

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECTS 86 / 2

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In this regard, Senator Metzenbaum stated:

"...Former Supreme Court Justice Arthur Goldberg... has made the point publicly that the director is unable to have available to him or her the necessary tools to really find out what the corporation is doing except at a very superficial level. And perhaps the major corporations which have outside directors, perhaps there ought to be some kind of staffing for the board... not responsible to the executive officers, because no outside board member can really find out much about the company's activities except by the pro forma kind of responses... when you ask for a report."

Ralph Lazarus and Dean Yavitz opposed on the other hand, the concept of a separate staff although they believe the board should have access to the services of the regular corporate staff. Dean Yavitz stated with respect to proposals for a separate staff:

"I have a sense that that's liable to turn into an expensive and probably not very effective mechanism. I think it opens too many doors to the kind of our staff against your staff confrontations....So I would rather ...a provision that permits the board to retain outside services, outside talent, if it finds that internal resources fail to meet its needs and requirements."

Leonard Leiman pointed out that medium or small corporations may not be able to afford to pay directors enough to enable them to devote sufficient time to corporate affairs or to provide them with a staff. He emphasized expansion of the role of the professional advisers to the corporation, such as the outside auditors.

4. Limiting Tenure of Directors

A handful of commentators, including Evelyn Davis, Mary Gardner Jones, Mark Green and Winthrop Neilson, favored a limited number of terms for directors. Limited tenure, according to these commentators, would assure independence of directors and permit

the inclusion on the board of persons with new perspectives. While Lee Seidler agreed that over time it may be difficult for outside directors to maintain an objective viewpoint, he did not favor a maximum term of service for directors. He believes that experienced directors will make far better policy decisions and that it will be necessary to rely primarily on the integrity of directors to maintain their independence.

5. Characteristics Which Directors Should Possess

Many commentators referred, at least indirectly, to general characteristics which board members, either individually or as a group, should possess. These commentators often emphasized that absent such qualifications, suggested reforms, such as changes in the composition of the board, would not be effective. J. Wilson Newman, for example, stated:

"Corporations must take a fresh approach to the selection of directors. Greater attention must be given to finding people who have the ability to deal competently with business affairs and who have exhibited high standards of personal integrity. They must also have the independence to challenge the proposals which management has the duty to present, and the courage to overrule them when necessary. A system of checks and balances is essential, but only the character and ability of the directors will make it work successfully."

These commentators agreed with the view of the Business Roundtable that the board should include directors with different backgrounds, such as women, members of minority groups and persons whose major activity has been in public service or in the academic or scientific communities, because such a "mix" brings to the deliberations of the board different perspectives and experience.

Approximately ten commentators, including several individuals, indicated that it would be desirable if all directors had some equity ownership in the corporation on whose board they serve (e.g., Gilbert, Jacoby, Petrie, Wheat).

According to Francis Wheat:

"There is an old notion abroad that directors really ought to have some stake, however small, in the company of which they are directors in order partly to insure that they have something important to backstop their interest in and zeal for the rest of the stockholders."

Michael Knoll stated that according to a recent research project conducted by his brokerage firm, in only one of the Dow Jones Industrials, Alcoa, did inside directors own more than 2% of the outstanding voting stock.

6. Constituency Representation

Approximately twenty commentators discussed whether directors should represent distinct constituencies. Persons supporting constituency boards were, however, clearly in the minority. Representative of the proponents of constituency boards was Mark Green who stated:

"Each director would have the same obligations of — fiduciary obligations they now have to the company. In addition, each would wake up in the morning with a special mission. And we think that unless this were made explicit that those missions to ensure consumer protection, for example, or environmental protection, or technological assessment prior to implementation, are too often — and the evidence is clear on this — simply ignored."

Other commentators who favored particular constituency representation on the board included Allen Mansfield (labor and consumer representation) and Ashley Brown (community representation, particularly on the boards of public utilities).

The majority of commentators, however, opposed the notion of constituency directorships. These commentators, including Ray Garrett, Mary Gardner Jones and Dean Yavitz believed that constituency boards would result in divisiveness and, according to Ralph Lazarus, would eliminate "the common standard and common objectives of Board performance — an obligation that all Board members share to all shareholders." In this regard, Mr. Lazarus pointed out that American Labor is showing little interest in constituency representation at the board level, and both he and Richard Smith believe that labor should not be present on both sides of the bargaining table.

7. Composition of Board

Almost all of the commentators agreed that the board of directors has a crucial role to play in improving corporate accountability and corporate governance and that to perform this role the board must be able to exercise independent judgment. According to J. Wilson Newman,

"The board of directors...is really the key to the renewal that is so badly needed... We must realize the democratic potential of the system and make directors stronger representatives of the shareholders who elect them. We must create a balance of power, of authority on the one hand and responsibility within each corporate system. The way to do that is to make the board of directors an independent force in corporate affairs rather than a passive affiliate of management"

Several commentators stressed the need for an independent board to be a "window to the world" and provide innovative thinking (e.g., Senator Metzenbaum). Dean Yavitz stated in this regard:

"...my argument simply is that a good chief executive officer and a good group of his senior aides are just too deeply involved in corporate affairs, in relatively short run and close to operational affairs to really be able to spot clearly enough and in a sensitive manner the kind of changes that are going on in both expectations and demands of the [external] environment on the corporation."

Most commentators criticized the traditional board of directors, which is dominated by insiders, because they believe that such a board cannot adequately monitor the performance of management (e.g., Professor Jacoby, Nader, Dean Yavitz). Francis Wheat, for example, stated:

"A board composed largely of officers subordinate to the chief executive, plus a few outsiders hand-picked by him, can hardly be expected to hold the chief executive to a high standard of responsibility if he is otherwise inclined."

This view was seconded by the CLPI, which noted that the Northrop board had been "appointed" by the company's chief executive officer and, as a result, permitted him sufficient isolation to perpetrate illegal activities.

According to Professor Mace, research which he conducted in the late 1960's clearly indicates the reason why boards whose membership is controlled by the CEO are so ineffective:

"...the CEO's of large, medium, and small-sized corporations controlled the membership on the Board. And, not only that, they controlled what the Directors did or did not do. CEO's, I found, selected traditionalist friends, colleagues, associates, classmates, clubmates, who were not expected to ask discerning questions — certainly they were not expected to do anything more than approve what management proposed."

While a number of commentators affirmed the need for outside directors, without specifying the extent to which they should be represented on the board, and others recommended that the number of outsider directors be significant (e.g., Lazarus, Coombe), a large number of the commentators responding on the issue of board composition favored boards with a majority of outside directors. Most of these commentators believe that a majority of outside directors is necessary for the board to successfully perform its monitoring function (e.g., Alibrandi, Loc. Sommer).

Professor Mace questioned the ability of inside directors to perform this function:

"How could an inside director with aspirations of continued employment measure objectively the performance of the CEO? The fact is he can't and, he won't and he doesn't...Inside directors maintain discreet silence at meetings and they should, because if they don't they are promoted to become the regional manager in Timbuktu."

Keith Loudon, a professional director, and Robert Greely of the FAF pointed out that the contributions of management to the deliberations of the board can be made in their role as managers and, therefore, it is not necessary to include more than a minority of insiders on the board.

A handful of commentators discussed the issue of whether boards should consist entirely of outsiders. Joel Seligman proposed that no full-time operating executive be permitted to serve on the board. He stated:

"The greatest virtue of a fully independent board would be its tendency to prevent inefficient or illegal transactions from ever occurring. By removing executives from control of the board that is supposed to review their actions, directors will be able to ask tough questions without fear of offending fellow directors; they will be able to confirm operating managers' assertions of fact and subject manager's business initiatives to independent scrutiny."

Richard Smith, however, believes that serving on the board with members of management provides outside directors their best opportunity to evaluate management. Additionally, he opined that outside directors may be reluctant to take a position on major corporate decisions unless members of management share in the board's responsibility for actions taken by voting. Few commentators addressed the advisability of the Chief Executive Officer also holding the office of Chairman of the Board. Most of these commentators did not oppose this practice (e.g., Lazarus, Wheat, Dean Yavitz). Joseph Alibrandi, President of Whitaker Corporation, described the structure of that corporation's board, in which the chairman of the board is an outside director, as unique among American corporations. A strength of this arrangement, according to Mr. Alibrandi, is the ability of an outside director to gain access to independent sources and evaluations of information. In this regard, Mr. Alibrandi stated:

"...let's say he had a question with regard to some financial data or disclosure...he would not have to put himself in the position where he would have to go to management and say, 'I would like more information on such and such.' He would go to the Chairman of the Board, who has the power to use resources, and when I say resources, he can get an outside law firm to investigate something that the company is doing. He can hire an outside consultant completely on his own to evaluate or develop information...so, in effect, the outside directors would have the maximum capability...to develop that objective view of how management was doing..."

Senator Metzenbaum also favored having an outside director as chairman of the board so that control of the board agenda and annual meeting agenda would not be in the hands of the chief executive officer. He stated: "If you had the chairman independent and half of the board outside, you bring a tremendous breath of fresh air into the board room that isn't there now."

Several commentators (e.g., Geer) were concerned that expectations about the ability of outside directors to prevent excesses by management may not be realistic; Thus, Richard Lemon suggested that reliance on outside directors may be misplaced because they have the same background, the same training and are motivated by the same compensation system as management. Richard Smith and others questioned the ability of outside directors to do more than monitor ongoing management performance. William Gould agreed that management may be able to hide certain activities from the board, but believes that this problem would exist regardless of changes in board structure.

8. "Independent" Directors versus "Outside Directors"

Much of the discussion of how boards should be constituted revolved around the question of whether nonmanagement directors should be completely independent from management. In this regard, Bryan Smith referred to a Conference Board study released in September, 1977, which found that of 99 major U. S. manufacturing corporations surveyed, 83% had boards with a majority of outside directors, and also to an analysis of that study which showed that if former employees had been considered "insiders" the percentage of boards with a majority of outside members would be reduced to 60%. Mr. Smith also referred to the debate, reflected in the comments of the American Society of Corporate Secretaries on the Corporate Directors Guidebook, concerning whether former officers can be considered to be independent of management for any purpose, including audit committee membership.

Many commentators expressing views on the desired composition of the board and certain standing committees of the board made it clear that the terms "outside" and "non-management" are not synonymous, and that certain affiliations with management may be sufficient to disqualify one from being considered an "outside" director. Thus, William Gould, Esq., stated:

"I would draw a distinction between the definition of an outside director and what I would call an independent director. I am not satisfied that a board must consist solely of outside directors if you included within the definition of an outside director somebody with a relationship to the corporation. Because in my mind those people are not independent enough to really recognize the responsibility to the shareholders."

A number of commentators agreed with Mr. Gould that retired company employees and persons with important business or professional relationships with the corporation should not be considered "outsiders" or "independent" in determining the composition of the board or membership on the audit, compensation and nominating committees.

Referring to the Conference Board study of board composition, Professor Mace "discovered that 41 percent of all 'outside directors' were...retired people, investment bankers, commercial bankers, and outside legal counsel. And, boy, they are no more outsiders than having the CEO's wife on the Board."

Many commentators believe that the corporation's commercial and investment bankers are not truly independent because they provide services to the corporation (e.g., Professor Cary, Hutson, B. Smith, Sommer, Senator Metzenbaum). While Bryan Smith believes that the corporation's outside counsel can be considered independent, many commentators disagreed (e.g., Professor Cary) or objected to counsel serving at all, pointing out the potential ethical conflicts which can arise from having outside counsel sit on the board (e.g., W. Gould, Sommer).

A few commentators, including Professor Cary and Samuel K. White of Sun Company, also believe that representatives of significant customers or suppliers of the corporation should not be considered outside or independent.

Keith Louden proposed that only persons whose sole source of income from the corporation is a director's fee should be considered "independent".

9. Need for a Committee System

Commentators generally favored the establishment of certain standing committees of the board as a means of efficiently carrying out its legal and operational responsibilities (e.g., Dean Yavitz) and of helping to assure the autonomy and independence of the board (e.g., Heard). Commentators discussing the committee system favored the formation of three standing committees, the audit, compensation and nominating committees, and suggested that these committees be comprised of at least a majority of outside directors.

The audit committee would, according to William Gould, "provide a direct avenue of communication between the outside directors and the corporation's auditors...giving such auditors a responsive level of authority higher than management." According to Lee Seidler, Deputy Chairman of the Commission on Auditor Responsibility, the audit committee should take an active role in negotiations between the corporation and the auditor regarding the auditor's engagement in order to assure that audit quality is not sacrificed because of considerations of cost. A number of commentators referred to a function often assigned to the audit committee of ensuring employee compliance with the corporation's standards of ethical conduct and of attempting to prevent fraud and other illegal activities (e.g., Wheat). These commentators also point out, however, that the audit committee may have difficulty performing the role of in-house policemen. Thus, Professor Mace stated:

"My concern is that our higher expectation of what the audit committees will do is greater than most audit committees can in fact do. For example, I doubt very much that audit committees are likely to be much more effective in uncovering well-concealed programs for frauds, payoffs, bribes and kickbacks than when we had no audit committees at all."

The compensation committee would conduct arm's length negotiations of salaries and fringe benefits for management according to William Gould and Joel Seligman, among others, which would assure that remuneration levels are reasonable.

The nominating committee would receive suggestions for possible candidates for directors from other board members and shareholders. Richard Smith believes that suggestions could also be made by management and that the committee slate should be reviewed with management before being presented to shareholders. William Gould stated that the nominating committee could define the

standards, qualifications and conflict of interest policies to be used in selecting director candidates and have overall responsibility for preserving the quality of the board. The qualifications for board membership should include, according to Bryan Smith and the CLPI, a substantial, well-defined commitment of time. Several commentators stressed the crucial role to be played by the nominating committee in assuring that boards become truly independent of management. These commentators emphasized that the nominating committee should be composed entirely of outside directors (e.g., CLPI, Professor Eisenberg, Dean Yavitz, J. Newman).

D. Increasing the Role of the Self-Regulatory Organizations

The releases announcing the proxy rule re-examination raised the question of whether improvements in corporate governance and corporate accountability could be achieved through amendments to the listing requirements of the self-regulatory organization. A number of commentators addressed the appropriateness and feasibility of such an approach.

1. Commission's Authority to Effect Change Through Influencing Self-Regulatory Organizations

Several commentators questioned the authority of the Commission to attempt to influence self-regulatory organizations to make rules accomplishing changes which the Commission could not bring about itself. Professor William L. Cary, for example, cautioned against requiring self-regulatory organizations to amend their listing requirements and achieve reforms, such as requiring more outside directors on corporate boards, which are currently beyond Commission authority. David Ruder also questioned whether the Commission could act through self-regulatory organizations in order to influence internal corporate affairs. On the other hand, some support was expressed for expanded use of informal Commission suggestions for self-regulatory action, similar to the approach used in connection with audit committees.

At least one commentator, however, challenged the authority of the self-regulatory organizations to promulgate certain rule changes affecting corporate structure and governance. (Union Carbide letter).

2. Appropriateness of Commission Action through Influencing Self-Regulatory Organizations

Whether or not they were of the opinion that the Commission had the authority to act by influencing self-regulatory organizations, a large group of commentators believed that such action was not wise or appropriate. Among the arguments cited for this view were the following:

- (1) The Commission should not attempt to do indirectly what it cannot do directly. A number of commentators, such as the ASCS, ABCNY-Securities Reg., and the Business Roundtable, were of the opinion that it would be a bad policy for the Commission to become involved through the self-regulatory organizations in areas in which it has no direct authority.
- (2) Rules promulgated by self-regulatory organizations would not be of general applicability. The American Society of Corporate Secretaries pointed out that only about two thousand corporations are listed on

the New York and American Stock Exchanges, whereas almost 6,900 filed proxy material with the Commission in 1977. The Society also suggested that promulgation of certain rules by the stock exchanges might discourage the listing of securities.

- (3) Self-regulatory organizations are not qualified to make rules regarding corporate governance. For example, David Ratner pointed out that corporate governance is a matter of secondary importance to most self-regulatory organizations. Neil H. Jacoby agreed that corporate governance questions were extraneous to the purposes of self-regulatory organizations. Similarly, General Motors Corporation argued that self-regulatory organizations do not have the expertise or capacity to deal with technical questions regarding shareholders' rights. General Electric Corporation expressed concern that rule-making by self-regulatory organizations might be used to evade the legal procedures which must be observed in the Commission's rule making.
- (4) Other arguments against rule-making through self-regulatory organizations were that access to capital markets should be as free as possible (Hebert) and that exchange listing rules, for example, might not be flexible enough to allow for exceptional cases (Ruder).

Several commentators expressed varying degrees of support for rule-making action in the area of corporate governance on the part of self-regulatory organizations. Alice E Hennessey of Boise Cascade Corporation, for example, stated that self-regulatory organizations could appropriately implement corporate governance proposals since they understand the needs of the business community and shareholder interests. She indicated however, that Boise Cascade had not actively supported this sort of activity on the part of self-regulatory organizations.

3. Specific Proposals for Amending Listing Requirements of Self-Regulatory Organizations

Among the specific rule proposals suggested for implementation by self-regulatory organizations were the following:

- (1) Requiring companies coming under the jurisdiction of the organization to have a majority of "outside" directors (Feis);

- (2) Requiring companies to adopt procedures for shareholder nominations (Gallaway);
- (3) Promoting voting by the beneficial owner rather than the intermediary in the case of street name stock (Gallaway);
- (4) Requiring compliance with federal environmental regulations (Reinisch);
- (5) Requiring cumulative voting in the election of directors (Reinisch); and
- (6) Requiring federal incorporation if such a statute is adopted (Reinisch).

E. Federal Minimum Standards Legislation

While minimum standards legislation appeared to have more support than a federal chartering approach, it was opposed by a majority of the commentators. In addition to the general concerns about increased federal intervention into internal corporate process, and the widely held belief that existing standards are adequate, opponents of such legislation expressed the view that minimum standards would actually become maximum standards (Georgeson), that they would be no more effective a deterrent to misconduct than the fear of shareholder derivative suits already is (Levi Strauss), that they would not be likely to require a higher standard of conduct than now exists, and that if they did, in fact, make directors insurers of fairness by eliminating the "business judgement rule" defense or limiting indemnification, qualified persons would be deterred from serving as directors (Union Carbide).

Advocates of a minimum standards bill, on the other hand, stressed the need for clearer federal rights of action (CLPI), a higher level of fiduciary standard than can be imposed by states concerned with protecting local companies and producing revenues (Seligman, Cary) and the importance of changing corporate structure (CLPI). They suggested, therefore, that the bill should contain an explicit private right of action (Kaye, Cary, Ratner), require directors to meet a standard of "inherent fairness" (Cary), prohibit staggered boards and other anti-takeover devices (Eskin, Matheson, Mansfield), guarantee cumulative voting (Gintel, Matheson, Soss), mandate structural reforms for boards of directors (Wheat, Metzenbaum), prohibit director indemnification, limit director tenure to four two year terms to maintain consistent turnover (Seligman), require periodic changes of outside auditors (Brown), and outlaw the use of manipulative procedures in connection with annual meetings (Lemon).

F. Federal Chartering

The question of the desirability of legislation requiring federal chartering provoked very heated debate but was supported only by a handful of people. Principal advocates of this type of legislation expressed the view that our state chartering system has "disintegrated" and that a legal system that worked well in the earlier part of this century is no longer adequate, in view of the size of corporations and their potential to do harm (Nader). These persons suggested that most public, multinational corporations are governed entirely through private decision-making, when in fact there is a very real need that persons such as employees, consumers, shareholders, members of the community and other affected constituencies also have a voice in the decision making process. (Ryder, Hayden). The inclusion of their views, would, it was suggested, raise the level of corporate social responsibilities. It would also have the advantage of including all groups affected by big business behavior in corporate governance, rather than limiting this right only to shareholders. Since federal chartering is designed to restructure corporations from within, it would not require a new federal bureaucracy to implement such a law (Hayden).

Opponents of federal chartering, however, expressed strong opposition to this approach. They opined that federal chartering would result in such a concentration of power in the federal government that a basic restructuring of our political organizations would inevitably occur (Bower). Federal chartering was equated with total government regulation of corporations which, it was feared, would become an easy vehicle for total regulation of the American economy (Cary). It was also suggested that the central goal of proponents of federal chartering is not to improve the law of incorporation but rather, to establish new federal controls designed to remedy various perceived social ills. The abuses cited by those who support such legislation, including pollution and illegal payments, have never been matters covered by state corporation law and the remedies for abuses of this sort lie in specific substantive legislation, separately considered and adopted only after full political debate (Crompton).

G. Reaction to SEC Solicitation of Comments on Need for Legislation

While a number of commentators praised the Commission's concern with the broad issues raised in this proceeding, others found the breadth of this inquiry to be inappropriate. Typical of this reaction was the response of Levi-Strauss, which noted that a corporation has four constituencies: shareholders, employees, customers and the public. The Commission's concern is with shareholders and the sector of the public which is directly involved in the securities market. It should not become

a "self-appointed guardian", of the public interest in areas essentially unrelated to its areas of expertise and competence. Similarly, the ABA noted that the Commission's mandate does not extend to substantive laws relating to corporate governance, and the Pacific Gas and Electric Company emphasized that substituting federal law for existing state law is a matter which should be dealt with on its own merits by Congress, and not by the Commission.

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Kelsoism, GSOC, and AGSOC

Prepared for
The House Finance Committee
ALASKA STATE LEGISLATURE

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 associates¹ 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

¹These 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.

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

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 expeditious 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 revolution 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 unprecedentedly 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 Economic 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

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.

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

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 minimized. 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 to 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 another⁷ 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

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 ($\$200 \div .05$). 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:

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

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 Dawnligh Court
Anchorage, AK 99501
February 12, 1980

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

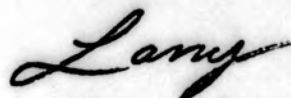
Dear Russ:

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 L. Ross

RECEIVED

MAR 18 1980

BUDGET/AUDIT
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 that¹²

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 Corporation.")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 accomplish 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 10 percent of AGSOC shareholders to wind up owning 100 percent 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 political act, creates economic 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; all 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 octopus-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

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

²Kelso & 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.

³Ibid., p. 24.

⁴Ibid., p. 16.

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

⁶Ibid., p. 28.

⁷Ibid., pp. 28-34.

⁸Ibid., p. 3.

⁹Ibid., p. 5.

¹⁰Kelso et al, p. 15.

¹¹Ibid., pp. 70-71.

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

¹³Kelso et al, p. 25.

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

¹⁵Kelso et al, pp. 79-80.

¹⁶Ibid., p. 27.

¹⁷Mike 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.

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

¹⁹Kelso et al, p. 7.

- ²⁰It's Time to Take Stock in Alaska, p. 1.
- ²¹William P. Albrecht, Jr., Macroeconomic Principles (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1979), pp. 70-71.
- ²²Kelso et al, p. 7.
- ²³Doogan, p. 14.
- ²⁴John Kenneth Galbraith, The New Industrial State (Boston: Houghton Mifflin Company, 1967), p. 6.
- ²⁵It's Time to Take Stock in Alaska, p. 2.
- ²⁶Friedman, p. 15.
- ²⁷Ibid., p. 16.
- ²⁸Ibid., 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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