could be 50 percent or more. The appropriate money would, in effect, sit there; it could be put to no other use. This use of state money would be at the expense of other uses. There would be no free lunch.

Neither the enabling act nor the appropriation act appear to present any constitutional issue. An adequate "public purpose" can almost certainly be found.

The proposed AGSOC bill includes a start-up loan guarantee fund for which it appropriates $5,000,000. This fund is for the limited purpose of enabling the AGSOC, when created, to be able to borrow enough to cover its organizational, start-up costs. The bill, however, makes no provision for a loan guarantee fund designed to cover investments made by the AGSOC.

It has been stated that the bill does not provide for an investment loan guarantee fund in order to maximize the flexibility and discretion of AGSOC's board of directors. Others have suggested that it might well be a political maneuver--a two stage strategy. Initial silence with respect to the loan guarantee fund should increase the probability of passing the AGSOC bill because the issue of financial consequences would be minimzied. Then, once the AGSOC bill is passed, it would be easier to pass the necessary enabling and appropriation acts on the grounds that, without them, there can be no AGSOC.

The key to long term legislative control over an AGSOC, whether created by a legislative act or by referendum, lies in the enabling and appropriation acts in connection with successive loan guarantee funds. But the significance of the fund goes further: it can affect the nature of the investment decision-making process.

The Investment Decision-making Process. The declared goals of AGSOC's investment decision-making process are that it be professional and free of political considerations. The nature of AGSOC's investment decision-making process raises important issues that might well have an adverse effect upon the realization of these goals. It is apparent that five parties will be involved in this process: the seller of the asset, the creditors, AGSOC's management team, AGSOC's Board of Directors, and the Legislature. The anticipated role of each will be briefly discussed.

1. The Seller of the Asset. The purchase price of the asset will be negotiated by the seller of the asset and AGSOC's management. Because of the nature of the decision-making process, however, participation in one form or another along the way can be expected from the creditors, AGSOC's Board of Directors, and the Legislature. The result of the negotiation between the seller and management will reflect their relative positions with respect to information, risk preferences, and negotiating skills and power. As pointed out in the last part of this section, these differences are key to determining the price and resulting profitability of the transaction.

2. Role of Creditors. Creditors hold a veto power. With 100 percent debt financing, nothing happens without their approval. Their interest in the extent of a loan guarantee fund will depend upon the degree of risk involved in the investment. It is clear that Mr. Kelso and his associates prefer relatively low risk, blue chip type of investments. Speiser, for example, says that "Kelso thinks that venture capital (capital for starting new enterprises) is a game to be played by the very wealthy" (PA, p. 80). The proponents of AGSOC appear to be somewhat ambiguous as to whether AGSOC should be used to promote development and new ventures or should be limited to taking over a part of a major, successful enterprise. Whichever is the case, it is certain that the creditor will relate the risk to the amount of money demanded in the loan guarantee fund.

3. Role of AGSOC's Management. Management is to make the initial investment decision for AGSOC. This will be presumably a professional decision, i.e., based on the intrinsic merits of the case. But their decision must be approved by the Board of Directors. Given the probable political nature of the Board as described in the following section, it is quite certain that management will have to exist and survive in a political environment.

4. Role of the Board of Directors. The role of the Board is critical in the investment decision-making process. The Board's approval is necessary before any project can begin. At this point we can expect political considerations to be injected directly into the process because the Board is quite

explicitly designed to be a political institution. Directors run in a statewide election; the usual proxy system is prohibited. The electorate is broader than the usual electorate because stockholders (and, therefore, voters) will include those younger than the normal voter. In addition, after a phase-in period each Director will serve a limited term of two years. There will be an election every year at which one half of the Board must stand. Given such short terms and annual elections, a Director will always be running for office. In addition, the candidate nominated by the Board can be challenged by nominees put forward by groups of stockholders. Under these circumstances it is hard to escape the conclusion that the Board will be a political institution and that the investment decision-making process will be significantly influenced by political considerations.

It is legitimate to ask what, in this context, is meant by the term "political." Without impugning the motives of anyone, in this context political means that the decision-making process is subject to a perverse incentive system; Directors will be unable tc make decisions that are unpopular with this diversely structured electorate whose decisions will almost certainly not be professional in nature.

5. Role of the Legislature. The Legislature becomes involved in the investment decision-making process because of the almost inevitable need for a loan guarantee fund and the consequent need for passage of the enabling and appropriation acts. It is here that the Legislature takes over the investment decision-

making process; its political decision-making process will be able to dominate the investment decision-making process at this point. The Legislature is the final hurdle.

While one enabling act may be able to serve more than one project, it is more than likely that each project will require its own appropriation act. This is likely because each project can be expected to differ as to risks and the identity of creditors and, therefore, as to the magnitude of the loan guarantee fund. By the very nature of the AGSOC arrangements, the Legislature will be involved in the investment decision-making process and will be held accountable at the polls.

In sum, Alaskan participation in the investment decision-making process will be influenced by two political institutions (the Legislature and the Board of Directors) which may or may not be able to work together in harmony with one another[7] and a third group (AGSOC management) which, through ostensibly professional, must function and survive in a political environment. These considerations mean that Alaska would probably have to depend heavily on creditors to sift the good risks from the bad risks. In projects of the magnitude presently contemplated, it is doubtful wisdom for debtors to depend so heavily upon creditors. Such dependence will, at best, come at a price.

6. Is an AGSOC-type Investment Possible? The non-speculative and non-operating investment in an income-producing asset creates

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[7] For example, they differ (1) as to the nature and extent of their electorates, (2) as to the roles of the traditional political parties, and (3) as to the range of issues that they must consider and the consequent focus of their energies.

some interesting questions as to the nature of the profitability of the investment. Two examples will be used to illustrate the nature of the problems involved. The first example involves the purchase of an asset with a limited life; the second is a perpetual asset.

Asset with a Finite Life. Assume an asset with a five year life that produces an annual after-tax income of $100. Further assume that the buyer and seller have the same information, the same risk preference, and are subject to the same discount rate of five percent. Under these conditions, what is the maximum price that the buyer should pay and what is the minimum price that the seller should accept? Both prices should depend upon the calculations by the buyer and seller of the discounted present value of that future flow of income. Based on calculations given in an Appendix to this report, the maximum price of the buyer and the minimum price of the seller are both $432 (rounded off). A deal is possible.

If the buyer bought the asset for $432, how would he fare after five years? The buyer would have received an income of $500 over the life of the asset. Over the five years, however, he would have paid back $432 to his creditor, returning the principle borrowed plus a total interest payment of $68 (rounded off). In short, the buyer would have paid out $500 for the $500 that he received. His cash outflow equals his cash inflow. He started with nothing and wound up with nothing. The general rule is that, if markets work efficiently and if the buyer functions only as a non-speculative investor, the price paid

(i.e., the amount borrowed) plus the interest paid on the debt will just equal the income generated by the asset over its life. This principle also holds in the case of an asset with perpetual life.

Asset with Perpetual Life. Assume an asset with a perpetual life that generates an annual after-tax income of $100. Further assume that the buyer and seller have the same information, the same risk preference, and are subject to the same discount rate of five percent. Under these conditions, the maximum price that the buyer will pay and the minimum price that the seller will accept is $2,000 ($200 ÷ .05). Assume that the buyer borrows $2,000 for ten years to buy the perpetual asset. At the end of the ten years, the buyer will own the asset and its future stream of income. He will, however, have received only $1,000 in income while he will have repaid the $2,000 that he borrowed plus ten years of interest. In short, after ten years he will own the perpetual asset but he will have paid out much more than he received during that time. After ten years the asset should begin to pay back his arrears. Theoretically, however, over time, this transaction should also wash, i.e., the cash inflow should equal cash outflow.

If the general principle holds that repayment of principle plus the interest paid equals the income generated by the asset over its life, how can a buyer borrow, invest, pay back, and still make money? It can be done but under a different set of circumstances than those that govern the general principle. A buyer, for example, can make money if he has better information

than the seller, is a better negotiator than the seller, is both more risk prone and lucky, or is able by one way or another to increase the annual income generated by the asset. Income can be increased in the following two ways. If the buyer is an operator as well as an investor and if he is more efficient than the seller, income will increase because of the more efficient operation. Second, income will increase if the buyer gets an income tax break that was not available to the seller. It should also be noted, however, that the buyer can lose if it turns out that the seller had better information, that the buyer encountered bad luck, or that income fell because, for example, the buyer was a less efficient operator.

The above analysis is relevant to the proposed AGSOC program in at least two ways. First, it demonstrates the critical role in the viability of an AGSOC of the two "silk purse" tax exemptions that were initially sought and finally refused. And, second, it suggests that AGSOC proponents will begin to promote AGSOC as an operating company rather than as a holding company. As an operating company, an AGSOC would apparently gain a tax advantage through its tax integration feature and might be able to increase income if it proved to be more efficient as an operator than the seller. But AGSOC as an operating company would break with the Kelso tradition as to the nature of investment in his capital diffusion program.

The Holding v. Operating Company Issue. The federal enabling statute simply empowers a GSOC "to invest in properties." It is assumed that this empowers the GSOC not only to purchase

and hold securities in other corporations (the holding company issue) but also to purchase assets and operate a business in its own name (the operating company issue). As a holding company, the federal law limits a GSOC's holding to 20 percent of the stock of any corporation. As an operating company, however, a GSOC can apparently own 100 percent of the assets of a business operated under its own corporate name.

In the Kelso scheme of things, the 90 percent of households were to be allowed to invest only in a limited group of corporations. This group was more broadly conceived in CM than in the later TFT and PA. In CM individual households were to purchase directly the stock in existing corporations so as to realize a "balance between securities of well-seasoned corporations and those of still somewhat speculative businesses;" investment in the securities of "brand new and completely unseasoned enterprises" as well as those of "unseasoned and speculative" (CM, p. 241) firms was to be denied. Concern over the need to reduce the level of concentration, however, induced Kelso and Adler to suggest that the program "should direct a predominant share of new capital formation into new enterprises owned by new capitalists" (CM, p. 215). In later writings investment recommendations became more cautious.

In TFT Kelso and Hetter wrote of investment only in terms of "well-managed" firms (TFT, p. 61 and P. 97). Speiser in his PA is more descriptive. According to him, Kelso advocated investment only in the "big winners," the "profitable giants" (PA, p. 56), the "major successful businesses" (PA, p. 54), and

and the "largest and most successful" corporations (PA, p. 80). Investment was to be discouraged in "new start-up ventures" (PA, p. 56) and in "venture capital (because that) is a game to be played by the very wealthy" (PA, p. 80).

In sum, investment by households was to be done either directly or through a special mutual fund arrangement in major, well-managed corporations. Investment in speculative or start-up ventures was to be discouraged. In no event and at no place did Kelso and his associates in the three books covered in this report recommend a comprehensive capital diffusion program that would involve creation of and investment by non-capitalists in a special corporation that would both acquire productive assets and manage the operation.

As we noted in the previous section, AGSOC proponents may well come under increasing pressure to transform an AGSOC from a holding company into an operating company. Such a development would certainly break with Kelso's previous reasoned conceptions of the nature of investment by non-capitalist households in the corporate economy. The expected result of this development would be significantly to increase both the risk characteristics and the degree of uncertainty associated with the AGSOC. There would probably be adverse effects on the ability to secure 100 percent debt financing and on the probability of a reasonable pay-out period.

Appendix

The discounted present value of a future income stream is calculated by this formula:

$$\frac{Y_1}{2+i} + \frac{Y_2}{(2+i)^2} + \frac{Y_3}{(2+i)^3} \cdots + \frac{Y_n}{(2+i)^n} \quad \text{where}$$

Y is the annual income for that year, i is the discount rate, and n is number of the years in the asset's life. If we assume Y to be $100, i to be 5 percent, and the life of the asset to be five years, the result of the calculations would be:

$$\frac{\$100}{1.05} + \frac{\$100}{1.1} + \frac{\$100}{1.16} + \frac{\$100}{1.22} + \frac{\$100}{1.28} =$$

$$\$95.24 + \$90.90 + \$86.21 + \$81.97 + \$78.13 = \$432.45$$

The buyer should, therefore, be willing to pay $432 for the asset or less. Using the same calculations, the similarly situated seller would accept no less than $432.

If the buyer borrowed $432 for five years at five percent to buy the asset, his situation at the end of five years would be:

1. He would have received $500 in income over the five year period.
2. He would have paid back the $432 he borrowed plus $68 in interest payments on the declining balance to the creditor--a total of $500.

In short, his cash inflow would equal his cash outflow for the five year period.

2111 Dawnlight Court
Anchorage, AK 99501
February 12, 1980

Representative Russ Meekins, Jr.
Chairman, House Finance Committee
Pouch WF
Juneau, Alaska 99811

Dear Russ:

Enclosed please find my examination of the proposed Alaska General Stock Ownership Corporation (AGSOC), entitled "Alaska's AGSOC Plan: A Study in Political Economy." As you know, this paper was prepared for the House Finance Committee under contract with the Division of Legislative Finance.

Given the formidable task of evaluating the potential implications of such a complex plan, I have endeavored to keep my analysis as clear, concise, and brief as possible. Please feel free to call on me if you need clarifications on any part of the paper.

I hope that my remarks will prove valuable to you and your committee as you evaluate the AGSOC bill.

Sincerely,

Larry

Larry L. Ross

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COMMITTEE

ALASKA'S AGSOC PLAN:

A STUDY IN POLITICAL ECONOMY

by

Larry L. Ross

Prepared for
The House Finance Committee
of the State of Alaska
under contract with
The Division of Legislative Finance

February 15, 1980

I. INTRODUCTION

"Share the wealth. Every man a king." The history of America is dotted with innumerable schemes which promised to alleviate the trend toward an unequal distribution of wealth and its counterpart, income. In the mid-1800's Karl Marx and Friedrich Engels proposed a proletarian revolution to overthrow the capitalist mode of production. The more conservative Henry George, "a printer who thought much about economics,"[1] was nearly elected mayor of New York City in 1886 on a platform based on a single tax on land. In the 1930's Governor Huey Long of Louisiana promised to revise capitalism and make "every man a king." More recently, Howard Jarvis of California led a taxpayers' revolt culminating in the passage of Proposition 13, and is presently promoting a constitutional amendment to limit spending by the federal government.

The people of Alaska are now being asked to consider the implementation of an Alaska General Stock Ownership Corporation (AGSOC). Heavily supported by Senator Mike Gravel, the AGSOC proposal was developed by Louis Kelso of San Francisco, father of such share-the-wealth plans as ESOP (Employee Stock Ownership Plan) and CSOP (Consumer Stock Ownership Plan). According to Kelso, AGSOC is an "attempt to change the course of American Economic History, and eventually world history,"[2] by spreading the ownership of productive capital among a broad base of the

citizenry. Kelso introduces his AGSOC proposal through a scathing attack of capitalism reminiscent of that levelled by Marx and Engels over a hundred years ago. Yet, in contrast to the founders of modern communism, Kelso's solution to capitalism's inherent tendency toward self-destruction is reform rather than revolution. Embracing the basic tenets of capitalism, Kelso expresses a burning concern that technology is speeding the system toward totalitarianism, the destruction of private property, and a resulting loss of human freedom. Enter AGSOC, a plan which Kelso says will "build the economic power of the people" through a re-distribution of Alaska's wealth.[3] And Kelso's dream is a lofty one: AGSOC, according to its author, "can build general affluence into all Alaskan citizens over a reasonably brief span of time."[4]

II. PURPOSE

The purpose of this paper is to evaluate the Alaska General Stock Ownership Corporation (AGSOC) from an ideological perspective, with an emphasis on economic rather than political analysis. More specifically, the paper (1) compares the AGSOC proposal with the basic tenets of free enterprise as defined and described by classical liberal economists, (2) compares the proposed AGSOC with the contemporary workings of the free enterprise system, and (3) analyzes the potential impact of AGSOC on the centralization of political and economic power in Alaska and the public policy implications of the state government functioning as both guarantor and regulator of AGSOC.

III. AGSOC AND FREE ENTERPRISE

In the view of nineteenth century or classical liberalism, the essence of free enterprise is summarized in one word: freedom. Smith, Ricardo, Say, Malthus, Mill--each valued individual economic freedom above all else. And to each, freedom involved two dimensions: (1) entry--the freedom of the individual to enter an industry, to establish a business enterprise; and (2) laissez faire--the freedom of the individual from restrictions on entry imposed by powerful institutions, most notably government.

Classical liberals believe that the power of government must be both limited and dispersed. In economic affairs, government's role should essentially be restricted to defining and preserving the rights of private property; to, as Milton Friedman states in Capitalism and Freedom, "determine, arbitrate, and enforce the rules of the game."[5] In most cases, therefore, the free market competitive forces of supply and demand should be utilized to provide those goods most wanted by society and to set prices. However, in the limited number of cases "in which strictly voluntary exchange is either exceedingly costly or practically impossible,"[6] government intervention might be justified. Examples according to Friedman include (1) technical monopolies (industries in which normal competition would naturally tend toward monopoly), (2) neighborhood effects (market exchanges which generate either spillover costs or benefits to third

parties), and (3) paternalism (government accepting responsibility to care for persons unable to care for themselves, such as children and the mentally ill).[7] Finally, given the need for government in this limited number of situations, governmental power should be dispersed, not centralized. If government action is needed, let it occur at the lowest level possible, at the city rather than state level, at the state rather than federal level. As Friedman argues,[8]

> If I do not like what my local community does, be it in sewage disposal, or zoning, or schools, I can move to another local community, and though few may make this step, the mere possibility acts as a check. If I do not like what my state does, I can move to another. If I do not like what Washington imposes, I can have few alternatives in this world of jealous nations.

Classical liberal economists identify four distinct categories of productive resources, or factors of production. These are (1) land, or natural resources; (2) labor; (3) capital (tools, machinery, plant, equipment); and (4) entrepreneurial ability (responsibility for organizing production, adapting new technology to production, innovating, bearing risk, etc.). Because each factor is assumed to be scarce relative to human wants, each commands a price or "return" in the marketplace. Thus, rental income flows to land, wages to labor, interest payments to capital, and profit to entrepreneurial ability.

The classical liberal view, then, is that of an economy dominated by free competitive markets and with minimal government interference into individual affairs, a system emphasizing "freedom as the ultimate goal and the individual as the ultimate entity in the society."[9] In such a world, each person would be

free to engage in "free enterprise" as he or she saw fit, to enter into contracts of his/her own choosing. The state's role would primarily be restricted to defining and preserving private property rights, except in cases of technical monopoly, neighborhood effects, or paternalism. With the role of the individual and the state thus defined, the economy would basically be self-regulating and would, in the nineteenth century view, automatically tend toward equilibrium at full employment.

The AGSOC proposal is based on what Louis Kelso, its developer, calls his "theory of Universal Capitalism or Two-Factor Economics."[10] This theory, which identifies only labor and capital as being productive resources, runs totally contrary to the classical liberal recognition of four factors. By omitting land and entrepreneurial ability from the factors of production, Kelso is apparently trying to differentiate himself from the classical liberal tradition as well as from the modern or Keynesian view. One wonders why Kelso does not simply go one step further and, like Marx, recognize only factor, labor, as being the source of all value. This, of course, would not serve Kelso's ends, since ultimately his solution to the unequal distribution of wealth and income under capitalism is reform of the system rather than revolution as proposed by Marxists.

It is interesting to note that, in fact, much of the critique of capitalism contained in Kelso's Report to the Alaska State Legislature bears great similarity to the Marxian analysis. In contrast to the classical liberal view of capitalism as a system offering opportunity and upward mobility for the working

class, both Marx and Kelso see inequality as the natural result of competitive capitalism. And, like Marx, Kelso sees technology as being the engine of historical change. As Kelso states in his Report,[11]

> Labor power is broadly owned by the great majority of American workers, while the ownership of capital is highly concentrated. Thus, as earnings shift from labor to capital, without government interference, more and more income will flow to fewer and fewer people. It is the shifting of income as a result of technology which threatens the foundations of our society. It means that fewer and fewer people will own an even larger portion of our productive power and the income accompanying it while labor receives an ever decreasing portion.

While cloudiness surrounds the relationship between AGSOC and the State of Alaska, there is little doubt that the AGSOC plan deviates significantly from the classical liberal perspective regarding the relationship between business and the state. The AGSOC Educational Committee promotional pamphlet says that[12]

> The state would charter AGSOC and help identify all Alaska residents so that each would get a share of AGSOC stock.
>
> But once AGSOC was launched, it would be on its own.

A careful look at the remainder of this pamphlet, plus the proposed legislation, may lead one to conclude otherwise.

Unlike a private corporation, AGSOC would be created by a political body, the Alaska State Legislature. AGSOC's three incorporators would be political appointees, named to their positions by the governor, the president of the State Senate, and the speaker of the Alaska House of Representatives. These political appointees would then choose AGSOC's board of directors, which would appoint management. To whom will AGSOC's managers and directors ultimately be responsible, if not to the politicians

who created them?

In contrast to the classical view of free enterprise as emphasizing almost exclusively private initiative and private financing of business, AGSOC would be tied to the state from its inception. These ties would include at the very least state loans or loan guarantees to pay AGSOC's start-up costs, and might also involve either state loan guarantees or direct state loans to finance AGSOC's proposed investments in large scale projects such as the Trans Alaska Pipeline System (TAPS), a natural gas pipeline, a fish processing plant, etc. Senator Gravel's comments notwithstanding, one wonders what rational businessperson would be willing to lend millions of dollars to a corporation which has no assets, no "track record," and therefore no collateral. The strong likelihood exists that AGSOC, conceived and born by an act of the state, will remain dependent on the state throughout its lifetime. Such government involvement in the private sector might be justified by classical liberals on the grounds of technical monopoly, neighborhood effects, and/or paternalism. But Kelso clearly points out that his motivation is to create a more equitable distribution of wealth and income in Alaska, to correct "the destruction of private property in the American economy, and hastening [of] the totalitarian society. . ."[13]

One of the beauties of the free enterprise system is that it treats everyone equally. The marketplace imposes severe fines on those who discriminate; racial ethnic, sexual distinctions are struck down by the impersonal free market. Each individual receives equal opportunity, equal access to economic power.

The AGSOC promotional pamphlet states that AGSOC would be "owned by all Alaskans."[14] This statement is deceiving. In reality AGSOC would not be owned by all Alaskans, but instead by a special class of Alaskans, those persons residing in the state between two specific points in time. Persons emigrating from Alaska before this period, and persons immigrating into Alaska after this period, would in general be excluded from AGSOC ownership. (Within limitations, some of these people might be able to acquire AGSOC shares secondhand.) From the classical liberal perspective, the proposed AGSOC would, through a political act, foster and promote economic discrimination in Alaska, a discrimination which, according to Kelso, is necessary in order to prevent dilution of capital.[15] Kelso even acknowledges that AGSOC is inconsistent with the principles of free enterprise: "ownership of shares is restricted to residents of Alaska, limiting the ability to develop a competitive and realistic market for the shares of AGSOC."[16]

Under the model of pure capitalism, the risks and uncertainties associated with free enterprise are borne by the owners of businesses. Profits (and losses) flow to entrepreneurs as compensation for sacrificing their scarce factor of production. AGSOC deviates from this model in that AGSOC shareholders and AGSOC risk-bearers are two different groups of people. As previously mentioned, AGSOC would be owned by a special limited class of Alaskans. Yet the risks and uncertainties associated with AGSOC's investments would be borne by all Alaskans collectively, through the state's guarantees of loans to AGSOC,

and/or direct state loans to the corporation. Put another way, all Alaskans, through use of state money, may wind up having to pay for AGSOC's losses. (This possibility was astutely pointed out by Mike Doogan in "An Analysis of the Two-Factor Theory As Applied to Alaska in Proposals for an Alaska General Stock Ownership Corportion.")[17] Contrary to the AGSOC promotional pamphlet's statement that "the idea behind AGSOC is to make every Alaskan a 'capitalist,'"[18] it appears that AGSOC might make some Alaskans capitalists, but at the expense of making all Alaskans share the risk of the capitalists' losses.

Included among the basic tenets of free enterprise are freedom of entry (the ability of individuals to both enter and leave markets of their own free will) and freedom of contract. The proposed AGSOC, by imposing restrictions on the selling and transfer of shares, as well as on the number of shares owned by a single shareholder, appears to curb both freedom of entry and freedom of contract, and to severely restrict traditional rights of private property. Kelso's Report to the Alaska State Legislature recommends "a far-ranging educational and communications program between AGSOC and its shareholders to encourage them to not sell their AGSOC shares." This program, when combined with Kelso's recommendation that, during the initial five year period, the selling price of any AGSOC stock "be pegged at book value, which could significantly discourage such sales,"[19] contradicts the principles of free enterprise and competitive capitalism.

Conclusion

The AGSOC plan, as proposed by Louis Kelso and Senator Mike

Gravel, represents a vast departure from the world of free enterprise envisioned by classical liberals. By imposing restrictions on free entry and private property rights, and by extending the role of the state into economic matters, AGSOC contrasts significantly with the dreams of Adam Smith and Milton Friedman. Despite the heralding of AGSOC as "a way to give everyone a stake in the free enterprise system,"[20] one is inevitably led to the conclusion that AGSOC would revise and perhaps re-define "free enterprise" to suit public (and perhaps private) aims.

IV. AGSOC AND MODERN CAPITALISM

America in the late twentieth century lies far from the dream world of pure capitalism envisioned by classical liberals. Big business, big banks, and big unions abound; the annual sales of our largest corporations exceed the Gross National Products of many foreign nations. Regardless of one's ideological viewpoint, it is difficult to deny the existence of significant market power (the ability of a firm to influence or set price) and its counterpart, barriers to entry.

Coupled with market power and barriers to entry is the fact that both income and wealth are unequally distributed in the United States. In 1976, for example, the lowest 20 percent of families received 5 percent of the income, while the highest 20 percent received 41 percent of the income; in addition, the top 5 percent of American families received about 16 percent of total income. Wealth (income-producing assets such as stocks, bonds, and land) is even more unequally distributed: it is estimated that in 1970 almost 40 percent of the country's wealth was held by less than 4 percent of the population.[21]

To promote distributional equity, to curb abuses of market power, and to insure freedom of entry, government at all levels has expanded its scope since the 1930's. Classical liberals limited government to defining and preserving private property rights and to providing those goods justified by technical

monopolies, neighborhood effects, and paternalism. Government today far exceeds those boundaries, extending into nearly every aspect of American life, including (1) maintaining competition (e.g., antitrust, regulation, nationalization); (2) redistributing income (e.g., welfare, Medicare, subsidies, farm price supports, minimum wage laws, progressive income); and (3) stabilizing the economy through both monetary and fiscal policy, and direct market interventions such as wage-price controls. Federal, state, and local government expenditures today comprise roughly one-fourth of our Gross National Product.

The AGSOC plan of Louis Kelso is billed as a method of redistributing the wealth of Alaska so as to create a more equitable distribution of wealth and income. Any person who believes in the dignity of man and in egalitarian principles would have difficulty questioning AGSOC's stated aim: "to build the ownership of income producing capital into Alaskan residents."[22] The fundamental question is, therefore, not what is AGSOC's purpose, but will it <u>accomplish</u> its purpose?

As mentioned in section III of this paper, AGSOC would not benefit all Alaskans, but instead would bestow the privilege of owning wealth upon a special limited class of Alaskans. Furthermore, as Doogan points out, a potential exists for <u>10 percent</u> of AGSOC shareholders to wind up owning <u>100 percent</u> of AGSOC stock.[23] This raises doubts about AGSOC's ability to promote equity in wealth and income distribution.

What would be the effect of AGSOC on market power and barriers to entry? While this topic is pursued in section V of

this paper, suffice to say that it appears that AGSOC will do little to either reduce the market power of big business, big banks, and big labor, or to break down existing barriers to entry. AGSOC, in fact, by creating a huge corporation with the state of Alaska's "blessing," may even intensify tendencies toward oligopoly and monopoly. State loans and/or loan guarantees to AGSOC, plus politically appointed incorporators and politically sensitive directors and managers, may actually have the effect of expanding the symbiotic relationship between American business and government which economist John Kenneth Galbraith describes in The New Industrial State. Instead of free enterprise, argues Galbraith, "we have an economic system which, whatever its formal ideological billing, is in substantial part a planned economy."[24]

Conclusion

AGSOC's ability to alter existing inequities in the distribution of wealth and income is doubtful. It also appears that AGSOC would be ineffective as a means of limiting market power or decreasing barriers to entry; in fact, through its mutualistic relationship with the state of Alaska, it may solidify existing market structures and hasten the "planned economy."

V. AGSOC, POWER, AND THE STATE

AGSOC, a "strictly private enterprise, not a state corporation"[25] according to its supporters, is presented as a means of diffusing economic power in Alaska, a grass roots plan to return power to the people. However, as argued previously, it is not entirely clear that AGSOC will accomplish this goal; in fact, existing concentrations of power may be perpetuated and even increased if this plan is adopted. One thing is certain: AGSOC represents a blurring of the distinction between government and business, between public and private, between the individual and the state, between politics and economics.

The possibility that AGSOC may cause further centralization of economic power in Alaska has already been pointed out. AGSOC, by a <u>political</u> act, creates <u>economic</u> consequences, including at least (1) the birth of a special and limited class of Alaskans, owners of AGSOC capital; and (2) the potential for AGSOC to end up being owned by only 10 percent of its original shareholders. AGSOC owners and AGSOC risk-bearers are different groups of people; <u>all</u> of Alaska's residents, through state loans and/or loan guarantees to AGSOC, must bear the risk associated with AGSOC's investments. Yet, the profits made from such investments accrue only to the restricted class of AGSOC shareholders.

The separation of ownership and control in the modern corporation is an accepted fact of life. While AGSOC ownership would appear to be quite broadly diffused, as least during the

initial five-year period, day-to-day control of AGSOC would lie in the hands of a few managers. A small management group chosen by an even smaller group of directors would possess power to make economic decisions affecting the lives of thousands of Alaskans. And these decisions would very likely be backed financially by all Alaskans collectively through the state.

It has been proposed that AGSOC invest in large scale capital-intensive enterprises, such as the Trans Alaska Pipeline System, the natural gas pipeline, etc. Such investments could, in effect, create a huge octupus-like holding company, whose tentacles extend into a variety of industries. The power of such a company could be enormous. It is apparent that AGSOC might involve extensive antitrust implications for both intrastate and interstate commerce.

The classical liberal tradition warns us that when political and economic affairs are mixed, a strong likelihood of concentration and centralization of power exists:[26]

> The fundamental threat to freedom is power to coerce, be it in the hands of a monarch, a dictator, an oligarchy, or a momentary majority. The preservation of freedom requires the elimination of such concentration of power to the fullest possible extent and the dispersal and distribution of whatever power may be eliminated--a system of checks and balances. By removing the organization of economic activity from the control of political authority, the market eliminates this source of coercive power. It enables economic strength to be a check to political power rather than a reinforcement.

AGSOC would be a politically created economic enterprise. AGSOC's incorporators, political appointees, would appoint a board of directors which would then hire management. To whom would AGSOC's managers and directors be ultimately responsible,

if not to the state which gave birth to them? Would AGSOC be allowed to endorse political candidates or to make political contributions? If so, might it not exert much political as well as economic power? Would state and federal government employees, and elected and appointed government officials, be eligible to serve as AGSOC directors or managers? If so, conflicts of interest might naturally arise. Could managers or directors of existing large corporations also sit on AGSOC's board? And what about the probable formation of large AGSOC voting blocs by special interest groups? These are merely a few questions that need to be answered before definite conclusions can be reached concerning AGSOC's effect on the centralization of political and economic power in Alaska.

Several persons, including the governor of Alaska, have pointed out the tendency for AGSOC interests to at one time or another be at odds with state interests. The state is placed in the ambivalent position of being asked to serve as both guarantor and regulator of AGSOC. One wonders how effectively the state can function in both roles. For example, the state creates the AGSOC, which then becomes a profit maximizer seeking to exploit Alaska's natural resources; this exploitation is perhaps even supported by state loans or loan guarantees. Yet, the state is also charged with the responsibility of preserving the aesthetic qualities of the Alaska wilderness. Might not a conflict arise? In addition, would it not be in AGSOC's best interest for state income taxes on corporations to be lowered or even eliminated, or for AGSOC to receive a "special" exemption from state taxes?

If so, one measure of the cost of AGSOC might be the loss of state income tax revenues and the resulting foregone social welfare programs flowing to Alaskans. The AGSOC plan, offered as an aid for those at the lower end of the income scale, might actually result in a net loss in these groups' economic wellbeing.

Conclusion

Milton Friedman cautions that "if economic power is joined to political power, concentration seems almost inevitable. On the other hand, if economic power is kept in separate hands from political power, it can serve as a check and a counter to political power."[27] The AGSOC plan, if implemented, could create a monster whose power is immune from checks and balances; at the very least, a political allocation of resources would in some cases probably be substituted for an economic one (and also, sometimes, vice versa).

The changes which AGSOC would bring about in Alaska are unclear, and individual reactions to the plan are presently colored by emotionalism and rhetoric. Eventually, it is hoped, the fate of this share-the-wealth proposal will be decided through rational analysis tempered with careful consideration of Alaskans' values. Perhaps the following can serve as a guideline:[28]

> Freedom is a rare and delicate plant. Our minds tell us, and history confirms, that the great threat to freedom is the concentration of power. Government is necessary to preserve our freedom, it is an instrument through which we can exercise our freedom; yet by concentrating power in political hands, it is also a threat to freedom. Even though the men who wield this power initially be of good will and even though they be not corrupted by the power they exercise, the power will both attract and form men of a different stamp.

FOOTNOTES

[1]Paul A. Samuelson, Economics (10th ed.; New York: McGraw-Hill Book Company, 1976), p. 564.

[2]Kelso & Co., Inc., Design of an Alaskan General Stock Ownership Plan: A Report to the Alaska State Legislature, Vol. I (San Francisco: Kelso & Co., Inc., 1979), p. 9.

[3]Ibid., p. 24.

[4]Ibid., p. 16.

[5]Milton Friedman, Capitalism and Freedom (Chicago: The University of Chicago Press, 1962), p. 27.

[6]Ibid., p. 28.

[7]Ibid., pp. 28-34.

[8]Ibid., p. 3.

[9]Ibid., p. 5.

[10]Kelso et al, p. 15.

[11]Ibid., pp. 70-71.

[12]It's Time to Take Stock in Alaska (Anchorage, Alaska: AGSOC Educational Committee, 1979), p. 2.

[13]Kelso et al, p. 25.

[14]It's Time to Take Stock in Alaska, p. 1.

[15]Kelso et al, pp. 79-80.

[16]Ibid., p. 27.

[17]Mike Doogan, "An Analysis of the Two-Factor Theory As Applied to Alaska in Proposals for An Alaska General Stock Ownership Corporation"(paper prepared for the House Finance Committee of the State of Alaska under contract with the Division of Legislative Finance, March 9, 1979), pp. 12-13.

[18]It's Time to Take Stock in Alaska, p. 2.

[19]Kelso et al, p. 7.

[20] It's Time to Take Stock in Alaska, p. 1.

[21] William P. Albrecht, Jr., Macroeconomic Principles (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1979), pp. 70-71.

[22] Kelso et al, p. 7.

[23] Doogan, p. 14.

[24] John Kenneth Galbraith, The New Industrial State (Boston: Houghton Mifflin Company, 1967), p. 6.

[25] It's Time to Take Stock in Alaska, p. 2.

[26] Friedman, p. 15.

[27] Ibid., p. 16.

[28] Ibid., p. 2.

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THE RELATIONSHIP

BETWEEN

CASH FLOW AND TAXABLE INCOME

IN

GENERAL STOCK OWNERSHIP CORPORATIONS

Senator Mike Gravel

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EXECUTIVE SUMMARY

The Potential Problem

The law governing GSOCs attributes GSOC taxable income to GSOC shareholders raising the possibility of shareholder tax liability on attributed GSOC income in excess of GSOC cash distributions. This could present hardships for the shareholders who might not have sufficient funds to pay the taxes due.

When Can It Occur

Shareholder tax liability in excess of cash available for distribution can occur when the corporation has (1) cash flow expenditures which are non-deductible for tax purposes or (2) items included in taxable income which do not represent cash flow income.

Examples of non-deductible cash flow expenditures include principal amortization on installment debt, some political and charitable contributions, the excess portion of unreasonably high salaries, illegal payments and contributions to non-qualified or disqualified retirement plans. Examples of items included in taxable income which do not represent cash flow income include depreciation and investment tax credit recapture income and income from installment sales with excessive down payments.

Shareholder Protection

The special tax treatment for GSOCs must be elected. If no election is filed the GSOC is taxed as a regular business corporation. To qualify for the election the corporation must meet the requirements of a GSOC which include limitations desireable in any state chartered broadly owned corporation.

GSOC management is the shareholders' first line of defense. Potential problems can be avoided with careful planning. However, since corporate management may err the law provides for termination of the special tax treatment voluntarily upon request of the corporation or involuntarily by operation of law. Termination closes off the attribution of corporate taxable income to the shareholders and the corporation is taxed as a normal business corporation. As a last resort the state legislature can revoke the GSOC corporate charter terminating its existence.

Conclusion

GSOC management has the tools to prevent shareholder tax liability in excess of GSOC distributions. Failing this the law allows the termination of special tax status in a number of ways closing off the attribution of income to the shareholders and protecting them regardless of management decisions.

The General Stock Ownership Corporation (GSOC) provisions of the Internal Revenue Code (Subchapter U, Sections 1391-1397) present an interesting question regarding the relationship between taxable income and cash flow of the corporation and distributions to its shareholders. Several witnesses before the State Affairs Committee have commented upon this issue during consideration of HB 240. This paper analyses the potential problem and the protections for the shareholders built into the statutes.

THE POTENTIAL PROBLEM

Subchapter U of the Internal Revenue Code (Code) provides that the taxable income of a GSOC is attributed annually to its shareholders. With minor exceptions taxable income of a GSOC is computed in a manner similar to other corporations. Shareholders must include in income for tax purposes their share of GSOC income for the year. The tax liability of a GSOC shareholder arising because of his share ownership is determined by multiplying the income attributed to him from the GSOC by his marginal tax rate. This tax is increased by the shareholder's portion of any net investment recapture tax and reduced by his share of any net investment credit.

To provide shareholders cash sufficient to meet the tax liability created by the attribution of GSOC income the Code requires a GSOC to distribute annually to its shareholders an amount equal to at least 90 percent of its taxable income. This distribution requirement applys irrespective of corporate

cash flow. However, if the GSOC fails to make the required distribution the only penalty is a 20 percent deficiency tax assessed against the corporation. Application of this tax does not absolve GSOC shareholders from the obligation to pay tax on the income attributed to them from the corporation.

Taxable income does not necessarily reflect cash flow available for distribution to shareholders. It is an artificial number arrived at in an effort to determine on an annual basis the average earnings of a company or individual over a lifetime. Some items such as depreciation on capital assets reduce taxable income without affecting cash flow while other items which are actual cash flow expenses, such as the repayment of debt principal, do not reduce taxable income. Thus, cash flow after expenses may be either more or less than taxable income.

Concerns have been expressed that GSOC cash flow could be insufficient to meet the distribution requirements and perhaps so low that no distributions occur at all. In such a case GSOC shareholders might have income tax liability as a result of income attributed to them from the GSOC and yet have no cash distributions from the corporation with which to pay the taxes. We shall attempt to analyse the risks presented by this scenario and the protections afforded the shareholders.

WHEN CAN THE PROBLEM OCCUR

Two general types of situations can cause taxable income to exceed cash flow. Taxable income can exceed cash flow where (1) cash flow expenditures are non-deductible for tax purposes

and (2) items of taxable income do not represent cash flow income. The first category of transactions includes the amortization of debt principal, illegal payments and unreasonably high salaries. The second category includes recapture of depreciation and investment tax credits and installment sales with excessive down payments.

Non-deductible Expenditures

Non-deductible expenditures reduce GSOC cash flow available for distribution to the shareholders without reducing taxable income attributed to shareholders for income tax purposes. Carried to an extreme these expenditures could eliminate all the cash in a corporation, but still not reduce the taxable income. The taxable income would be attributed to the shareholders who would incur tax liability based on the attributed income, but the corporation would have no cash to distribute and the shareholders would be required to finance the additional tax liability out of other income. This could work considerable hardship upon many shareholders.

There are many expenses which do not reduce taxable income. The more common of these include contributions to disqualified retirement plans, some charitable and political contributions and the excess portion of unreasonably high salaries. Amortization of debt principal is also a very common non-deductible cash flow expense. Although interest payments on a loan are deductible for Federal income tax purposes payments which reduce the principal amount due on the loan are not. In many cases the non-deductible principal portion of a loan payment may

represent the lion's share of the annual loan amortization cash flow. Since this principal amortization component of debt service requires cash payments from the corporation it is the type of non-deductible expenditure which could cause problems for the shareholders of a GSOC.

Other non-deductible corporate expenses can result in GSOC expenditures which do not reduce taxable income. Generally all ordinary and necessary business expenses are deductible in computing taxable income. However, some political and charitable contributions, the excess portion of unreasonably high salaries, illegal payments and contributions to non-qualified or disqualified retirement plans are not deductible. While this list of items is not exclusive these are the more common non-deductible corporate expenses. The common thread through all of these transactions is that they are avoidable with careful planning by management. There is no event which could involuntarily trigger large increases in taxable income without a corresponding increase in cash flow. The problem presented by loan amortization principal can be avoided through the installment purchase solely of depreciable assets with depreciation schedules carefully arranged to provide tax protection for principal amortization cash flow. This solution is workable becasue, over the life of an asset, depreciation and principal amortization will be the same. Thus, if a problem should occur in this area it will almost certainly be the result of bad management.

Taxable Income Without Cash Flow

The other situation in which cash flow available for distribution may not be adequate to cover the additional shareholder tax liability occurs where items which are included in taxable income do not represent cash flow income to the corporation. Generally, this occurs where a taxpayer has receive cash flow income in the past which was non-taxable at the time of receipt. The inclusion of this cash flow in taxable income occurs at a later date when recognition for tax purposes is triggered by some event. The most common of this income type is recapture income. The law "recaptures" the tax on income which avoided tax at the time it was earned. This prevents the permanent deferral of tax on certain types of income. There are two major kinds of recapture income, depreciation recapture and recapture of investment credits.

Depreciation Recapture

Tax law allows the owner of a capital asset used in a trade or business to recover his initial investment tax free over the life of the asset. The mechanism used to provide this recovery of investment is depreciation. The depreciation deduction reduces taxable income sheltering income from tax. If a taxpayer holds a capital asset for its full useful life he is allowed depreciation deductions equal to its initial cost and can shelter that amount of income from tax.

Depreciation recapture may occur where a taxpayer elects to use accellerated depreciation. Accellerated depreciation

allows additional depreciation deductions protecting from tax income which would otherwise be taxed currently. Accellerated depreciation provides deductions larger in the early years than straight line depreciation. It allows rapid capital cost recovery on depreciable assets in an effort to encourage modernization of capital stocks.

To prevent additional income sheltered by accellerated depreciation from permanently escaping taxation when the asset is disposed of taxable income is increased by the amount by which accellerated depreciation on the asset exceeded straight line depreciation. When this occurs taxpayers may have taxable income without cash flow and other income will be required to pay off the tax liability. Planning can save taxpayers in these situations. Accellerated depreciation shelters cash flow from tax which would otherwise be taxable at the time of receipt. If the taxpayer sets aside this income or a portion of it into a fund for depreciation recapture taxes at the time the asset is disposed of he will have sufficient funds available to pay the tax generated by the recapture income. An example might help to clarify the operation of the depreciation recapture provisions.

> John owns a rental apartment for which he paid $100,000. The unit will last for 20 years. John takes a depreciation deduction each year equal to one-twentieth of his investment or $5,000. This uniform annual depreciation deduction is known as straight line depreciation. After 20 years John will have taken depreciation deductions equal to the $100,000 he paid for the apartment. He will have recovered his investment through income on which he paid no tax.
>
> To encourage investment in rental housing the law allows John to recover his investment in a shorter period of time through accellerated depreciation. In some cases John can elect to take twice the normal depreciation deduction. If he takes a $10,000 depreciation deduction in the first year he will shelter $10,000 from tax. If he then sells the property

for $100,000 he will have a captial gain of $10,000 because he has been allowed to recover $10,000 of his investment tax free. The $10,000 depreciation deduction reduces his basis in the property for capital gains purposes resulting in a basis of $90,000 at the time of the sale.

If John had taken straight line depreciation on the apartment he would have had a capital gain of only $5,000 upon the sale because his basis would have been $95,000 at the end of the first year due to depreciation deductions of $5,000. The additional $5,000 deduction in year one has sheltered from tax $5,000 of additional income for John. However, as we have seen, this $5,000 which is sheltered by accellerated depreciation appears upon the sale of the property as a capital gain receiving special favorable tax treatment.

Through accellerated depreciation John has converted ordinary income into capital gain income taxed at 40% of ordinary income rates. To prevent this conversion of ordinary income into capital gains, or the permanent sheltering of ordinary income, the depreciation recapture provisions step in and require that $5,000 of John's $10,000 gain on the sale be taxed as ordinary income.

This description of one transaction subject to the depreciation recapture rules is for illustration purposes only. These rules are complex and many of the ramifications of these provisions have been excluded from the example in the interests of simplicity.

Investment Tax Credit Recapture

The Code allows an investment tax credit equal to ten percent of the purchase price of certain types of new and used property. This ten percent credit reduces taxes rather than reducing gross income as does a deduction. The property eligible for the investment tax credit is generally depreciable tangible personal property, excluding buildings and structural components, used by an individual or corporation engaged in a trade or business and having a useful life of at least three years.

The investment tax credit may be taken for the year in which the taxpayer places the asset into use in his trade or business.

To prevent the sheltering of income through the investment tax credit Congress provided recapture provisions similar to the depreciation recapture rules. If a taxpayer disposes prematurely of an asset on which he has received an investment tax credit the disposition triggers the recognition of investment tax credit recapture income to the taxpayer in an amount designed to generate tax liability equal to the credit which he earlier received. This investment tax credit recapture income is included in income for the year of disposition and may increase the taxpayer's liability. The recapture income is income only in the tax sense and may or may not represent cash flow. It is an effort to recover tax on income which was earlier sheltered by the investment tax credit. Planning for investment tax credit recapture income involves steps similar to those followed in planning for depreciation recapture income. It can be avoided entirely by not disposing of the asset or it can be funded through a reserve set aside from the income sheltered by the credit.

The law sets up special rules for the treatment of investment tax credits and investment credit recapture in GSOCs. The investment tax credit is not allowed to GSOCs. The investment tax credit to which a GSOC would be entitled if it were taxable flows through to the shareholders in much the same manner as income. The credit and any recapture of investment credit are netted at the corporate level. Thus, if a GSOC has both

investment credits and investment credit recapture income in the same year these items will be set off against each other and only the net credit or recapture will flow out to the shareholders. If there is a net investment tax credit, that amount will be prorated to the shareholders in the same manner as income. The credit will reduce the shareholders' tax liability. Net investment credit recapture is prorated to the shareholders and characterized as additional tax liability. Net investment credit recapture is not treated by the shareholders as additional taxable income, but as a direct addition to tax liability. It is different than depreciation recapture income which is treated as an addition to shareholder income. Investment credit recapture presents a more serious problem for the corporation and its shareholders because it increases tax liability rather than income. However, in nearly every case the generation of net investment credit recapture is avoidable or can be anticipated at the time the asset is acquired.

Installment Sales

The installment sale of an asset can generate taxable income without cash flow. The law allows a taxpayer to defer reporting income on an installment sale until the time payments are made. This allows the income from such a sale to be spread out over the life of the sales contract. However, if the seller receives more than 30 percent of the total contract price in the year of sale the entire gain is taxed as income in the year of sale ins spite of the fact that the seller did not receive

the full sales price at that time and may not do so for several years. this can mean that a seller has tax liability on gains from the sale in excess of the cash he received in the year of sale from the buyer. GSOCs, like other sellers, must operate within these rules.

PROTECTION FOR SHAREHOLDERS

GSOCs must elect to be subject to the flow through character and distribution requirements of subchapter U. Although the GSOC charter must provide "that such corporation shall qualify as a GSOC under the Internal Revenue Code," election of special tax treatment is not mandatory. If no election is filed a GSOC is taxed as a regular business corporation. GSOCs can qualify as such without making the election, however, in such a situation the primary advantage of GSOC status would be foregone.

The Election

There may be good reasons why a corporation might want to qualify as a GSOC and forego the election. If a corporation expected cash flow problems in the early years of operation or invested in projects with high reinvestment requirements it might desire to delay making the election until a more appropriate time. Comparable situations occur in closely held corporations where the owners may elect during loss years to be taxed under subchapter S, a provision allowing flow through of corporate losses and income to the shareholders of small corporations. But, when the corporation begins to turn a profit the election may be revoked and the income taxed to the corporation

rather than the shareholders. This is standard tax planning for high income shareholders of closely held corporations whose personal income tax rates may reach 70 percent. Since the maximum Federal corporate income tax rate is 46 percent, these individuals want losses to flow through to their personal returns and income to be taxed to the corporation. The subchapter S election allows such an outcome in certain cases.

Just as the subchapter S election provides flexibility in tax planning for high income shareholders of closely held corporations the subchapter U election provides flexibility for GSOC tax planning. The special tax treatment provided by subchapter U is not automatic. Election must be made by the GSOC or it will be treated as an ordinary business corporation subject to tax under the provisions of subchapter C, the general corporate tax provisions. The determination of whether or not to elect subchapter U treatment is one of the most important decisions to be made by the board of directors of a GSOC. The election need not be filed immediately upon formation of the corporation.

If the GSOC upon creation does not file an election one might ask why create a GSOC at all. Why not simply create a broadly owned conventional corporation not subject to the strictures of subchapter U? To answer this question we must separate those aspects of subchapter U required to qualify as a GSOC and those which flow from making the election. In so doing we find that the elements necessary to qualify as a GSOC are relatively innocuous. They include:

1. Chartered after 12/31/78 and before 1/1/84,

2. Chartered by legislation or initiative,

3. Charter providing-

- Only one class of stock
- Issuance of at least one share to each resident
- Issuance of shares only to "eligible individuals"
- Election to reject shares
- Transfer restrictions
- Intent to qualify as a GSOC

4. Limitations on use of state's condemation powers, and

5. Affiliated group limitations.

Most of these limitations might be appropriate to any broadly owned corporation initiated by a state. The affiliated group limitation is applicable only at the time an election is filed and a defect here could be cured by a reduction in GSOC subsidiary share ownership below the 20 percent limit prior to filing.

The special tax and distribution provisions of subchapter U apply only to those corporations making the election. In some cases inadequate drafting left ambiguities in this regard which are being clarified by a bill, S.2275, currently pending in the United States Senate. Thus, a corporation can qualify as a GSOC and be taxed as a normal buisness corporation leaving open the option to be taxed under subchapter U if it becomes appropriate at a later date. However, if a corporation does not meet the requirements of a GSOC upon creation it will be difficult to cure the defect if, at some point, the special tax treatment becomes attractive. In fact, if the defect were not cured prior to January 1, 1984, it is likely that attempts to cure the defect and elect subchapter U status for tax purposes would fail. However, if the corporation qualifies as a GSOC prior to January 1, 1984, the statute does not preclude election of

the special tax status subsequent to that date.

Management

The first and most important protection for GSOC shareholders is good management. GSOCs are not follproof. Like any corporation they can be successful only if carefully managed. This is true with respect to investment decisions and day to day operations as well as tax planning. Timing by GSOCs of an election for special tax status is an important management responsibility, but in order to analyse the protections for shareholders from tax liability in excess of cash distributions, we shall assume that the decision to be taxed under subchapter U has been made an a timely election filed.

GSOC management has a responsibility to protect the shareholders from tax liability on GSOC income in excess of distributions from the corporation. It would appear to be a violation of the shareholders' trust to allow any substantial amount of tax liability to befall them without providing distributions adequate, at least, to cover the liability for tax. If the management of a GSOC allowed such an event to occur without a vote of the shareholders it would seem appropriate for the shareholders to replace that management at the next opportunity.

Most of the events which could generate tax liability in excess of cash distributions involve discretionary acts by the corporation. Careful planning and attention to detail can avoid this undesireable result. In some cases the planning must occur at the time an asset is acquired to assure that principal amortization is accompained by depreciation deductions to preclude

mandatory distributions and taxable income in excess of cash flow. So long as management carefully plans its acquisitions and views each transaction with an eye toward its tax consequences problems can be avoided.

It is difficult to visualize an instance where tax liability in excess of cash flow for distribution cannot be avoided by responsible management. Every situation in which such an event could occur would require either an intentional decisions or gross negligence by corporate management. There does not appear to be any involuntary event which could result in this undesireable outcome. Thus, the GSOC management is the shareholders' best protection. However, since negligent management does occur at times in corporations additional protections for the shareholders are built into subchapter U.

Termination of Election

If GSOC management should fail to protect the shareholders from tax liability in excess of cash distributions termination of the subchapter U election may be undertaken either voluntarily or involuntarily. Termination of the election should be used as a last resort since once terminated the special tax status may not be regained by subsequent election. Upon termination of the election the GSOC is treated as an ordinary business corporation for tax purposes. The flow through of taxable income to the shareholders is eliminated and the corporation becomes subject to the corporate income tax.

Voluntary termination may be undertaken with the consent of the Secretary of Treasury. This safety valve was designed to

be available in the very situations which are contemplated in this paper. The provision was included with the concurrance of the Department of Treasury which has no interest in audits involving all the shareholders of a GSOC and preferred a statutory escape clause in the situation where shareholders might be faced with large tax liability and insufficient cash flow. The voluntary termination is effective for the first year to which the Secretary consents. It is effective for the entire year and, if significant tax liability in excess of cash available for distribution is anticipated, the Secretary can be expected to make his consent effective for the year in which the problems arose, thereby protecting the shareholders. Even if management is so negligent that the problem is not discovered until after the close of the taxable year for which it exists the Secretary has authority to grant the revocation of election for any taxable year, even those which have gone by. Thus, the shareholders are protected even if the problem is not discovered until after the close of the corporation's taxable year.

Subchapter U elections may also be terminated without the consent of the Secretary of Treasury in a manner which we shall refer to here as an involuntary termination. The Secretary has no control over whether an involuntary termination occurs. Once certain events occur the corporation ceases to be a GSOC and is removed from the provisions of subchapter U by operation of law.

Involuntary terminations can occur by accident and management must plan carefully to assure that involuntary termination does not occur unintentionally. An involuntary termination occurs whenever an electing corporation fails to meet the

definition of a GSOC under subchapter U. Events which would trigger an involuntary termination of subchapter U status include revocation of the corporation's charter by the sponsoring state, acquisition of more than 20 percent of the stock of another corporation, and amendment of the corporation's charter permitting the issue of a second class of stock.

An involuntary termination of subchapter U status is retroactive to the beginning of the year during which it occurs. Thus, subchapter U status could be terminated involuntarily on the last day of the corporation's taxable year and the flow through of corporate taxable income to the shareholders would be terminated retroactively to the beginning of the corporation's taxable year, 364 days earlier. For the entire year the corporation would be taxed as an ordinary business corporation and the shareholders would have no liability beyond tax on dividends actually distributed by the corporation.

Revocation of Charter

If all of the protections which have been examined should fail the ultimate power over the corporation continues to lie with the legislature of the authorizing state. The corporate charter granted by the state can be revoked by the state. This revocation might be made retroactive to the date on which the legislation was introduced or earlier, perhaps as early as the date on which the GSOC was created. The revocation of the charter terminates the subchapter U status effective the first day of the year for which the revocation is effective. In a charter

revocation all existing contracts of the GSOC would have to be honored, but a receiver could be appointed to handle this task along with liquidation of the corporation. The important aspect of the revocation is that it cuts off the flow through of corporate income tax consequences to the shareholders. Revocation of the corporate charter and liquidation of the corporation is a drastic measure and, with careful management and the other protections afforded under subchapter U, should never be required to protect shareholders from tax liability due to GSOC taxable income in excess of cash distributed to the shareholders by the GSOC.

CONCLUSION

The possibility of GSOC taxable income attributed to the shareholders resulting in shareholder tax liability in excess of cash distributions from the corporation warrants careful consideration by the management of any GSOC. Without careful planning it can occur and could have serious consequences for the shareholders. However, it is the responsibility of the GSOC management to assure that the decsisions which are made with respect to the operations of the corporation do not result in shareholder tax liability in excess of cash distributions. However, if the management of a GSOC fails to adequately protect the shareholders the law allows the termination of the subchapter U election in a number of ways in order to close off the flow through of corporate tax consequences to the shareholders. This assures that are protected regardless of management decisions.

ALASKA

GENERAL STOCK OWNERSHIP

CORPORATION

HOUSE STATE AFFAIRS COMMITTEE

Committee Action to April 27, 1979

BILL SUMMARY

ALASKA GENERAL STOCK OWNERSHIP CORPORATION

The general stock ownership corporation (GSOC) bill provides for the creation of a GSOC in Alaska and a new chapter of Alaska Statutes to regulate it. The AGSOC, taking advantage of new federal law, will be exempt from corporate income taxes. Income will be distributed to the shareholders and they will pay tax at their personal rates. The shareholders will be all the residents of Alaska as of the bill's effective date and stock will be distributed to them free of charge. The AGSOC will borrow funds to finance investments.

FORMATION OF THE AGSOC

The Alaska General Stock Ownership Corporation is formed by three incorporators appointed one each by the Speaker, Senate President and Governor. The incorporators will select nine people to serve as the initial board of directors subject to disapproval within 15 days by two of the three state officials mentioned. The incorporators will prepare and file the articles of incorporation to begin the AGSOC. The articles will include technical requirements of federal law restricting transfer of shares for five years and mandating issue of stock to all Alaska residents.

The directors, appointed by the incorporators, adopt bylaws, hire officers and begin the process of shareholder identification. The initial board serves only until the first shareholder meeting when the appointed directors must stand for election. The initial articles and bylaws of the corporation must be submitted to the legislature within 30 days of adoption and the legislature has 60 legislative days within which to disapprove of any provision by concurrent resolution.

AGSOC SHARES

One share of stock will be distributed free of charge to each Alaskans resident who was a resident on the effective date of the bill. Resident means a person who lives in Alaska and intends to remain here permanently. Only individuals may own AGSOC shares and no one may own more than ten. Each week for three months before issuance of stock the AGSOC must by newspaper, radio and television notify residents of their eligibility to receive stock. A resident who does not wish to receive stock may decline. For one year after the initial stock issue a qualified resident may receive his share of stock without charge and for an additional year may purchase his share for book value.

Federal law requires GSOCs to have a charter providing for the issuance of "at least one share (of stock) to each eligible individual." To fulfill this requirement the first share of GSOC stock must be issued without charge to the shareholders. However, there is no restriction upon subsequent sales of GSOC stock. Thus, provision is made for the subsequent sale of AGSOC stock if the shareholders approve.

SHAREHOLDER POWERS

Each share of stock may be voted at shareholder meetings with 1/3 of the shares required for a quorum. Proxies are prohibited and in their place a corporate ballot and shareholder's pamphlet will be prepared, under regulations insuring fairness, and mailed to each shareholder. Shareholders vote their ballot by mail and cumulative voting is prohibited. The shareholders may nominate directors and place issues on the corporate ballot by petition of 1,000 shareholders. Notice of the right to nominate directors and place issues on the corporation ballot must be made by publication at least 150 days before the shareholder meeting and the meeting notice and ballot must be mailed at least 60 days before the meeting.

AGSOC is required to keep complete books and records available for shareholder inspection and any corporate agent wrongfully refusing shareholder access may be fined $1,000 per day. Shareholders have the right to remove the entire board by a majority vote or any single director by a vote at least as large as that which elected him. The attorney general or 100 shareholders may file suit to remove a director for fraudulent or dishonest acts or gross abuse of authority. Any shareholder may file a derivative suit on behalf of the corporation if those responsible inside the AGSOC fail to do so. The shareholders have the right to amend the bylaws and with a 2/3 vote the articles of incorporation.

DIRECTORS AND OFFICERS

The board of directors has management responsibility for AGSOC. The chariman and at least 3/4 of the board must be Alaskans. Board meetings must be held in the state, but members may participate by conference telephone. Outside directors can never constitute a quorum except when meeting to fill vacancies in the board. AGSOC will have nine directors although the number may be changed in the bylaws. The entire appointed initial board will stand for election at the first annual meeting. Thereafter, members serve for two years with half the board elected each year. Criminal misdemeanor penalties are provided for directors making distributions designed to deceive creditors or shareholders of AGSOC and any agent of AGSOC who makes fraudulent statements regarding the value of shares.

Officers of the AGSOC are appointed by the board of directors and serve at their pleasure. The board establishes the duties of the officers and may replace them at any time.

OTHER PROVISIONS

AGSOC is prevented from making endorsements of political candidates or ballot issues and may not spend money for lobbying of the legislature. Many of the other provisions of the Committee bill have been carried over substantially from existing Alaska corporate law. The provisions regarding sales of assets outside the ordinary course of business, dissolution of the corporation, restatement of the articles of incorporation, requirements for annual reports to the Dept. of Commerce, filing fees and charges, procedural provisions and forms, and power of the Commissioner of Commerce are all basically the same provisions which apply to existing Alaska corporations. The bill does retain the right in the legislature to change the law with respect to AGSOC at any time so long as the creditors of the corporation are protected.

SECTION BY SECTION ANALYSIS

This analysis of Committee action on the Alaska General Stock Ownership Corporation legislation describes the provisions of Section 1 of the Committee bill as of April 27, 1979. Since many of the provisions of the Committee Substitute are carried over wholly or in part from the Alaska Business Corporations Act (ABCA) there is included at the end of each section description a reference to the corresponding section of the ABCA, if any.

ARTICLE 1. SUBSTANTIVE PROVISIONS.

.005. PURPOSES. This section makes it clear that, unless the enabling legislation for a GSOC provides otherwise, the corporation may engage in any legal business. (ABCA 10.05.003).

.010. GENERAL STOCK OWNERSHIP CORPORATIONS. This section makes it clear that corporation organized under chapter 50, Title 10, are general stock ownership corporations subject to Internal Revenue Code Subchapter "U" and are not agencies of the state for any purpose.

.015. GENERAL POWER. This section grants to GSOCs the powers of normal corporations to conduct business. Two changes have been made in adapting the ABCA provisions to GSOCs.

1) There is a limitations in (4) preventing a GSOC from investing in property "acquired by it, or for its benefit, through the right of eminent domain . . . ." This limitation prevents GSOCs from acting in collusion with an agency or local government to acquire a going business from an unwilling seller. GSOCs are not prevented from investing in projects where some minor portion of the project is acquired through condemnation if the local government determines that the exercise of its condemnation power is appropriate.

2) The power to establish stock bonus plans is deleted from subsection (15) because of the special nature of GSOCs and the limitations on share ownership would make it difficult for a GSOC to adopt a qualified stock bonus plan for its employees. If the GSOC desires to have its employees benefit from growth in the value of GSOC stock the corporation could adopt a funded "phantom stock" program. (ABCA 10.05.009).

.020. INDEMNIFICATION OF OFFICERS, DIRECTORS, EMPLOYEES AND AGENTS; INSURANCE. This section is carried over unchanged from the ABCA and allows the corporation to indemnify its directors or employees for expenses and fines incurred as a result of thier actions on behalf of the corporation if they acted in good faith. Indemnification is disallowed in derivative suits where the defendant is guilty of negligence or misconduct in his duties unless the court determines the indemnification is proper. The corporation may purchase insurance on behalf of its directors and employees for claims against them arising out of their corporate positions. (ABCA 10.05.010).

.030. DEFENSE OF ULTRA VIRES. Meaning "beyond the power" an ultra vires act is one which the corporation did not have authority to perform. This section, carried over from the ABCA, provides that this lack of corporate power can be asserted by a shareholder, the corporation, or the attorney general. It may not, however, be asserted by another party to a transaction with the corporation as grounds for failing to perform. (ABCA 10.05.018).

.035. CORPORATE NAME. This section requires that a GSOC include in its corporate name the words "general stock ownership corporation" or an abbreviation thereof. In addition, the name may not be misleading or deceptively similar to the name of another corporation doing business in Alaska. (ABCA 10.05.021).

.040. RESERVATION OF CORPORATE NAME. This section allows a person or corporation to reserve a specific name for a general stock ownership corporation for a period of two years with a renewal period of one year. Reservation of a name might be used where an individual seeks to establish a GSOCs by initiative petition or where an existing GSOC seeks to change its name upon the approval of its shareholders. The name may be reserved by this section during the period in which the necessary activities are undertaken to make the name effective. (ABCA 10.05.024, .027, and .033).

.045. FOREIGN GENERAL STOCK OWNERSHIP CORPORATIONS. General stock ownership corporations chartered in another state and doing business in Alaska are subject to the rules of the Alaska Business Corporations Act (AS 10.05).

.050. REGISTERED OFFICE AND REGISTERED AGENT. The registered agent is the agent for the corporation upon whom legal papers may be served. This provision requires that the corporation maintain a registered office and agent within the state. (AS 10.05.045)

.055. FILING LIST OF REGISTERED CORPORATIONS WITH SUPERIOR COURT.
.060. CHANGE OF REGISTERED OFFICE OR AGENT.
.065. REGISTRATION OF REGISTERED AGENT.
These three sections set out the rules for registration of the registered agent with the Commissioner of Commerce, the listing of registered agents and offices with the superior courts throughout the state, and the method by which a registered agent may change the registered office or resign his position. These provisions are carried over intact from AS 10.05.048, .051, and .054 respectively.

.070. SERVICE OF PROCESS ON CORPORATION. In addition to designating the registered agent as agent for service of legal papers on the corporation this section allows the Commissioner of Commerce to be served on behalf of the corporation when the registered agent cannot be found. (AS 10.05.057).

.075. CREATION AND ISSUANCE OF SHARES. This section allows the corporation to create and issue shares of no par value stock. The total number of shares available for issue must be stated in the articles of incorporation. GSOCs are prohibited from issuing "par value" stock since that concept, developed for the protection of shareholders, has no application in a corporation such as the GSOC where shares are to be distributed initially without payment by the shareholders.

.080. CONSIDERATION FOR SHARES. The federal GSOC legislation requires that a GSOC have a charter providing for the issuance of "at least one share (of stock) to each eligible individual." In order to fulfill this requirement it appears that the first share of GSOC stock must be issued without charge to the shareholders. However, there does not appear to be any restriction in the federal legislation upon subsequent sales of stock by GSOCs except for the general limitations upon share ownership. In keeping with the Committee's desire for a generally applicable GSOC chapter provision is made for the subsequent sale of stock by GSOCs. Thus, this section allows the GSOC to issue shares without consideration or for a payment fixed in advance by a vote of the shareholders.

Sales of corporation stock by the corporation may not be made at a price in excess of book value if the shares sold are treasury shares, that is shares which have been issued and repurchased by the corporation. (AS 10.05.096).

.085. PAYMENT FOR SHARES. Payment for shares may be made in cash, other property or services, but not in notes or future services. (AS 10.05.099).

.090. JUDGMENT OF BOARD OR SHAREHOLDER AS TO VALUE OF CONSIDERATION CONCLUSIVE. This section allows the directors or the shareholders to conclusively determine the value of payment for shares in the absence of fraud. (AS 10.05.102).

.095. EXPENSES OF ORGANIZATION, REORGANIZATION AND FINANCING. In sales of stock by a corporation shares entitled to the full protections of limited liability must be fully paid and nonassessable. This means that the full sales price for the stock has been received by the corporation. However, if the stock is sold through an underwriter the fees will come out of the sales proceeds before they are paid to the corporation. Likewise, the organizational expenses of the corporation may be paid out of stock sales before the proceeds are remitted to the corporation. This section clarifys that in such cases the shares are deemed to be fully paid. (AS 10.05.111).

.100. CERTIFICATES REPRESENTING SHARES. This provisions sets out the requirements as to form of stock certificates which must be signed by the corporate officers. (AS 10.05.114)

.105. INFORMATION REQUIRED TO BE STATED ON CERTIFICATE. The stock certificates or other evidences of ownership must include information regarding the person to whom they are issued, that they are no par value shares, and that the corporation is organized in Alaska. (AS 10.05.117).

.110. FULL PAYMENT REQUIRED FOR CERTIFICATE. If payment is required for shares they may not be issued until full payment is received. (AS 10.05.120).

.115. ISSUANCE OF FRACTIONAL SHARES. GSOCs may issue fractional shares of stock and these fractional shares hold dividend, voting and distribution rights equal to their fractional interest. It may be necessary for a GSOC to issue fractional shares in the situation where a shareholder leaves his stock to his heirs and there is more than one child beneficiary. (AS 10.05.123).

.120. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS. This section, adopted directly from ABCA, limits the liability of shareholders and those who have agreed to purchase share to the amount which they agreed to pay to the corporation for the shares. Subsequent holders of the stock are protected if they received the stock in good faith. (AS 10.05.126).

.125. BYLAWS. The board of directors adopts the initial bylaws of a GSOC subject to review and rejection by the legislature under section 335 of the bill. Subsequent bylaws may be adopted, amended or repealed by a vote of either the shareholders or directors.

.130. MEETINGS OF SHAREHOLDERS. The time and location of the annual shareholders meeting is established in the bylaws. The specific place is set by the board. Special shareholder meetings may be called by the president of the GSOC, the board or the holders of at least 1,000 shares. Shareholder meetings may be teleconferenced. (AS 10.05.138).

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.135. NOTICE OF SHAREHOLDER'S MEETINGS. This section requires written notice of shareholder's meetings mailed to shareholders not less than 60 days before the meeting. In addition, notice of shareholders' rights to add ballot issues or nominate directors must be made by publication at least once a week for four weeks beginning at least 150 days before the meeting. (AS 10.05.141).

.140. CLOSING OF TRANSFER BOOKS AND FIXING RECORD DATE. To determine the shareholders of the corporation for purposes of a dividend distribution or voting rights the transfer books of the corporation may be closed prior to the date of the proposed activity or a "record date" may be established and the shareholders determined as of that date. Time limits are provided beyond which the transfer books may not be closed in order to protect shareholder voting rights and to allow interested parties to inspect the share records of the corporation prior to shareholders' meetings. (AS 10.05.144).

.145. VOTING LIST. The responsible officer of the corporation must make available at the registered office of the corporation beginning at least 60 days before any shareholders' meeting a list of the shareholders eligible to vote at the meeting and access to this list must be provided to all shareholders. (AS 10.05.147).

.150. QUORUM OF SHAREHOLDERS. 1/3 of the shares constitute a quorum for action by the shareholders and a majority vote of a quorum is sufficient to bind the shareholders in most cases. (AS 10.05.153).

.155. PROXY VOTING PROHIBITED. Because of the ballot mechanism whereby each shareholder is allowed to vote in person through his ballot proxies are unnecessary in general stock ownership corporations and are therefore prohibited.

.160. VOTING FOR DIRECTORS. Each shareholder may vote his shares for directors but cumulative voting is prohibited. This means that each share can cast only one vote for director in any contested election for a directorship position.

.165. VOTING OF SHARES IN THE NAME OF ANOTHER.
.170. VOTING OF PLEDGED SHARES.
These sections allow shares held by an administrator, executor or guardian to be voted by him without a transfer of the shares into his name. Shares held by a pledgee may be voted by the pledgor until transferred into the pledgee's name. (AS 10.05.165 and . 168).

.175. CORPORATION BALLOT. Voting at meetings of shareholders will be by ballot rather than through the normal corporate vehicle of proxies. The ballot will be prepared by the corporation subject to review for fairness by the Commissioner of Commerce. It will be mailed to each shareholder with the notice of the shareholders' meeting and voted by mailing it back to the corporation before the date of the meeting.

Shareholders may, by petition of 1,000 or more, nominate directors and place issues on the corporate ballot. In addition, the directors may place issues and candidates on the ballot by a majority bote. Information on board candidates and ballot issues is to be provided to the shareholders by the corporation and these materials will be filed with the Commissioner of Commerce and subject to the regulations and criminal penalties applicable thereto.

.180. BOARD OF DIRECTORS. The board of directors is charged with management responsibility for the corporation and their compensation is to be fixed in the bylaws. The chairman and at least 3/4 of the board must be residents of Alaska insuring that outside directors may never constitute a quorum of directors except when meeting to fill vacancies in directors seats until the next shareholdler meeting. Officers or employees of the corporation may not serve on the board of directors. (AS 10.05.174).

.185. NUMBER OF DIRECTORS. The minimum number of directors is three and the number is to be fixed in the bylaws except that the original number is fixed by the enabling legislation. If the bylaws are silent the number fixed in the enabling legislation is the proper number. The number of directors can be changed through a bylaw amendment.

The board members serve for two year terms and they are to be divided into classes with only half the board standing for election at any one annual meeting. This staggering of the board members' terms provides for some continuity of management on the board of directors. (AS 10.05.177).

.190. ELECTION OF DIRECTORS. Directors are to be elected at the annual meetings and each director hold office until his successor is elected and qualified. This prevents gaps in board membership except upon death or incompetance of a board member. (AS 10.05.183).

.195. VACANCIES. Vacancies in the board caused by death, resignation or incompetance may be filled by a majority vote of the remaining directors. Directors elected by the board to fill a vacancy must stand for election by the shareholders at the next shareholders' meeting and are elected to fill the remaining portion of the directors position originally filled by vote of the board. No vacancy may continue for more than 6 months or until the next shareholders' meeting. (AS 10.05.189).

.200. QUORUM OF DIRECTORS. A majority of the total number of directors fixed in the bylaws, articles or enabling legislation constitutes a quorum and action may be taken by a majority vote of a quorum. By allowing only ¼ of the board to be outsiders Alaskan control of the board is assured. One-quarter of the board can never constitute a majority of a quorum except in the event of a vacancy in which case the board must act to fill the vacancy. (AS 10.05.192).

.205. PLACE AND NOTICE OF DIRECTORS' MEETINGS. Directors meetings may be held only in Alaska and regular meetings of the board may be held without notice. Special board meetings require notice specifying the purpose of the meeting. (AS 10.05.198).

.210. PARTICIPATION BY TELEPHONE. Directors may participate in directors meetings by telephone if all the participants may hear and be heard by each other. (AS 10.05.199).

.215. DISTRIBUTIONS. Some restrictions on corporate distributions are necessary because the limited liability feature of corporations prohibits creditors from levying against shareholders if the corporation distributes its way to insolvency. The traditional restraints which have been used to protect creditors of corporations are the devices of stated capital, capital surplus, earned surplus and retained earnings. Through these devices corporations are required to keep at least something in the till for creditors.

However, the traditional restraints never ensured that cash would be on hand for creditors and they have been eroded by numerous exceptions allowing the corporation to designate capital surplus and create surplus by reduction of capital. As a result corporations have been able to make distributions beyond the point where liabilities to third parties were protected.

Under the ABCA dividends may generally be declared only out of earned surplus. (AS 10.05.204). There are several exceptions to this rule. Dividends may be paid in cash out of depletion reserves by natural resource companies and in stock out of capital surplus. (AS 10.05.204). However, a dividend may not be declared if the corporation would thereby be rendered insolvent. (AS 10.05.201). These restrictions provide some protection to creditors in that at least 75% of the amount received for shares must be allocated to stated capital, but the remaining 25% may be allocated to capital surplus available for distribution under certain circumstances.

Similarily, the ABCA provides that a corporation may acquire shares issued by it only from earned surplus except in special situations. (AS 10.05.012). This distinction between the sources from which shares may be purchased and those from which dividends may be paid does not make much sense since a purchase of shares on a prorata basis has the same effect as a dividend with regard to the protection of creditors.

To protect the creditors and shareholders of general stock ownership corporations and to rationalize restrictions upon the payment of dividends and repurchase of shares, this section provides restrictions on shareholder distributions based upon the current financial condition of the corporation. This section, adapted from a 1977 California amendment to the California Corporations Code, eliminates the concepts of stated capital and capital surplus in favor of a simple balance sheet test.

Under this section the corporation may always make the distribution required by subchapter "U" of the Internal Revenue Code. Thus, the corporation may always distribute to its shareholders an amount equal to 90% of its taxable income.

For distributions in excess of 90% of taxable income the corporation must fulfill either of two tests:

1) The corporation may make a distribution out of retained earnings.

2) If there are no retained earnings the corporation may make a distribution only if it meets a two pronged test:

   a) The assets of the corporation, after the distribution are at least equal to 1¼ times its liabilities, AND

   b) The current assets, after the distribution, are at least equal to the current liabilities (a "liquidity test").

   If the average pretax income plus interest expense for the two preceeding fiscal years is not at least equal to the average interest expense for those years the current assets must be at least 1¼ times current liabilities.

   If the corporation does not classify its assets into current and fixed in accordance with generally accepted accounting principles the current assets or liquidity test does not apply.

.220. DISTRIBUTIONS IN PARTIAL LIQUIDATION. Distributions in partial liquidation are special distributions which reduce the capital value of the corporation. They are distributions out of capital rather than earnings. These distributions may be made only upon a 2/3 vote of the shareholders and must be identified as distributions in partial liquidation. (AS 10.05.207).

.225. CERTAIN LOANS PROHIBITED. Loans by the corporation to its officers or directors are prohibited. (AS 10.05.213).

.230. LIABILITY OF DIRECTORS IN CERTAIN CASES. This section carried over from ABCA makes directors personally liable for distributions and stock purchases by the corporation in violation of the distribution limitations. (AS 10.05. 216).

.235. EFFECT OF GOOD FAITH RELIANCE ON FINANCIAL STATEMENTS OR BOOK VALUE. Directors are not liable under the preceeding section if they relied upon financial statements of the corporation represented to him to be correct. (AS 10.05. 219).

.240. PRESUMPTION OF CONSENT OF DIRECTOR AND FILING OF DISSENT. A director present at a meeting is presumed to consent to the action taken by the board at such a meeting unless he files a dissent in accordance with this section. (AS 10.0 5.222).

.245. DIRECTOR'S RIGHT TO CONTRIBUTION. A director sued for violation of the distribution rules is entitled to contribution (a sharing of the damages) from all directors assenting to or voting for the action. (AS 10.05.225).

.250. OFFICERS. Officers of the corporation are elected by the board of directors and serve at their pleasure. (AS 10.05.228).

.255. DUTIES OF OFFICERS. The board and the bylaws establish the duties of the corporate officers. (AS 10.05.231)

.260. REMOVAL OF OFFICERS. Officers may be removed by the board but removal does not prejudice contract rights. (AS 10.05. 234).

.265. BOOKS AND RECORDS. GSOCs are required to keep complete books and records and make them available for inspection by shareholders and the Dept. of Commerce at the principal place of corporate business or the registered office. (AS 10.05.237).

.270. SHAREHOLDER'S RIGHT TO EXAMINE BOOKS AND RECORDS. Shareholders have the right to examine books of the corporation at a reasonable time upon written demand. Access to the books of the corporation can be denied if sought for an "improper" purpose.

The proper purpose restriction is a carryover from common law where the restriction insured that the examination was for an honest purpose and not to gratify curiosity or for speculative or vexatious purposes. It was designed to make certain that the purpose of the shareholder desiring to make examinations must be germain to his interests as a shareholder, that it was proper and lawful in character, and that it was not inimical to the interests of the corporation.

To clarify the applicability of this common law doctrine a number of states, including Alaska, have adopted into their corporation codes an inspection of records provision requiring the proper purpose. Under these provisions the shareholder is presumed to have the right of inspection and the lack of a proper purpose can only be asserted as a defense to a claim of wrongful denial of inspection. There is no comprehensive definition of what constitutes a proper purpose since there are innumerable valid reasons for a shareholder to inspect the books of his corporation. However, case law has indicated many such purposes a partial list of which would include:

1) To ascertain the value of a shareholder's stock.
2) To acquire knowledge to enable him to vote understandingly at a shareholder's meeting.
3) To investigate into consideration actually paid for stock and the failure to distribute dividends.
4) To investigate irregularities resulting in secret profits to officers of the corporation.
5) To determine correctness of financial statements and the existance of collateral for notes.
6) To determine whether a shareholder is being discriminated against in relation to his shares. (AS 10.05.237).

.275. LIABILITY FOR REFUSAL OF EXAMINATION. Any agent of the corporation wrongfully refusing shareholder access to the books and records of the corporation is subject to a fine of $1,000 per day for each day of wrongful refusal. (AS 10.05.243).

.280. COURT MAY COMPEL INSPECTION. Courts have the power to compel inspection of the corporations books. (AS 10.05.249).

.285. SHAREHOLDERS' RIGHT TO FINANCIAL STATEMENT. The corporation must provide the shareholders with a financial statement upon request. (AS 10.05.249).

.290. REMOVAL OF DIRECTORS BY SUPERIOR COURT. This new provision allows a court, upon the suit of the attorney general or 100 shareholders 18 or older, to remove a director for fraudulent or dishonest acts or gross abuse of authority and bar such director from reelection.

This provision is not a simple removal clause, but gives standing to the shareholders and the attoreny general to ask a court to remove a director for specific reasons. In order to have the court remove the director the shareholders or the attorney general bringing suit must still prove the director guilty of the offenses charged.

.295. SHAREHOLDER REMOVAL OF DIRECTORS. This section allows the shareholders to remove the entire board by a majority vote or any single director by a vote at least as large as that which elected him at his last election.

.300. SHAREHOLDERS' DERIVATIVE ACTION. Shareholders may file suit on behalf of the corporation if those responsible inside the corporation fail to do so. Alaska Supreme Court Rule 23.1 provides for such an action, but does not specify treatment of security for expenses and other details. This section allows the court discretion to require security for expenses incurred in the prosecution of the suit. The court must approve of any settlement to insure that those prosecuting the suit are not simply bought off. The proceeds of any successful action or settlement must be accounted for to the court which may authorize reasonable expenses to the parties.

.305. FRAUDULENT TRANSFERS OF SHARES. Transferring or obtaining shares of the corporation by fraud is a felony.

.310. POLITICAL ACTIVITIES. GSOCs may not endorse candidates or ballot issues nor spend money in support or opposition of either. They are also prohibited from spending any monies to lobby the legislature. Voilations are a misdemeanor punishable by a jail term and a $10,000 fine.

ARTICLE 2. FORMATION OF CORPORATIONS.

.315. INCORPORATORS. Incorporators are those persons who file the articles of incorporation to begin the corporation's existance. This must be done by at least three people over the age of 18. (AS 10.05.252).

.320. ARTICLES OF INCORPORATION. This section sets out the minimun requirements of the articles of a GSOC including the provisions required by subchapter "U" of the Internal Revenue Code that the corporation have only one class of stock, issued only to individuals, with the right to elect not to receive a share, and subject to transfer restrictions for five years. Other provisions are carried over from the ABCA. (AS 10.05.255).

.325. FILING OF ARTICLES OF INCORPORATION. Articles of incorporation are to be filed with the Commissioner of Commerce who shall certify the filing and return one original of the articles to the corporation. (AS 10.05.258).

.330. EFFECT OF ISSUANCE OF CERTIFICATE OF INCORPORATION. Upon issuing the certificate corporate life begins. (AS 10.05.261).

.335. ARTICLES OF INCORPORATION AND INITIAL BYLAWS. The articles and initial bylaws must be submitted to the legislature within 30 days of issuing the certificate of incorporation and, if not disapproved within 60 legislative days by concurrent resolution, they are approved. Legislative disapproval may not abrogate any contract obligations of the corporation and may be overridden by a shareholder vote.

.340. ORGANIZATION MEETING OF DIRECTORS. The incorporators shall call an organizational meeting of directors in the state for the purpose of adopting bylaws, electing officers and conducting other business necessary to the organization of the corporation. (AS 10.05.267).

ARTICLE 3. APPLICATION FOR SHARES.

.345. NOTIFICATION OF ELIGIBLE SHAREHOLDERS. Since stock is to be distributed free of charge initially all Alaska residents must be notified of its availability. This section sets out the minimum notice requirements of weekly broadcast and publication for at least three month before stock distribution and monthly broadcase and publication for eleven months after distribution. These are minimum requirements only and the board of directors may determine that the corporation should take other steps to identify and notify potential shareholders.

.350 CORPORATION NOT LIABLE TO SHAREHOLDERS. Although GSOCs are required to take reasonable steps to notify potential shareholders of their right to stock the burden of applying for stock lies with the resident and the corporation is not liable for failure to notify or issue stock to a potential shareholder. If a resident makes application for stock after the distribution of one or more dividends he looses his right to those dividends and is entitled to receive only those dividends declared and paid after the date upon which his stock was issued to him.

.355. LATE APPLICATION FOR SHARES. Any individual who is eligible to receive an initial distribution of shares but who fails to apply for issuance of stock may be issued a share without charge at any time within one year of the original issue. The one year period coincides with the period during which a shareholder may elect not to receive his stock and have his share cancelled. For one additional year a person who would have been eligible to receive an initial share but did not get one may purchase his share at book value. Original issue is cut off completely after the two year period.

.360. PENALTIES FOR MISREPRESENTATION OF ELIGIBILITY AS SHAREHOLDER. The superior court is given jurisdiction to void stock issued to an ineligible individual who obtained his shares by fraud and allows the corporation to recover any distributions paid to such a shareholder.

ARTICLE 4. AMENDMENT.

.365. RIGHT TO AMEND ARTICLES OF INCORPORATION. The articles of the corporation may be amended to include any legal provision. (AS 10.05.270).

.370. PURPOSES FOR WHICH ARTICLES MAY BE AMENDED. This section lists some, but not all, of the legal purposes for which the articles may be amended. (AS 10.05.273).

.375. PROCEDURE TO AMEND ARTICLES OF INCORPORATION. The board of directors or the shareholders can propose amendments to the articles of incorporation, but the articles may only be amended upon a 2/3 majority vote of a quorum of shareholders.

.380. ARTICLES OF AMENDMENT.
.385. FILING OF ARTICLES OF AMENDMENT.
.390. EFFECT OF CERTIFCATE OF AMENDMENT.
These three sections provide that an amendment approved by the shareholders to the articles of incorporation must be filed with the Commissioner of Commerce in the same manner as the original articles of incorporation and once certified by the Commissioner the amendment becomes effective. These sections are adopted directly from AS 10.05.285, .288, and .291 respectively.

.395. RESTATED ARTICLES OF INCORPORATION.
.400. EXECUTION OF RESTATED ARTICLES OF INCORPORATION.
.405. CONTENTS OF RESTATED ARTICLES OF INCORPORATION.
.410. FILING OF RESTATED ARTICLES OF INCORPORATION.
.415. EFFECT OF ISSUANCE OF RESTATED CERTIFICATE OF INCORPORATION.
These five section deal with restated articles of incorporation. Restated articles of incorporation for purposes of GSOCs are simply a consolidation and updating of the articles of incorporation with current amendments. This allows the corporation to have on file with the Commissioner a current copy of the articles of incorporation incorporating all amendments. The provisions are adopted essentially from ABCA except that GSOCs are not allowed to amend the articles of incorporation through filing restated articles and for that reason are allowed to file restated articles upon motion of the board of directors. (AS 10.05.294, .297, .300, .303, and .306 respectively).

ARTICLE 5. SALE OF ASSETS.

.420. SALE OR MORTGAGE OF ASSETS IN REGULAR COURSE OF BUSINESS. The board of directors may sell or dispose of all the assets of the corporation if it is in the ordinary course of the corporation's business. (AS 10.05.435).

.425. SALE OR MORTGAGE OF ASSETS OTHER THAN IN REGULAR COURSE OF BUSINESS. Sale of all the assets of the corporation other than in the ordinary course of business requires a vote of the shareholders. (AS 10.05.438).

.430. APPROVAL OF PLAN BY SHAREHOLDERS. A 2/3 vote of the shareholders is required to approve a sale of all the assets of the corporation outside the ordinary course of business. (AS 10.05. 441).

.435. ABANDONMENT OF PLAN BY BOARD OF DIRECTORS. Even though a vote of the shareholders is required to approve a sale of all the assets the sale may be abandon by the board since such sales are unusual and may require quick decisions which cannot be effectively put to the shareholders. If the shareholders are unhappy about the abandonment they have the power to remove the board and it is to be expected that the board would not abandon such a sale without good cause. (AS 10.05.444).

.440. RIGHTS OF DISSENTING SHAREHOLDERS UPON SALE OR EXCHANGE OF ASSETS.
.445. NOTICE TO DISSENTING SHAREHOLDER.
.450. PAYMENT TO DISSENTING SHAREHOLDER AFTER AGREEMENT ON VALUE OF SHARES.
.455. ACTION BY DISSENTING SHAREHOLDER TO COMPEL PAYMENT UPON FAILURE TO AGREE ON VALUE.
.460. EFFECT OF ABANDONMENT OR REVOCATION OF SALE OR EXCHANGE ON SHAREHOLDER'S RIGHTS.
.465. STATUS OF SHARES ACQUIRED FROM DISSENTING SHAREHOLDER.
These section deal with the shareholder who does not wish to be a part of the sale of substantially all the assets of the corporation in spite of the 2/3 majority vote of the shareholders. Such a shareholder can dissent from the sale and have the corporation purchase his shares. There are notice provisions and opportunity for the shareholder and the corporation to agree upon a purchase price for the shares. If the shareholder and the corporation cannot agree upon a price the matter can be decided by a court. If the sale is abandoned the dissenting shareholder looses his right to receive payment from the corporation for his share and he remains a shareholder. Shares acquired from a dissenting shareholder become treasury shares.

ARTICLE 6. DISSOLUTION.

GSOCs may be dissolved voluntarily by a 2/3 vote of a quorum of shareholders (.475) or by the Commissioner of Commerce (.530). In a voluntary dissolution the question may be put to the shareholders upon action of the board or a petition of 1,000 shareholders (.475). On affirmative vote of the shareholders a statement of intent to dissolve signed by corporate officers (.480) is filed with the commissioner of Commerce (.485). When the statement is officially filed by the Commissioner the corporation must cease doing business and wind up its operations (.470). However, the corporate existance continues while the corporation notifies creditors,

collects and liquidates assets and pays off its obligations (.490)(.495). When the business of the corporation has been wound up articles of dissolution (.515) are filed with the Commissioner (.520) and when certified the corporate existance ceases (.525). Voluntary dissolutions may be revoked at any time by a 2/3 vote of the shareholders (.500) in which case the corporation files a statement of revocation (.505) and the dissolution process is terminated (.510).

A GSOC may be dissolved involuntarily by the Commissioner of Commerce with 60 days notice for failure to file reports or pay fees, failure to maintain a registered agent or office or change either without notice, and unfilled board vacancies continuing beyond the allowable time (.530). A corporation can be reinstated within two years upon remedy of the violation.

The superior court may dissolve a GSOC (.530)and has jurisdiction to liquidate the corporation's assets (.540). The Attorney General may bring suit to dissolve the corporation where there was fraudulent incorporation or continual abuse of corporate authority (.530).

In addition a suit for liquidation of the corporations assets may be brought by:

1) A shareholder where the board is deadlocked; the board is action in an illegal, oppressive, or fraudulent manner; the shareholders are deadlocked for two annual meetings; or, the corporation's assets are being misapplied (.545).
2) A creditor when the creditor's claim is unsatisfied and the corporation is insolvent (.550).
3) The corporation upon request to have a voluntary dissolution continued under court supervision(.555).
4) The Attorney General in conjunction with a suit for dissolution (.560).

The shareholders need not be a party to the action for liquidation (.565). The court has authority to appoint a qualified receiver (.605) for the corporation with power defined by the court (.585) to collect and sell its assets (.570)(.575). Proceeds are to be used to pay expenses allowed by the court (.590) and debts of the corporation with the remainder distributed to the shareholders (.580).

The receiver may sue and be sued (.595) and all claims against the corporation must be filed in a timely manner with the court or the receiver (.610). Liquidation may be terminated by the court (.615) but upon completion the court must enter a decree of dissolution (.620).

The article on dissolution is carried over substantially intact from ABCA (AS 10.05.465 - .594).

ARTICLE 7. GENERAL PROVISIONS.

.625. AS 10.05 INCORPORATED BY REFERENCE. In order to reduce duplication this section incorporates by reference Sections .699 through .819 of ABCA (AS 10.05.699 - .819). These sections deal with requirements for annual reports to be filed with the Commissioner of Commerce, filing fees and charges, procedural privisions and forms, and powers of the Commissioner of Commerce.

.630. FALSE STATEMENTS AFFECTING VALUE OF SHARES. An agent of a corporation who makes fraudulent statements regarding the value of shares is guilty of a misdemeanor.

.635. DIRECTOR MAKING UNLAWFUL DIVIDEND OR DISTRIBUTION OF ASSETS. A director who concurs in a distribution designed to deceive creditors or shareholders is guilty of a misdemeanor.

.640. RESERVATION OF POWER. Amendments to this chapter apply to all existing and future corporations organized under it, but an amendment may not abrogate the contractual obligations of any corporation.

.645. DEFINITIONS. Many of the definitions in this section are carried over from ABCA and may also be found in AS 10.05.825. However, there are two significant new definitions:

Certificate as used in the context of "stock certificate" may mean something other than the actual certificate such as a receipt evidencing ownership. This definition has been broadened in order to allow for the possibility that the stock certificates themselves may never be issued, but that the stock records may be kept by the corporation itself as the evidence of ownership in a particular shareholder which ownership would be represented in the hands of the shareholder by a receipt. Such a receipt would be required to carry all the same information as is required on the certificate itself.

Resident is defined as a person who lives in Alaska and intends to remain here permanently. The definition allows for temporary travel or employment outside without loss of residency. If a dispute arises over residency all of the facts and circumstances indicative of permanent residency must be considered.

AN ANALYSIS OF THE TWO-FACTOR THEORY AS APPLIED TO ALASKA IN PROPOSALS FOR AN ALASKA GENERAL STOCK OWNERSHIP CORPORATION

Prepared for the House Finance Committee
under contract with
The Division of Legislative Finance

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Introduction

Legislative proposals (SSSB170 and SSHB240) to establish an Alaska General Stock Ownership Corporation (AGSOC) are best understood if considered in two parts. First is the economic theory underlying the proposals; second is the mechanics of the proposals themselves. This report attempts to examine both parts.

Examination of the economic theory underlying the AGSOC proposals can help policy makers decide if an AGSOC ought to be created, while examination of the mechanics of the proposals can help them decide if an AGSOC can be created. Logic dictates that the theory be examined first, the mechanics second.

Part 1: Economic Theory Underlying The AGSOC

The Two-Factor Theory

There can be no argument that Louis Kelso holds patent to the economic theory that underlies proposals for the creation of an AGSOC. This theory is dubbed by Kelso the two-factor theory of economics.

Throughout his writings on capitalism[1], Kelso argues that the one-factor (labor) theory of economics[2] does not

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[1] This analysis is based on a reading of Kelso's The New Capitalists and Design of an Alaskan General Stock Ownership Plan, Volume I.

[2] The one-factor theory holds that all wealth is created by labor. Its most rigid application is found in the writings of Karl Marx.

properly describe an industrialized economy. Instead, Kelso posits a two-factor theory, those factors being labor and capital.[3] The gulf between the continuing belief in one-factor economics and the reality of two-factor economics, Kelso says, is responsible for a growing imbalance in the United States economy. To describe the situation in Kelso's own words:

> "Two facts must be kept in mind. The first is that capital produces at least 90 percent of the gross national product in our economy; yet all but a small fraction of the capital instruments are owned (for the most part indirectly through share ownership) by 5 percent of the households of the economy. The second fact is that in spite of this concentration of apparent ownership, 70 percent of the income currently produced is distributed through labor."[4]

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[3] Throughout his analysis, Kelso uses the term capital to encompass capital investment (money diverted from the consumer economy to finance production), capital instruments (stocks, etc., purchased with capital investment), and capital goods (factors of actual production, excluding labor, purchased with capital investment through capital instruments). Simply put, capital is wealth devoted to productions rather than consumption.

[4] The New Capitalists, by Louis O. Kelso and Mortimer J. Adler, Greenwood Press, Westport, Conn., 1961, p.5.

Kelso's two facts actually are three, and these three facts, Kelso argues, create an economic problem that must be solved.

Fact #1: Capital produces an increasing share of wealth

This is occurring, Kelso says, through technological change. Technology is both purchased with capital (capital investment and instruments) and a part of capital (capital goods). As machines perform more and men less, the proportionate share of wealth produced by labor is decreased. Thus, the value of labor declines.

This becomes a part of the economic problem because, as we shall see below, most Americans have only the value of their labor on which to subsist. This dictates that labor must be compensated at an artificial, pre-technological level.

Fact #2: Capital is concentrated

The ownership of capital is concentrated in the hands of a few, according to Kelso, because of a structural bias against risk.

Capital formation (the acquisition of capital investment to purchase capital goods) commonly occurs, he says, through borrowing. A borrower used debt to acquire a wealth-producer (a capital good, such as an expanded plant, a new business, etc.). The wealth produced is used to retire the debt, leaving the borrower to enjoy all the wealth produced after the debt is retired.

This process, Kelso argues, contains a structural bias against risk. Lenders want to be repaid regardless of the success of the wealth producer acquired with their money. So, lenders lend to those who already have enough wealth to repay even if the wealth producer acquired with the borrowed money goes belly up.

In short, it takes money to make money.[5]

Fact #3: Labor receives more wealth than it produces

As note above, Kelso argues that technological change is decreasing labor's share of wealth production. But, because capital is closely held, most Americans continue to gain their income only, or primarily, from their labor.

Thus, to avoid wide-spread poverty, labor must be compensated at a level above its level of wealth production. This is done, Kelso says, one of two ways.

First, labor increasingly is being compensated for its attendance at the scene of production, rather than its actual part in productions. Simply put, men are paid to show up and watch machines produce wealth.

Second, government transfers wealth from capital to labor. Government taxes capital-produced wealth and transfers that wealth to labor. These transfer payments, Kelso says, are made under a variety of guises: make-work

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[5]Throughout his analysis, Kelso assumes that individual capital and corporate capital act the same way in the economy.

projects, social security payments, unemployment compensation, welfare payments, and so forth.[6]

Problems with the economy

These inter-related facts point to a fundamental problem in the United States economy: the economy is disfunctional because the means of acquiring real wealth are available to a few while the many subsist on artifical, transferred wealth.

The need to transfer wealth has changed the United States economic system from capitalism to a mixture of capitalism and socialism, Kelso argues. At the same time, Kelso says, the perception of the economy has not changed to match the facts.

Breaking this down further, we find what could be called the problem's symptoms.

First, the artifical compensation of labor is inefficient, making U.S. products non-competitive in world and domestic markets.

Second, although Kelso does not stress this, transfer payment distribution methods are inefficient, creating growing bureaucracies.[7]

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[6]Kelso's analysis does not directly address two other elements of taxation: the financing of so-called public goods and the compensation through transfer payments of existence as opposed to the compensation of labor.

[7]These bureaucracies might themselves be considered make-work projects, thus becoming recipients as well as providers of transfer payments.

Third, those who are compensated beyond their labor's worth are degraded. This is caused, Kelso says, by the historical identification of a man's labor value with his personal value.

Finally, the United States is moving away from the fulfillment of the capitalist dream, instead of toward it.

The two-step solution

Solving these problems requires two steps be taken, Kelso asserts.

First, we must realize that the one-factor theory is wrong. If we were to do this, Kelso argues, we could see that full employment is not a proper economic goal. Rather, Kelso says, unemployment is a proper goal of an industrialized economy because labor is an inefficient method of wealth production.

Second, we must follow this realization with actions designed to transfer the income of the many from labor to capital. This will allow unemployment without poverty, eliminate the need for transfer payments and restore the economy to its capitalist beginnings.

This change from labor value to capital value is, Kelso argues, both morally and practically necessary if the United States economy is to survive and compete in the modern world.

Financed capitalism

Kelso simply asserts the necessity to change our view of the economy, but he creates the method of capitalist income transfer. He calls this method financed capitalism. Its goal, in Kelso's own frighteningly mechanistic phrase, is to build capital into more Americans.

All that financed capitalism really requires is allowing more Americans access to borrowing for capital formation. Kelso has created a variety of methods to allow this access, all dependent on risk pooling and tax advantages. In short, Kelso doesn't really want to change the basic system of capital formation; he merely wants to adapt it to serve more Americans.

Kelso's specific propsoal for Alaska, the AGSOC, will be discussed in detail in Part 2 of this report.

Some Alaskan questions

The basic question is how well Kelso's theory applies to Alaska. Specifically:

Is capital producing an increasing share of wealth in Alaska?

Is capital concentrated in Alaska?

Is labor receiving more wealth than it produces?

Answers to the first and third questions require the performance of extensive statistical analysis on Alaska's economy. Without such analysis policy makers can only assume that, since

the Alaska economy is a part of the larger national economy, the answers is "yes" to both questions.

Common sense tells us that a partial answer to the second question is "yes", too. Some Alaskans are wealthier than others.

But such an answer ignores real questions about the continued existence of entrepreneurs in Alaska, long after entrepreneurs have ceased to be a major force in the rest of the U.S. economy. This, too, needs to be properly analyzed.

Finally, a blanket "yes" answer to these questions ignores the singular peculiarity of the Alaska economy: the existence of vast amounts of public capital.

This capital is in the form of resources, held by the state for its citizens.[8] Traditionally, this capital has been rented to the private sector for development. The private sector used its own capital, acquired much as Kelso describes, to develop the resource.

The rent paid is in two forms. The first, which fits the Kelso analysis, is taxes, paid to the state as a government. Resource taxation is no different than any other form of taxation in its philosophical bases.

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[8] A full explanation of this phenomenon would require a book. Suffice it to say that the peculiar circumstances of Alaska at the time it became a state have led to this peculiarity in Alaska's economy.

But, the second form of rent is vastly different. This is the rent paid to the state as an owner of the resource: bonus, royalty, least rental, etc. To emphasize the point: this second form of rent is paid to the state as though it were being paid to all Alaskans.

Both morally and practically, Alaskans already own vast amounts of capital. The Alaska question is not how to make capitalists of the state's citizens, to which the AGSOC may or may not be the answer. Rather, the Alaska question is how to grant control of existing capital to its real owners.[9]

Because of this Alaska peculiarity, the state's residents don't really need the transfer benefits[10] of the AGSOC. Without these benefits, the AGSOC becomes one of a number of potential distribution methods, ranging from the state budget to dividing the resources into equal shares and giving them to Alaska residents.

Thus, Part 2 of this report will consider the AGSOC simply as a method of distributing capital already owned by Alaskans.

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[9] Actually, there are two, inter-related questions: how do we maximize the return (rent) for our capital (resources) and how do we most efficiently distribute that return to its real owners.

[10] These benefits are mainly tax advantages. In this sense, the AGSOC offers additional capital, since it would take capital from the federal government as well as from the state government. It should be remembered, however, that this capital is only borrowed. Tax liability falls on the individual at the time he receives dividends.

Part 2: The mechanics of AGSOC

To Alaskans, the AGSOC proposed in SSSB170 and SSHB240 is simply the latest in a series of plans to distribute public capital to its real owners. These plans include Gov. Jay Hammond's ill-fated Alaska, Inc., various other proposals for the Alaska Permanent Fund, income tax rebates and so forth.

As a distribution method, AGSOC is much like the Alaska Permanent Fund: it is financed by segregating a sum of public capital. Like some permanent fund proposals, the AGSOC is established as a quasi-governmental entity. And, like other permanent fund proposals, the AGSOC would make direct payments to Alaska residents. Once the AGSOC is established and the money segregated, however, the AGSOC becomes a completely private operation. No other proposal, permanent fund or otherwise, removes the distribution function so completely from existing government.

SSSB 170 and SSHB 240

The AGSOC begins with the appointment by the governor of nine incorporators, the majority of whom must be state residents (page 1, line 11-14).[11]

Initially, these incorporators serve as the board of directors, with provision for electing new directors (page 2, line 27 to page 3, line 10).

The corporation then notifies Alaskans that it will issue stock (page 3, line 11-19).

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[11] All page and line references are to either SSSB 170 or SSHB 240, since they are identical.

The stock is issued, one share to each resident applicant as defined in the bill (page 1, line 23 to page 2, line 3).

The corporation is not liable for those who fail to apply for a share (page 3, lines 20-28), but it may award a share to a late applicant (page 3, line 29 to page 4, line 5).

Those who attempt to obtain a share illegally are subject to penalties (page 4, lines 6-21 and page 7, lines 2-6).

During the first five years of the corporation's existence, no share may be transferred unless a shareholder dies or ceases to be a resident (page 2, lines 4-9). Shares transferred in the first five years must first be offered to the AGSOC (page 2, lines 21-26).

After five years shares may be transferred, although not to non-residents, minors or anyone already owning 10 shares (page 2, lines 10-15).

The corporation must remain an AGSOC and cannot use eminent domain to acquire property (page 2, lines 16-20).

The corporation must distribute at least 90 per cent of its taxable income each year, unless such distribution would make the corporation insolvent (page 4, lines 22-29).

The corporation is not an instrumentality of the state (page 1, lines 20-22).

State financial assistance to the AGSOC consists of a special loan guarantee fund (page 5, lines 4-14).

Policy considerations in SSSB 170 and SSHB 240

The AGSOC created by the two bills raises a number of policy considerations.

First, the AGSOC would belong to a special class of citizens. As currently structured, stock would go only to those people "who were residents of the state on the effective date of this Act,[12] and who continued to be residents until the date of issuance of the shares;". This means those who arrive in the state or are born in the state the day after the act takes effect are not entitled to AGSOC shares. Likewise, anyone who leaves the state before the stock is issued will not be entitled to a share.

Constitutional problems may be avoided if the period between the effective date and stock issuance is sufficiently short. But, like any arbitrary qualification, this residency requirement raises a question of equity.

Kelso has addressed this problem, saying that those who don't qualify for the first AGSOC could qualify for the next. Even assuming that there is a next AGSOC, this does not fully answer the equity questions. The requirements for structuring any AGSOC dictate there will be some time lag. Thus, two children born one day apart would be members of different classes

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[12]The act takes effect immediately upon passage.

for some time.

Second, while the return would go to a special class, the risk would be shared by all. It is assumed that the loan guarantee made by the state would be made for the term of the loan.[13] During that term the state as a whole, including residents who are not AGSOC shareholders, would be liable if the AGSOC failed to repay.

Third, the AGSOC would change the criteria for making decisions about using public capital. Those who say the state should be run like a business generally mean that the methods be businesslike, not the goals. But the AGSOC, like other corporations, is most likely to make its decisions on strict profit-and-loss criteria. For the public money involved, social goals would disappear. The single goal would be profit. Thus, not only would there be no direct benefit to non-shareholder residents but also there would be no indirect benefit in the form of services.

Fourth, the AGSOC is likely to limit, rather than expand, decision-making power. There are two considerations here:

a. The likelihood that corporate decisions will actually be controlled by each and every stockholder is remote. Generally, the management of a corporation makes the decisions and there is nothing the the AGSOC proposal that would change this.

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[13] It is unlikely that the term of a loan would be less than 20 years.

b. By allowing one resident to hold 10 shares of stock, the AGSOC proposals allow 10 per cent of the stockholders to hold 100 per cent of the stock.

Fifth, the AGSOC directors can commit the use of state funds without regard to elected representatives of the people. By allowing an unconditional loan guarantee, the proposals allow the AGSOC directors to commit the state to contingent liabilities over which it has no control. The provision that loans to be guaranteed be approved by the commissionerof revenue does not alter the fact that those who can constitutionally appropriate funds are left out of the decision-making process.

Sixth, a large amount of public capital must be committed for even small individual dividends. In order to provide just $10 a month to 400,000 shareholders, the AGSOC must earn $48 million a year. With a profit-to-worth ratio as high as 15 per cent, the business acquired by the AGSOC must be worth about $320 million.[14]

Seventh, tax benefits accre to this corporation, not the shareholders. AGSOC earnings become taxable as personal income when they are paid as dividends to the shareholders. Although the corporation's tax exempt status makes it attractive

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[14] Actually, this figure would be higher, since the AGSOC is required to distribute only 90 per cent of its taxable income.

to lenders, it is no more attractive than any other corporation to shareholders except that initial shares are free. In this regard, tax rebates are more beneficial to many, if not all, Alaskans than taxable dividends from the AGSOC.

Eighth, the AGSOC and the state are likely to clash. Assuming the AGSOC purchases an in-state firm or firms, it is likely to be subject to state regulation. This will, in effect, set the citizen-as-shareholder against the citizen-as-citizen; that is, the citizen against himself in regulatory matters. The impact on politics cannot be predicted.

Conclusion

As a distribution method, the AGSOC presents many problems that are not solved in current proposals. Unless there is clear evidence that the AGSOC is something more than a distribution method, policy makers would be wise to measure it against all other suggested distribution methods. Only then will they be able to determine if the benefits outweigh the costs.

Two-Factor Theory And ESOP Financing

Why, In An Adva..ced Industrial Economy,
Substantial Income-Producing Capital
Must Be Owned By Corporate Employees

And

How--With Very Slight Changes In Basic
Business Strategy--This Can Be
Effectively Accomplished Through Employee
Stock Ownership Plan (ESOP) Financing:

°The Most Potent Instrument For The Purpose

°The Most Advantageous To The Corporation

°The Most Beneficial To Employees

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Although two-factor economics is a new and fundamental concept, it is simple and straightforward. The reasoning runs as follows:

1. While it is true that people, participating in the economy through the performance of their various tasks, are a basic source of productive input, they are not the only source of productive input.

2. Non-human things, such as land, structures and machines, also make productive input into the economy.

3. The division of the input sources into two types is both necessary and adequate, because the ownership of labor power cannot be concentrated, while the ownership of non-human things can easily be concentrated. It is, after all, an individual's property in an input factor that entitles him to receive what it produces.

4. Under the logic and morality of a market economy, productive input into the economy is the basis for the individual's right to receive income from it. Economic outtake is conditioned on economic input. To accountants and businessmen, this relationship is simply double-entry bookkeeping. To economists, it is "Say's Law" or "Say's Identity". To moralists, it is the Puritan Ethic, or simply the principle of economic justice defined by Aristotle. To lawyers, it is the principle of private property, under which the owners of capital and the individual owners of labor power are accorded the income equivalent of what each privately-owned input factor contributed to production.

Figure 1: *SAY'S LAW: THE BASIC LAW OF TWO-FACTOR ECONOMICS*

For every dollar spent, somebody gets a dollar in economic value. Say's Law is simply a prose statement of the principle of double-entry bookkeeping, which is the logic of a private property, market economy.

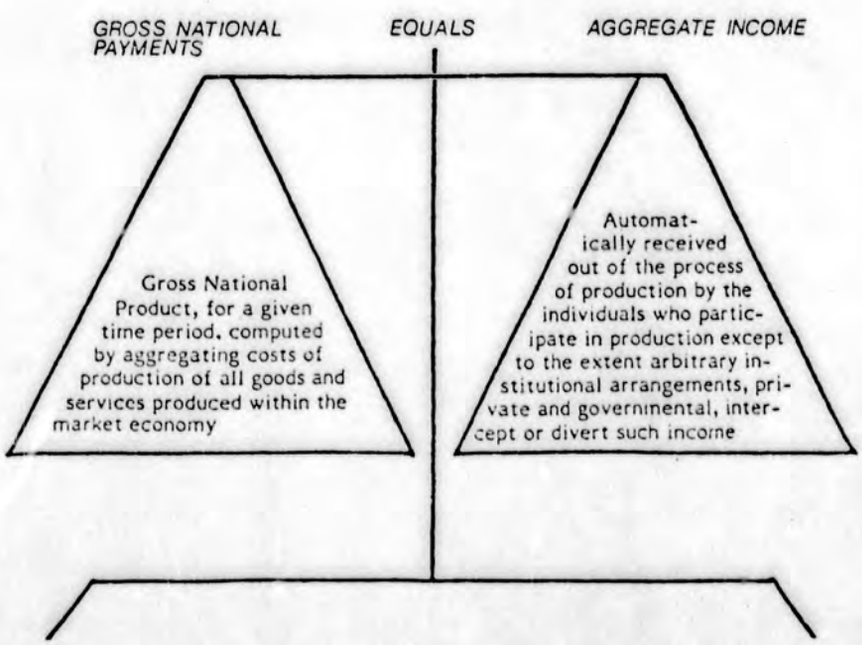
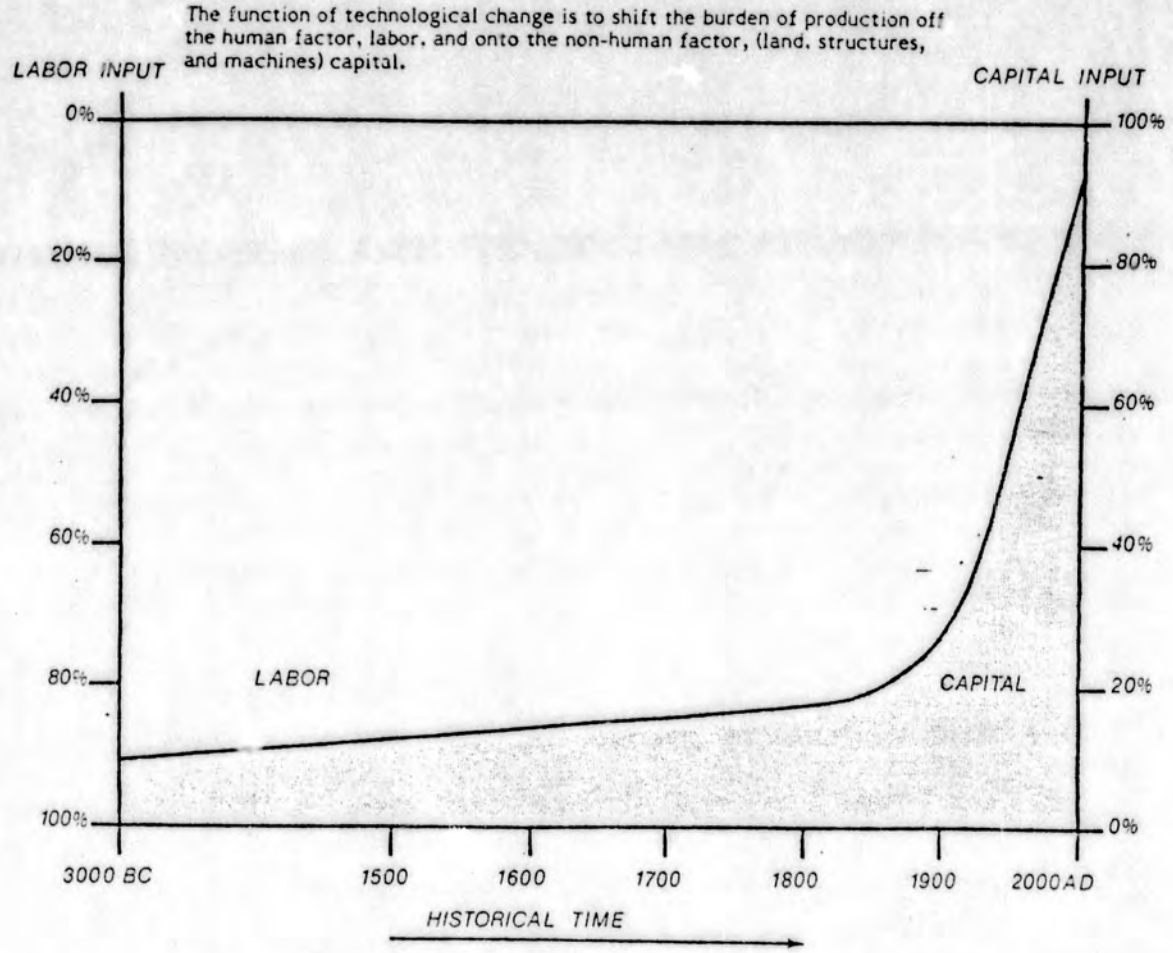


Figure 2: *SAY'S LAW ILLUSTRATED ON THE BASIS OF 1973 STATISTICS (IN BILLIONS)*

Gross National Product		Pre-tax Income	
Less adjustments for capital consumption allowances, indirect business tax and non-tax liability, business transfer payments and other minor adjustments.		Pre-tax Income Automatically Arising out of Production and Received by the Participants in Production	
CONSUMER COSTS OF:		INCOME OF PARTICIPANTS IN:	
Agriculture, forestry, and fisheries	$ 37.8	Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7	Mining	9.7
Contract construction	57.5	Contract construction	57.5
Manufacturing	291.9	Manufacturing	291.9
Transportation	39.3	Transportation	39.3
Communications	21.7	Communications	21.7
Electric, gas, and sanitary services	19.8	Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5	Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9	Finance, insurance, and real estate	118.9
Services	133.6	Services	133.6
Government and government enterprises	162.9	Government and government enterprises	162.9
Foreign trade and transactions	9.6	Foreign trade and transactions	9.6
	$1,054.3	—	$1,054.3

5. Technological advance, which is the phenomenon responsible for the Industrial Revolution, as well as our own automation revolution, and all of the intermediate revolutions brought about by science and technology, changes, and is intended to change, the input mix. It shifts the burden of production off labor (the human factor) and onto capital (the non-human factor). Technological change does not operate directly on labor. It cannot increase the productiveness of an individual worker. It increases the productiveness of machines, tools, structures, land and processes. The economic productiveness of human workers--what they can accomplish with their unaided muscles or minds has not changed during the course of history, if the value of that productiveness is determined objectively and competitively by the free operation of the law of supply and demand.

Figure 3: *THE FUNCTION OF TECHNOLOGICAL CHANGE*



6. In the United States economy, the world's most advanced, the process of technological change has gone so far that most of the goods and services today are produced by capital instruments; only a minor portion of the productive input is made by people. With rare exceptions, it is capital that produces affluence. Labor, in a free labor market, can normally produce only subsistence. The relative distribution of aggregate personal income between workers (roughly 3/4ths) and the owners of capital (1/4th) does not reflect the relatively higher productive input by capital because our governmental economic policy (the Employment Act of 1946), and implementing legislation, attempts to repeal the law of supply and demand as it applies to the value of labor. This is the purpose of minimum wage laws, coercive fixing of wages, vast governmental make-work programs, government subsidies to industry and other government entities to "create" jobs, etc.

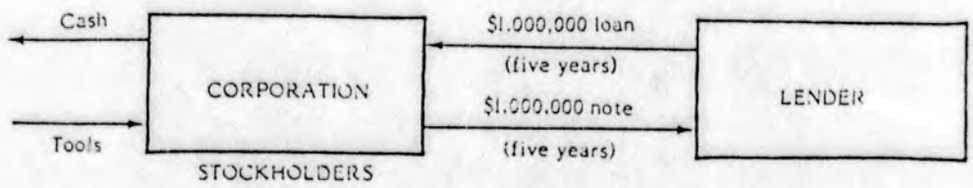
The costs of all such efforts enter into the costs of production, directly or indirectly, and thus are inflationary precisely because they are not reflected in the increased production of goods and services by labor. Such costs, neither representing increased labor input nor labor shortages, are, in fact, disguised welfare. They are injected into the costs of the same quantities of goods and services that, prior to the coerces increases, would have been produced at lower costs. These attempts to overvalue labor constitute the monetization of welfare.

7. The shifting of the input mix from labor to capital would cause no economic problem, even under competitive labor markets, if the declining productiveness of labor were offset by increasing capital ownership, i.e., if, as technology diminished the productive role of the human factor, workers simultaneously acquired ownership of enough productive capital to compensate for their loss, or even better, enough capital to provide what few labor-dependent persons have ever achieved, a truly affluent standard of living.

8. Unfortunately, traditional techniques of finance do exactly the reverse of what the situation logically requires. They insure that all newly-formed capital will be automatically owned by those who own all existing capital. Under these techniques, the $100 billion-plus of new capital formation that comes into existence each year in the U.S. economy becomes owned by a tiny proprietary class--5% of consumer units at most. If averaged over the past 15 years, about 98% of new capital formation in the corporate sector (which produces more than 85% of total private sector goods and services) is financed out of direct cash flow or borrowings repaid out of cash flow.

Figure 4: *CONVENTIONAL CORPORATE FINANCE*

Including internal cash flow, borrowings repaid from after-tax cash flow, accelerated depreciation, depletion, and investment tax credit, but excluding sale of new stock to the public for cash

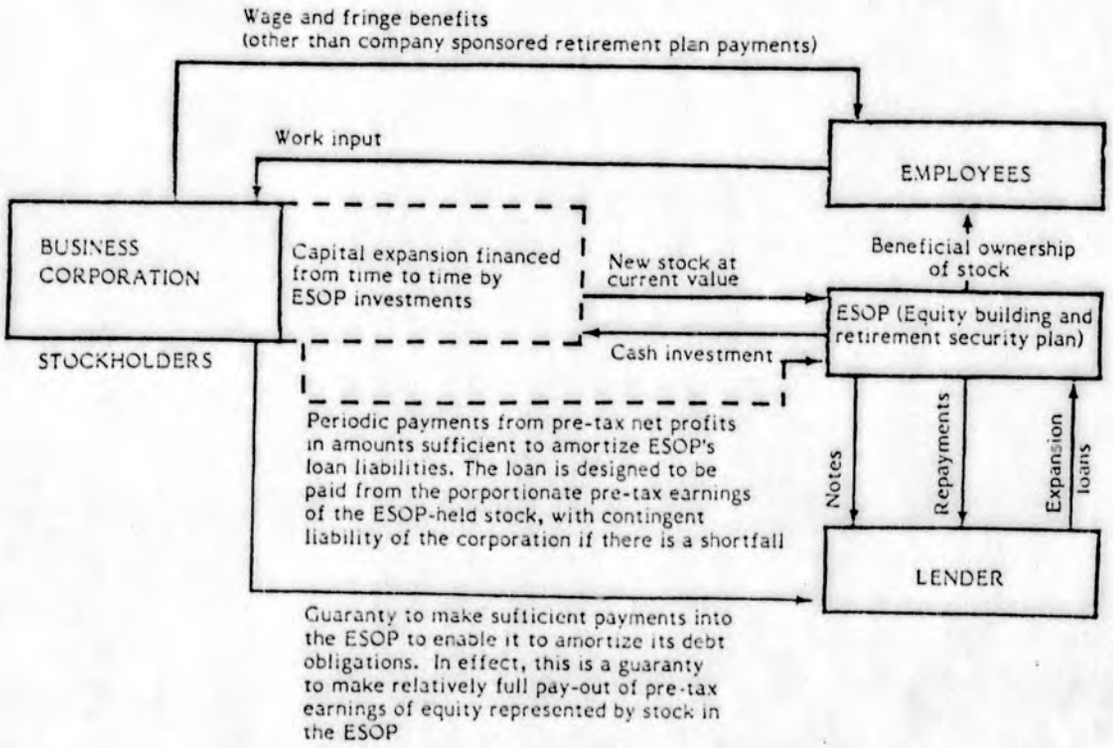


These methods of financing new capital formation have one common characteristic: they do not create a single new stockholder. The portion of new capital formation (about 2%) financed by sale of equity stock to the public does not alter this propensity. Every qualitative study of stock ownership to date shows that ownership of virtually all individually-owned productive capital is lodged in the top 5% of consumer units. These are the families who have excess funds to buy newly-issued stock. Conventional finance has created this monopoly.

9. The logic of business finance is to invest in productive capital that will pay for itself within a reasonably short space of time, normally three to five years, and then go on throwing off wealth indefinitely, its productive power being replenished through depreciation funds set aside out of gross income before net income is computed. Two-factor financing techniques, of which the most widely used today is the Employee Stock Ownership Plan or ESOP, makes this logic available to employees.

Figure 5: *BUSINESS CORPORATION FINANCED BY A PROPERLY DESIGNED ESOP*

Intended to simultaneously (1) finance growth of the corporation, and provide second incomes for the employees (if the stock is dividend paying and, after shares are paid for, the dividends pass through the ESOP currently to the employees) and (2) to build retirement security in the form of equity capital ownership.



10. ESOP financing, on the one hand, provides low cost capital, through the use of pre-corporate-tax funds, to finance corporate growth, and on the other hand, builds ownership into workers without diminishing their take-home pay or calling upon their small or nonexistent savings.

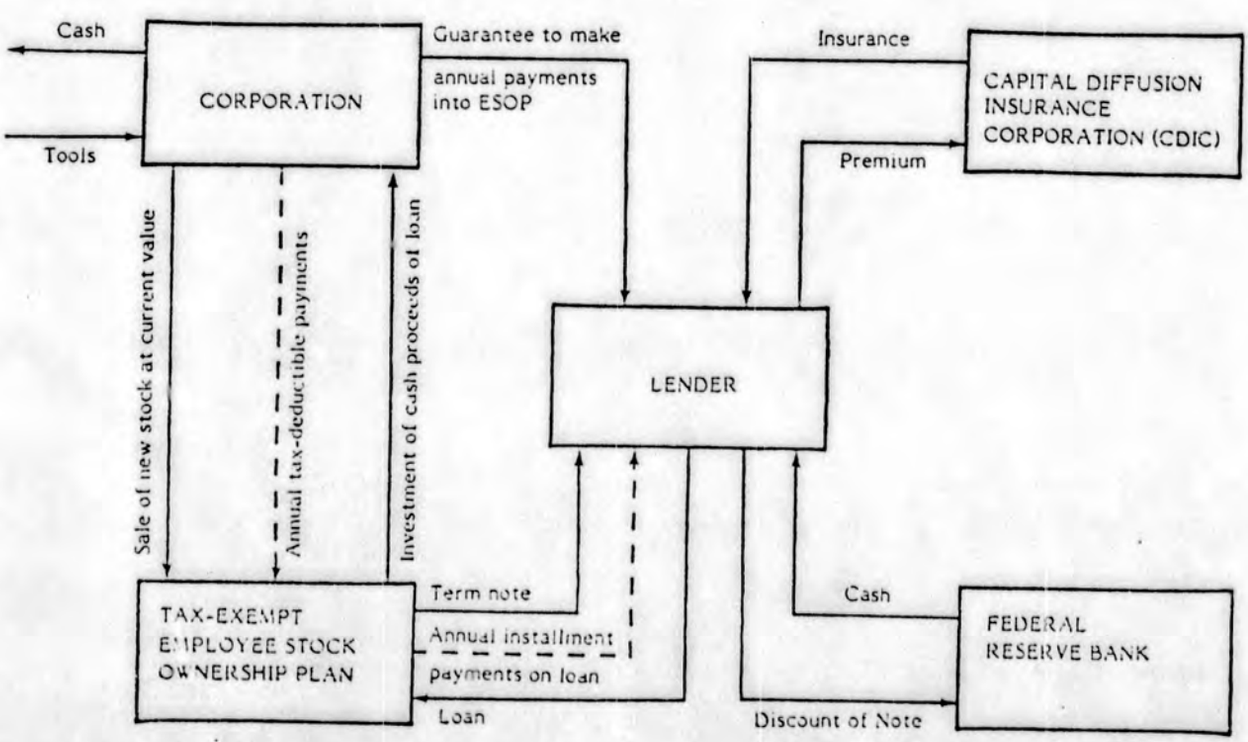
11. With minor legislative changes to provide capital diffusion insurance (modeled after FHA insurance) for lenders that make sound ownership broadening loans and to make the financing paper held by lenders discountable at a rate not in excess of the administrative costs of the Federal Reserve Bank, two factor techniques provide means for financing unlimited growth, while building market power, economic security, and growing current second incomes from capital* into the masses of workers; thus the market power of potential consumers rises in step with the productive output of the economy.

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*Where the stock in the ESOP pays a dividend, the plan often provides that, after each particular share of stock is paid for, the dividends on it shall currently pass through the trust into the workers' pockets.

Figure 6: *FINANCING ECONOMIC GROWTH*

Financing economic growth by monetizing productive capital while building market power into consumers through ESOP financing

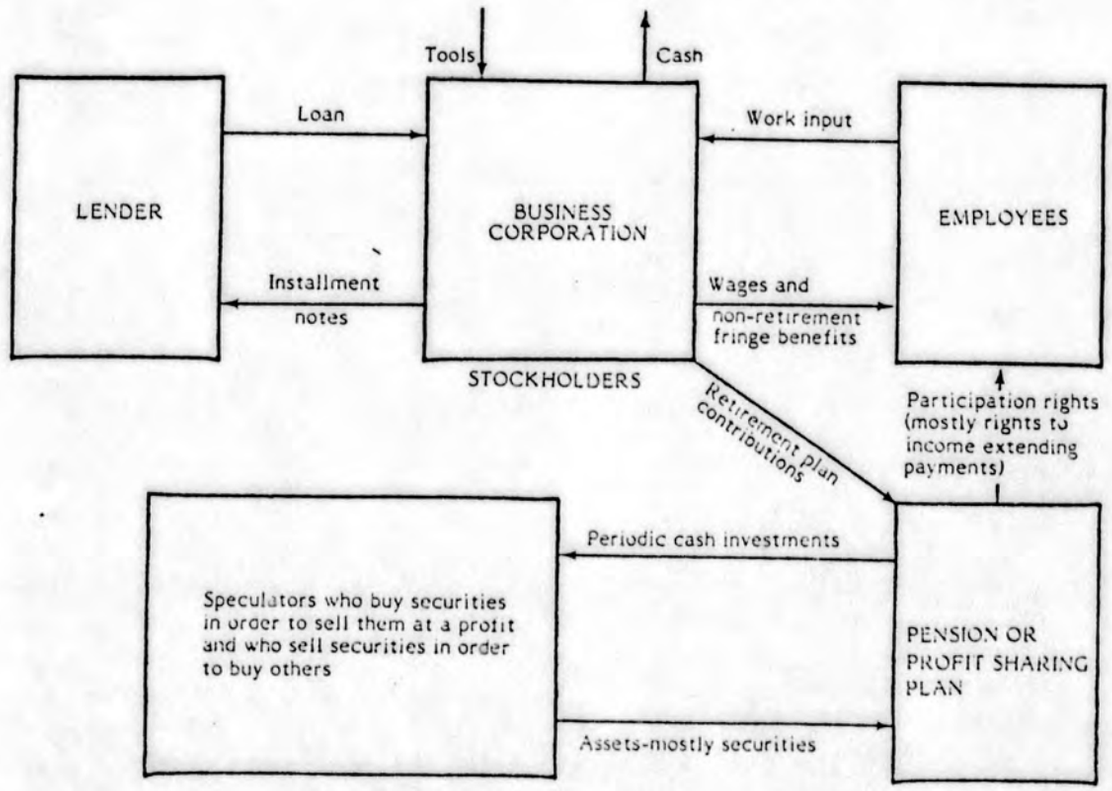


12. Inflation is eliminated. Institutional barriers, such as lack of "money" to finance solid, self-liquidating economic growth are eliminated; legitimate leisure, built upon the ownership of a holding of productive capital that will enable a man or woman to produce a viable income, becomes possible over a reasonable working lifetime; and the burden of public taxes imposed upon producers to support the non-productive and under-productive can ultimately be virtually eliminated. Fully productive households and individuals do not need to be subsidized.

13. The ESOP is an enormous cost-saver for the corporation which--sooner or later--can substitute it for a fixed-benefit pension plan, or any other pension plan or conventional profit-sharing plan. All payments by the corporation into these conventional plans are <u>pure cost</u>.

Figure 7: *CONVENTIONAL FINANCING OF A BUSINESS CORPORATION*

Conventional financing of a business corporation, other than by sale of new stock to the public for cash, with conventional pension or profit sharing plans invested wholly in assets purchased from sources other than the employer-corporation.

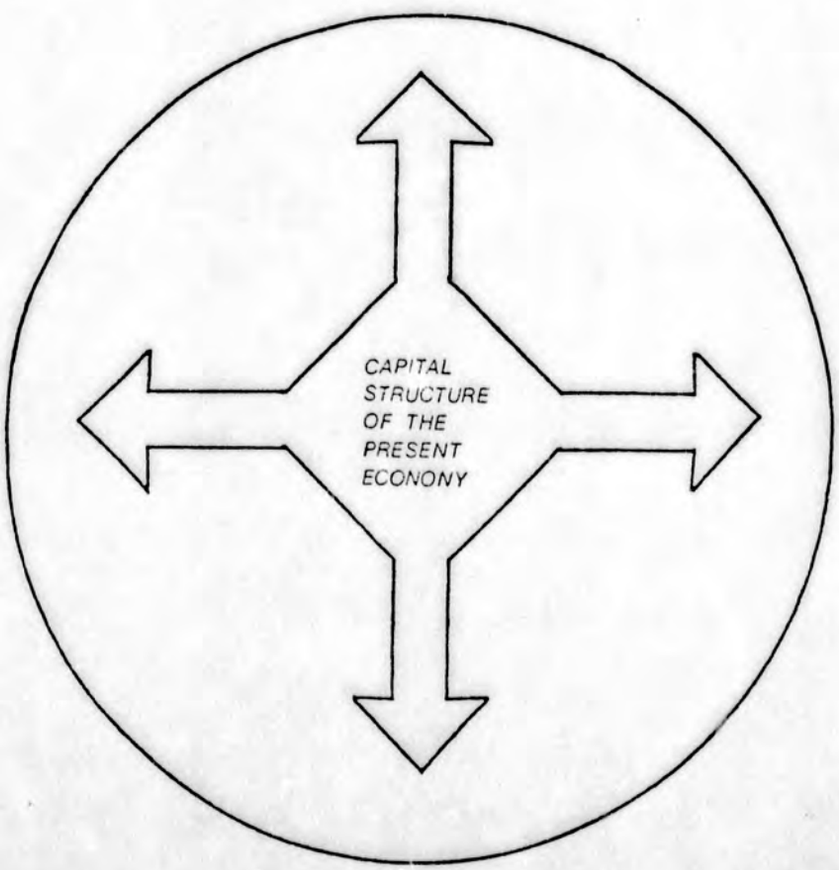


Compared with the ESOP (see Figure 5), not only does the identical dollar paid by the corporation to build stock ownership into employees also finance corporate growth, but corporate growth can be accomplished on pre-tax dollars. By comparing the ESOP (Figure 5) with conventional economic security-building plans (Figure 7), you will see that the ESOP enables the corporation to gain $3 of advantage for each dollar spent. And it conforms to the sound economic goal of enabling employees, who work hard and well over a reasonable working lifetime, to retire singularly well off.

14. Finally, because the economic goal implicit in Two-Factor Theory is to expand the U.S. economy (and any other economy that adopts it) sufficiently to enable all consumers to live well--general affluence--while also producing the technology to protect the environment, a change to a two-factor policy by business and government could give us twenty-five years or more of legitimate full employment. This would be time enough for society to adjust to a world in which each person will spend less time in economic work and more time in the work of civilization.

Figure 8: *OBJECTIVE OF TWO-FACTOR ECONOMICS*

Capital structure of the present economy, owned by 5% of consumers, expands ten-fold to create the SECOND ECONOMY, owned primarily by the 95% of consumers who now own no capital



SUGGESTED READING ON TWO-FACTOR ECONOMICS

Books

THE CAPITALIST MANIFESTO by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1958. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

THE NEW CAPITALISTS by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1961. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

TWO-FACTOR THEORY: THE ECONOMICS OF REALITY by Louis O. Kelso and Patricia Hetter (Random House, New York, 1967; Paperback Edition, Vintage Press, 1968)

Testimony

Testimony by Louis O. Kelso before the Joint Economic Committee, U.S. Congress, December 11-12, 1975, on "Employee Stock Ownership Plan Financing and Other Financing Concepts Based on Two-Factor Economics"

Testimony by Louis O. Kelso, Norman G. Kurland and Patricia Hetter before the Senate Finance Committee, U.S. Congress, March 31, 1976, on "Major Tax Revisions and Extension of Expiring Tax Cut Provisions"

Reports and Publications

"ESOPS: An Analytical Report" prepared for the Profit Sharing Council of America, Chicago, Illinois, by Hewitt Associates, Deerfield, Illinois

"Employee Stock Ownership Plans" prepared by The Committee of Publicly Owned Companies, New York, New York

"A Symposium on Employee Stock Ownership Plans", The American University Law Review, Spring 1977, Volume 26, No. 3, prepared by The Washington College of Law, American University, Washington, D.C.

"Making New Capitalists -- A Creative Response to Income Inequities" prepared by the 1977-78 Twentieth Session, Executive Seminar in National and International Affairs, Department of State

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