SCOMM

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GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

June 5, 1978

The Hon. Mike Gravel
United States Senator
4107 Dirksen Senate Office Building
Washington, D.C. 20510

Attention: Mr. Jerry Gauche

Dear Jerry:

With your note of May 24, 1978, you enclose "the latest GSOP draft" and comment that "we are getting closer." I have strained every brain cell I have and reflected on every relevant bit of experience that I have, and yet I cannot avoid my response springing up from your comment -- "Perhaps, but to what?"

My deep regard for you and for Senator Gravel, for your courageous and forthright concerns to work out solutions to the major world problem of the day -- workable methods of wealth generation and income distribution that are consistent with political democracy and a free-market, private property economy, and my own life-long dedication to these goals, compel me to say that I do not think the concept of a GSOP that you are working with is sound, that therefore it will be successfully attacked from many quarters, and that if it were enacted into legislation, I think it would create confusion from a source where a reputation for sound thinking is being built. If my analysis is in error, please show me where the error lies. My following comments spring only from a sense of duty, and not at all from a desire to second guess.

Here is the problem as I see it.

Assuming that the theoretically distinct legal and business institutions (I will call them "tools") for financing business on the one hand, and for making the poor rich (to the maximum extent practical in each instance) that have been developed to date are:

1) The ESOP,
2) The CSOP,
3) The GSOP,

let us examine the similarities and distinguishing characteristics of each:

Similarities and Differences:

a) Each is a financing device. Each would function to serve the general goals of accelerating economic growth and broadening legitimate acquisition of capital ownership without any added advantages arising out of changes in the income tax laws. Indeed, each would function best if there were no corporate income tax laws at all. (See Exhibit A attached.) But time of transition in the establishing and implementing of a new economic policy built on Two-Factor Economics is critical. The signs of impending economic collapse are alarming. And there <u>are</u> corporate <u>and</u> personal income tax laws. To the extent that changes in the tax laws can accelerate the goals of a Two-Factor policy, for the benefit of people, business and government, then it makes sense to speed the process with tax reforms. But it is basic to recognize that each of the three methods is a financing method, not a method of taxation or a method of paying compensation.

b) Each of these three methods applies primarily to a category of circumstances. The ESOP, while financing a wide variety of transactions for corporate businesses, is particularly suited to enabling employees to acquire economic independence over a reasonable working lifetime. If given further legislative encouragement by measures such as H.R. 462 which was introduced but not acted upon in the 94th Congress, the adoptions of ESOPs would be speeded up enormously, the welfare burdens of the future and thus the costs of government and the burdens of taxpayers, would be shrunken rapidly, and the personel tax base would be immeasurably enlarged.

c) The CSOP selects consumers as those to have capital ownership built into them, while being capable of meeting all financing needs of the future of certain kinds of businesses. It is suitable only to relatively large, capital intensive businesses where experience has shown long-sustained patronage or seller-customer relations to be the norm. It is particularly applicable to regulated public utilities; to banks, to savings banks; to savings and loan associations, and to various other enterprises. Investment is required in proportion to patronage, and thus the resulting capital ownership created by CSOPs is proportioned to patronage. Corporate customers of a CSOP might easily be required to pass through their shares to their stockholders to prevent the use of the method to concentrate wealth ownership. The only

CSOP established to date (1958-65) but an enormously successful one, is Valley Nitrogen Producers, one of the largest agricultural chemical producers in California, and a tremendous success.

d) CSOPs, used in conjunction with ESOPs, are ideal for financing the conversion of mutual companies of all sorts -- savings and loan associations, savings banks, insurance companies, commercial banks, etc. All these face gaping financing deficiencies in the near and distant future. All of these, except perhaps converted mutual insurance companies, should be owned by individual stockholders within the communities in which they operate. All should have broad constituencies. ESOP conversion, with, say, an arbitrary allocation of 25% to 35% of the stock to the employees through their ESOP and the remainder of their stock becoming owned by their customers, with eligibility of the loan financing paper to Federal Reserve discounting at the pure administrative cost to the Federal Reserve System, would put us into a 10-15% economic growth pattern, while building matching consumer power in the public utility field and in the savings and loan and banking fields. The present need for this low-cost financing in these two fields is recognized by experts in these industries today.

e) The unique characteristic of the GSOP (which Mortimer Adler and I at first called the Financed Capital Ownership Plan in THE NEW CAPITALISTS (1961) and in my testimony before the Heineman Commission in May, 1969) is that its stockholder constituency is selected <u>politically</u> because no other method seems appropriate. For that reason we have urged their use (in Puerto Rico and in Alaska) only when no other method seems to solve the problem.

f) The economies of Puerto Rico and Alaska are unique, and each has economic challenges and circumstances not found in the other 49 states in general. In the case of Puerto Rico, it has its own separate tax system. It had (and still has) a higher percentage of unemployment, and government employment than any state. In the case of Alaska, it has a high level of wealth in relation to its population size and only a GSOP would do the job. Absent these unusual circumstances, the GSOP is by its nature <u>a nationwide plan</u>. Its appropriate constituencies would be the elderly poor, the social security recipients as a way of phasing out their social security, enlarging their income and making them economically independent, government employees, the welfare-dependent, the chronically unemployed; in every case a nationwide constituency, selected by Congress.

g) The GSOP is a method almost useless without its contemplated direct link to the monetary system. It is, at heart, a method of changing from the monetization of welfare, as we are doing today, with the inevitable vaporization of the value of our monetary unit, to monetizing self-liquidating productive capital. It is a method of converting inflation into deflation, with uniformly beneficial side effects. It has with the rarest of exceptions no application to a political entity smaller than a sovereign nation having its own monetary system. It is basically national in character, not suited for states, counties, cities, in each of which it could begin to function as a governmental encroachment on private enterprise.

h) There have been good reasons for not "pushing" the GSOP in the U.S. economy as a whole, until a high growth level has been achieved through ESOPs and CSOPs and until a substantial part of the goal of general affluence has been achieved, apart from the unique characteristics of the economies of Alaska and Puerto Rico. The building of a national capital structure large enough to produce a high general standard of living will require maximum motivation of all potential members of the labor force to enter it and get the job done. My estimate is an economy with a capital structure in excess of seven times the capacity of the present one, on a per-capita basis.

i) One could easily differ with this reasoning and argue that the GSOP is imperative now in order to build capital ownership into government workers, the elderly, the unemployable, etc. If so, then it must be approached as a national program, not one that can be adopted by states, counties, cities or towns. It must broadly meet the financing requirements of business, and the legislative measures that accompany it must powerfully encourage equity financing and discourage debt financing, the availability of GSOP financing must be so clearly reliable that, again by legislative or tax measures, the high-payout of the yield on equity (restoration of private property in capital, the ownership of which is represented by corporate stock) can be required or motivated. The entire relationship of the process for qualification of the stocks of business corporations for ESOP financing and the registration of securities for SEC purposes must be integrated and simplified. The trusts (escrows) established to receive loan financing from banks, with CDIC insurance, must be of such nature as to promote long-term investment, not short-term (5 year) speculation, and finally a financing transaction that simply puts the average man in a position to buy capital with credit and to pay for it out of what it produces, must not be misinterpreted as an income or compensation transaction in the one-factor sense of the word and taxed as income. It is not income, and to so treat it would be to take two centuries to do what can be accomplished in 25 years.

Politically, Jerry, I think the CSOP is the thing to offer all 50 states in return for their support to Federal Reserve discount rights for the Alaskan GSOP within four or five years when it will be needed. The steps could be initiated now if desired; the sooner, the better. I do not think the Senate and House Banking Committees are going to be the obstacles you visualize because they know they are facing otherwise unsolveable problems.

But if you and the Senator think otherwise, I am ready to help. We are talking about either a new administrative agency or a new division in the Department of Commerce, and a whole new set of laws and amendments to existing securities laws, tax laws, welfare laws, social security laws, etc.

I sincerely believe the present approach would produce nothing but confusion.

Please tell me what you think.

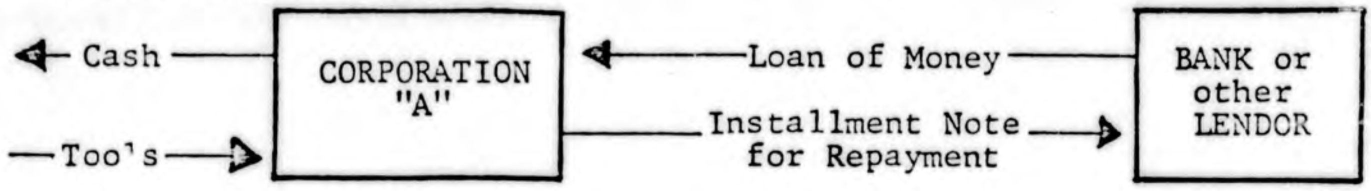
Warm regards to you and the Senator,

Louis O. Kelso

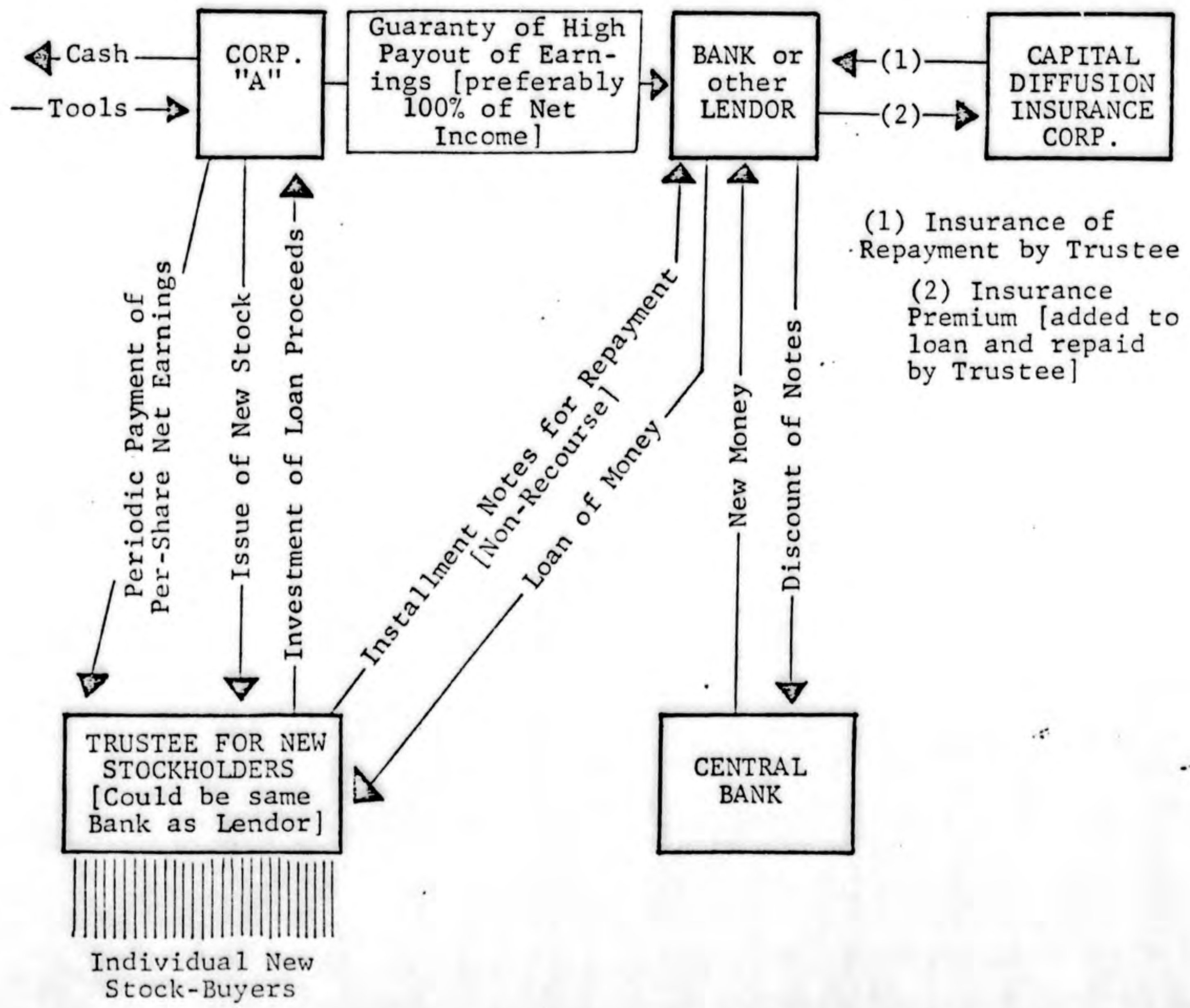
LOK:jhb

COMPARISON OF THE CONCENTRATING EFFECT OF CONVENTIONAL CORPORATE FINANCE
WITH
THE EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) TECHNIQUE OF
SIMULTANEOUSLY FINANCING NEW CAPITAL FORMATION
AND CREATING NEW CAPITAL OWNERS
WITHOUT IMPAIRING THEIR SAVINGS OR INCOMES FROM OTHER SOURCES*

I. THE CONVENTIONAL METHOD:



II. THE FINANCED CAPITALIST or THE ESOP ALTERNATIVE:



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EXPLANATION of CHART 10:

1. Method I above illustrates the economic effect of financing new corporate capital formation either through retained earnings or through borrowings repaid from retained earnings. In either case, when the loan is repaid, the productive power of a stationary body of stockholders is increased by the newly formed capital. No new shareholders are created.

2. Method II illustrates how, if corporate income taxes are eliminated, and corporate net earnings are fully paid out currently, so that the full income-producing power of real (i.e., physical) capital is made available to new stock purchasers, they can pay for their stock from the income produced by the underlying tools and assets, without diminishing their savings or reducing their consumption. The managements of large and stable corporations know that newly formed capital is self-financing, since a new expansion normally will not be undertaken unless it will quickly pay for itself -- usually in 3 to 5 years. But the conventional method of finance [Method I] makes this self-financeability available only to existing stockholders. Method II enables new stockholders to utilize it as well. By making the self-financeability of newly formed capital in well-managed businesses available to the propertyless majority, as well as to the capital-owning minority, Method II enables the many to raise their power to engage in production through capital ownership and thus to raise their consumer income. Thus, Method II is a method of building consumer power (i.e., markets) along with new productive power. To eliminate doubts of the bank or other lendor, a loan insurance plan is proposed, similar to the Federal Housing Insurance Corporation home mortgage plan in the U.S. and other similar national housing mortgage insurance plans.

3. Finally, since a new valid corporate strategy that increases production and sales, and also raises the power of financially under-powered workers and the unemployed to consume by making them owners of productive capital, should increase national growth rates in most industrial economies by 3 or 4 times previous rates [even more for developing economies], it must be assumed that all available accumulations of financial savings would be exhausted at an early date. The financed-capitalist paper must then be made discountable at a nominal rate with the central bank. This, in effect, finances new capital formation out of pure credit and monetizes newly formed capital in central bank-approved, well-managed corporations, where newly formed capital only comes into existence if it will, in the judgment of corporate management, pay for itself quickly; and then continue to produce goods or services indefinitely thereafter, its productiveness constantly restored through depreciation policies which set aside sufficient funds for that purpose before net income is computed. Because newly formed capital will continue to throw off goods and services indefinitely after the credit (loan and interest) has been repaid, this technique has the virtue, if properly used, of making continuously and simultaneously possible:

(a) Expansion of production of goods and services with rising worker incomes and without increases in unit costs, free of any limitations imposed by unavailability of accumulated financial savings. Thus, this technique can free an economy without savings accumulations from dependence on foreign investors.

(b) Progressive deflation with expanding opportunities of the non-capital-owning majority to acquire rising incomes through capital ownership. This proposal is the exact reverse of the inflationary process of one-factor economic systems under which labor demands progressively more pay for less work, packing the wage bill with welfare and using the price system to tax the public. As labor discovers it _is_ the public, it must again and again repeat the inflationary process.

4. For further discussion, see:

SUGGESTED READING ON TWO-FACTOR ECONOMICS

Books

THE CAPITALIST MANIFESTO by Louis O. Kelso and Mortimer J. Adler (Random House, New York, 1958; Greenwood Press, Westport, Connecticut, 1975)

THE NEW CAPITALISTS by Louis O. Kelso and Mortimer J. Adler (Random House, New York, 1961; Greenwood Press, Westport, Connecticut, 1975)

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

Testimony

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

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

Reports and Publications

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

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

"Uprooting World Poverty: A Job for Business" from the Fall 1964 issue of BUSINESS HORIZONS, Indiana University, Graduate School of Business.

KELSO & CO., INCORPORATED

By____________________________

Louis O. Kelso, President
and Chief Executive Officer

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

October 3, 1978

Mr. Jerry Gauche
Legislative Aide
Office of United States
Senator Mike Gravel
3121 Dirksen Senate Office
Building
Washington, D.C. 20510

SUBJECT: GSOP Legislation

Dear Jerry:

While I gather from our telephone conversation of Tuesday afternoon that substantial restructuring of the proposed GSOP bill has been done by the drafting team on the Joint Committee since your outline of September 25, 1978, a copy of which you sent to me, nevertheless I will give you the benefit of the comments of our tax counsel, George Byron Gordon, on your draft of September 25, 1978. The information may be of some use in your attempting to obtain modification of the bill so that amortization of corporate debt incurred for the purchase of capital assets will be treated by each Alaskan AGSOC stockholder taxpayer as a deductible expense.

The following references are to the sections, subsections and paragraphs as enumerated in your memorandum of September 25, 1978, to Messrs. Ted Sims, et al.

Section I, Paragraph 3

Should not the word "ownership" be changed to "initial ownership" or "issuance"? While all of the design thinking must be hammered out yet, is it not possible that there will be something similar to a vesting schedule, under which, after a certain period of years, or the reaching of a certain age, vested shares may be removed from the state? For example, an Alaskan resident may wish to retire to Hawaii. His ability to do so may be dependent upon his ownership of AGSOC stock. This would not result in permanent removal of the stock from the state if the stock can only be sold back to AGSOC. In other words, if AGSOC becomes the sole market for the stock.

Section II-B

In line 2, after the figure "531", insert a semi-colon and the following words: "shall be deemed not to be a regulated investment company nor a personal holding company for any purposes of the Internal Revenue Code or for any purposes of regulation by the Securities and

Exchange Commission."

Section II-B, Paragraph 2

Strike present language and insert in lieu: "Corporation would be subject to all other provisions of Subchapter C, except that payments for amortization for and interest upon debt incurred to purchase capital assets shall be deemed deductible expenses and shall be included in the incidence of income, deductions and deductible amortization of debt principal flowing through to stockholders."

Section C, Paragraph 1

Change the period after "C" to a comma and add the same language as that inserted in the preceding paragraph beginning with the words "except that payments for amortization" etc.

Section II-C, Paragraph 4

Add at the end a new Subparagraph (d) reading: "Deductible share of debt amortization payments by the Corporation."

Section III-A, Paragraph 1

After the last word in the third line, "income", add "as computed under Section II-B, Paragraph 2 above."

Section III-B, Paragraph 1

In line 2, strike the words "but only", and after the next word, "to", add "the".

At the end of line 3, following the word "return", add the words "or is reported as deductible debt service in the information return filed by the Corporation under Section II-C, Paragraph 4, above."

Section III-B, Paragraph 2

Add the last four words "(but not below zero)" following the word "reduced" in the first line.

In the second line, following the word "holders", add the words "other than dividend amounts in excess of debt amortization deduction."

Among the arguments that you can use and I am sure have already thought of to persuade the Treasury to go along with the deductibility of each citizen-stockholder's share of the debt service are the following:

1. The working man and the average citizen have never been able, barring some negligible accidents, to acquire any significant capital

ownership in after-tax dollars. ESOPs, on the other hand, are presently building capital ownership into millions of working people, and this will make them better taxpayers. To attempt to substitute the use of depreciation for non-Federal-taxation of corporate income used to pay for the citizen-stockholder's stock ultimately amounts to denying depreciation to the corporation, and thus assuring that it will be a slowly dying enterprise. This deprives the Treasury of better individual stockholder taxpayers with incomes derived from a healthy enterprise. Furthermore, since many people will not understand that the failure of the GSOP as a business is directly the result of a tax legislation error, further disenchantment with broad ownership of capital will result. This flaunts the policy already set forth by Congress in the Tax Reform Act of 1976, as well as the policy recommendation of the staff of the Joint Economic Committee in its Annual Report for 1976.

2. If the GSOP legislation, which can first be used in Alaska, is properly designed and is successful, it may be used to set up a national financed capital ownership plan that could be used on the one hand to finance corporate growth in general with low-cost capital, and to provide capital incomes to take the place of Social Security, and perhaps eventually welfare in general at the national level. In other words, an error at this level can defeat the solution of some of the most solution-resistant problems that the nation's economy faces today.

3. Even the recent publication by the State Department, "Making New Capitalists -- A Creative Response to Income Inequities", in its title, as well as in its text, acknowledges the wholesomeness of the two-factor financing technique behind the ESOP. All that our proposals would do is extend this principle to some major assets at the state level.

I wish you great success.

With best regards,

Sincerely,

Louis

Louis O. Kelso

LOK:ch

DATE: August 8, 1978

TO: Jerry Gauche, Legislative Aide to The Honorable Mike Gravel, United States Senator

FROM: Louis O. Kelso

SUGGESTIONS FOR REVISION OF S. 3223 AS INTRODUCED INTO THE SENATE OF THE 95TH CONGRESS, 2ND SESSION, ON JUNE 27, 1978 (CONGRESSIONAL RECORD, VOL. 124, NO. 96)

Purpose of Suggested Changes

It is suggested that the proposed changes will facilitate the use of GSOPs to finance economic growth and broaden direct and individual ownership of industry by the politically-selected constituency. These changes should also reduce the possibility of the abuse of the GSOP device to concentrate the control of industry as well as to prevent the potential politicizing of a GSOP. In other words, if a GSOP becomes simply another financial intermediary, even though it may pay out all of its earnings, it could become a threatening instrument for the control of industries and thus the election of its Board of Directors would inevitably become a political phenomenon. This is consistent with the comment made in Senator Gravel's floor statement at the time of introducing S. 3223 when he noted:

> "Therefore, I think the people of the State should hold direct ownership of any equity interest the State chooses to make in private business."
>
> * * *
>
> "Without providing for direct ownership of the stock a plan such as the one I propose would be unduly paternalistic."

Suggested Changes in the Initial Draft of S. 3223

(References are to the draft bill taken from the Congressional Record and not to the Committee Print with numbered lines.)

(1) Since under these proposed amendments a GSOP, such as the one proposed tentatively in Alaska, may establish its own trust division, whereas it is probable in every other state, any banking firm or business authorized to engage in the trust business (a regulated business in all states), after having met the qualifications laid down by the GSOP by regulation, will undoubtedly be used as the escrow holder for individual accounts, the acronym "GSOP" should be substituted for the word "trust" wherever it occurs. This would have the added effect of inviting assistance, and avoiding opposition, of the banking community.

(2) Section 1, line 6, change the word "trust" to "plan (GSOP)".

(3) Section 1, line 8, strike the words "or a" and in line 9, following, the words "political subdivision of a State".

(4) In line 10, add an "s" to the word "purpose".

(5) In line 10, after the word "of", insert "financing the acceleration of economic growth of all types of business corporations intended to be profit producing".

(6) In line 10, after the word "broadening", insert the word "equity".

(7) In Section 1, line 22, which begins with "(A)", add the following: "if the sponsoring jurisdiction be a State, it".

(8) Amend Section 1(B) in its entirety to read as follows:

"(B) provides for the borrowing by the GSOP from individuals, banks, insurance companies, pension or other retirement funds, governmental agencies, or other loan sources, for the purpose of investing the proceeds of such loans in the voting equity shares of any business corporation carrying on at least a significant part of its operations within the boundaries of the political entity that established such GSOP, with or without a limited or unlimited guarantee of the repayment of such debt by such political entity or a subdivision thereof or a governmental entity of which it is a subdivision, provided that:

(i) the corporate entity in which such investment is made by said GSOP shall fully meet criteria of credit worthiness established by regulations adopted by the political entity which established said GSOP or by the GSOP if the power to make such regulations has been delegated to it by such sponsoring political entity, which criteria shall be designed to assure the adequacy of the dividends to be paid by the corporation in which such investment is made over the term or terms of the loan or loans incurred by the GSOP to make such stock investment or investments, and which criteria shall take into consideration the added financial feasibility resulting from the guarantee of the repayment of such loan or loans by such political entity;

(ii) the shares of the issuing corporation purchased with each such investment shall have a fair market value at the time of closing of such purchase, or if such shares are not traded in any market or in quantities sufficient to constitute an effective market, an appraised value as determined by a qualified and experienced independent appraiser, at least equal to the purchase price paid therefor by said GSOP and shall be sufficient in number (to be achieved by the splitting of said shares or the consolidating of said shares, as may be required) to permit the allocation of shares or fractions of shares to the approved GSOP stock purchase escrow account of each such participant, as of the times of each repayment of an installment of the GSOP's money purchase indebtedness. Such allocation shall be on the basis of the original purchase price and may be based upon the anticipated aggregate principal and interest of the indebtedness over the term of the financing loan or loans, with allocations being made substantially equally over the aggregate number of repayment periods, and equally to each participant account existing at the end of each installment repayment period;

(iii) "approved GSOP purchase escrows" may be established within the corporation whose shares are purchased by said GSOP if said corporation be authorized by law to carry on such trust and escrow functions, or in any bank or other corporation legally authorized to do a trust business within the jurisdiction of the political entity establishing said GSOP, if the escrow operations of such escrow holder conform to regulations relating thereto promulgated by the political subdivision establishing said GSOP or its duly authorized delegate;

(iv) the vesting of the ownership of such shares so purchased by the GSOP shall take place _pro tanto_ only as the principal and interest of the loan financing incurred to purchase such shares is repaid;

(v) each participant shall be authorized to establish only one GSOP purchase escrow account, and all shares purchased by such GSOP in all corporations in which it may invest, to the extent that such shares are allocated to such participant, shall be allocated to that sole escrow account;

(vi) after the loan financing, principal and interest, applicable to the purchase of particular shares of stock in which said GSOP has invested is repaid, the dividends paid upon such shares, reduced only by deductions of a proportionate part of the expenses of operating the GSOP, which shall be allocated equally among all accounts in said GSOP, shall be paid into the escrow accounts in which such shares are held, and shall thereupon be promptly paid, after deduction only for approved escrow fees of the escrow agent, to the GSOP participant as the owner of said escrow account;

(vii) each corporation having shares of its equity stock purchased by said GSOP, whether upon original issue, or upon subsequent purchase from an intermediate buyer, shall, in order to make said shares eligible for purchase by said GSOP, legally commit itself in writing, in terms satisfactory to the GSOP, periodically to pay to said GSOP its full net earnings (gross earnings, less operating expenses and necessary and reasonable operating reserves and depreciation) allocable to the shares of its stock so purchased by said GSOP, in return for which, said GSOP shall commit itself, with the approval of the political entity which established said GSOP, to equity stock purchase participation in the future growth requirements of such issuing corporation in the proportion that the market value of the number of shares in said issuing corporation theretofore purchased by said GSOP shall bear, at the time of the closing of each such subsequent financing, to the total debt and equity capital of said issuing corporation;

(viii) the GSOP provides for the allocation to each existing GSOP purchase escrow of securities purchased by the GSOP since the last preceding allocation as of the last day of the GSOP's fiscal year in which the individual who established such escrow account became a participant in the GSOP, in a manner which does not discriminate among such participants on the basis of race, sex, age, income, or ownership of property."

(9) Section 1, paragraph "(C)", subparagraph "(i)", line 1, change the number at the end of the line from "5" to "10".

(10) Section 1, paragraph "(D)", line 2, after the words "by the trust" (changing as throughout the word "trust" to the word "plan"), insert the words "which it is authorized and directed to distribute to participants".

(11) Section 1, line 58, strike paragraph "(F)" in its entirety and insert the following:

"(F) provides that dividend payments made to a GSOP participant under the age of eighteen (18) years may be paid by the escrow holder for the account of such GSOP participant to his parent or other legally appointed guardian, but no dividends shall be paid, nor shall any of the securities held in such GSOP purchase escrow be distributed to the participant or his heirs or beneficiaries, and that before the distribution of portfolio securities shall be made to a participant, or his heirs or beneficiaries, he, or such heirs or beneficiaries, shall have taken and passed with a grade established by the GSOP to be satisfactory, an economic literacy test which shall be prescribed by the political entity establishing said GSOP, which political literacy test shall be designed to determine that the participant seeking the release from escrow of his portfolio securities is aware of the full significance of the ownership of equity stock representing productive capital; of the necessity of maintaining intact so far as may be economically feasible for such individual the principal of such equity portfolio, with such sales and reinvestment of the proceeds thereof in other and presumably more desirable equity or debt securities, should such be available, and using for purposes of consumption the income or yield thereof; that productive capital contributes to the production of goods and services in the same senses that labor does and that an individual may just as legitimately and morally engage in producing his income through such private capital ownership as through the exercise of his privately owned labor power; that because productive capital is a major source of affluence and economic security in a modern economy, such participant should interest and involve himself in the adequacy of the economic performance of the companies in which he holds equity investments, and upon such other matters as said political entity or the GSOP as its delegate shall determine appropriate for such economic literacy tests with a view to promoting stable, long-term investors to the extent of the capabilities of said GSOP."

(12) Section 1, last sentence beginning with "(G)", change the word "be" to "by".

(13) Section 2, line 9, after the word "security" insert "and only then to the extent he shall fail to reinvest the proceeds of such sale in income producing capital or equity stock representing such capital."

(14) Section 2, first paragraph, line 14 (the second line from the bottom of the page), after the figure "1954" add "to the extent that such sums are applied by the GSOP to the repayment of principal and/or interest of loans incurred for the purchase thereof, nor thereafter".

(15) Section 3, line 14, change the last word in the line, "a", to "General Stock Ownership Plan (GSOP) purchase escrow."

(16) Section 3, under subsection "(b) DEFINITIONS" in line 10, following the words "any individual for whom", change the word "an" to "a GSOP stock purchase escrow".

(17) In line 15, after the words "benefits are distributed from the", change the word "trust," to "GSOP stock purchase escrow,".

(18) Section 4, line 7, change the word "trusts" to "plans".

(19) Section 5, line 2 (in the title to the section), change the word "TRUSTS" to "PLANS".

THE ECONOMIC REASONING SUPPORTING THE CONTRACTING BY THE STATE OF ALASKA FOR AN IN-DEPTH ANALYSIS OF THE FEASIBILITY OF AND THE FINANCIAL AND ECONOMIC DESIGN ALTERNATIVES FOR ESTABLISHING A GENERAL STOCK OWNERSHIP PLAN FOR THE PURPOSE OF BUILDING CAPITAL OWNERSHIP INTO EVERY ALASKAN CITIZEN IN THE COURSE OF DEVELOPMENT OF THE NATURAL RESOURCES OF THAT STATE

By Louis O. Kelso and Patricia Hetter*

Everywhere the realization is growing that something basic in modern society is radically wrong; that in the words of Pope Paul's economic encyclical of a decade or so ago, "The world is sick." This assessment applied to the U. S. economy by former Chairman of the Federal Reserve Board who, before leaving that office, observed, "The old rules do not seem to work today." The most obvious symptom of this sickness is the accelerating tendency of the rich to grow richer, and of the poor to remain poor. But while the evidence of defective social structure everywhere stands out, it does not readily lead its victims to identify the responsible institutions. The very familiarity of institutions makes them invisible; the efforts of critics and reformers are invariably deflected to what they can see -- symptoms and effects. This is what prompted Thoreau to observe: "There are a thousand hacking at the branches of evil to one who is striking at the root."

The proposal of Kelso & Co., Incorporated (Kelso & Co.) involves an application of the theory of Universal Capitalism or Two Factor Economics, as it is called with equal propriety, to analyze the feasibility and to carry out a financial and economic design study for a General Stock Ownership Plan (GSOP) for the State of Alaska by showing the efficiency with which a properly designed GSOP for the State of Alaska can build general affluence into all Alaskan

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*Copyright 1978: Louis O. Kelso and Patricia Hetter, 111 Pine Street, San Francisco, California

citizens over a reasonably brief span of time. It will lay bare the false concepts and institutions responsible for the relentless concentration of wealth in an industrial society; it will show how they work, how they malfunction in the economy, and how many of the economic evils of contemporary life are directly or indirectly related to these false concepts and deficient institutions.

Endemic poverty in a world which has all the physical, managerial and engineering prerequisites for producing general affluence is only one symptom of the wealth concentration syndrome. Less obvious, but just as causally connected, are misuse of technology, resource waste, despoliation of the environment, declining personal freedom, increasing lawlessness and civil disorder, the waning of liberal education, the civil rights impasse, the youth revolt, urban concentration, rising public and private debt, public loss of confidence in leadership and the seemingly irreversible advance toward a totalitarian society.

The Kelso & Co. study, if accepted and underwritten by the State of Alaska, will demonstrate that the specific mechanisms that concentrate wealth are correctable, and will propose the detailed concrete methods for achieving the correction.

But it is appropriate here to ask why society has so long tolerated, and indeed remained officially oblivious to, institutional defects that were brutally apparent even in the earliest years of the Industrial Revolution. Why have we ignored the solid facts and so desperately clung to the straws of illusion? Why, for example, are we still pretending to believe that labor's productivity is rising? That technology creates toil? That we have achieved, within about five percent, legitimate "full employment" in the

United States today, or in any other industrial economy, or that full employment is a possible, or even an adequate economic goal?

The explanation for such massive intellectual dishonesty, we believe, is to be found in a simple but ancient misconception about how wealth is produced in the real physical world. Transmitted through generations of economists like a defective gene, the misconception has kept economics from developing into a rational science -- very much as the doctrine of spontaneous generation kept medicine from developing into a science until Pasteur's experimental researches crumbled organized resistance to the germ theory.

What the doctrine of spontaneous generation (the "hypothetical" production of living things from inanimate matter) was to 19th Century medicine, the labor theory of value and its offspring, the idea of full employment as an adequate economic goal and a pragmatic solution to the problem of income distribution, are to 20th Century economics. The notion that labor is the only, or chief, factor of production is the keystone of the conventional economic wisdom. Laissez-faire, Marxian Socialist and Keynesian theoreticians all treat the physical things that are factually the chief producers of wealth in an industrial economy -- tools, machines, structures and increasingly productive land -- as if they were extensions of the worker himself (the hammer, an extension of the hand; the wheel, of the foot; the computer, of the brain), or as if they were magic helpers that miraculously increased labor's productivity, or as if they were natural resources functioning gratuitously like the sun to raise labor productivity. So long as we indulge this myth, we need not concern ourselves with who owns what capital in the economy, nor with the fact that its ownership is unbelievably concentrated.

In the pre-industrial past, where labor was the principal factor of production and nature had endowed every individual with the power to labor, the labor theory of value was at least half a truth; the events that would expose the other, and most important, half had not yet occurred. But with the invention of the spinning jenny, the Newcomen engine, and the power loom, and hundreds of other non-human producers, the non-human factor of production moved explosively into the forefront and began its rapid conquest of the domain of production of goods and services. Unnoticed and uncomprehended, reality swiftly outgrew one-factor economic thought and the economic institutions erected upon it.

Technology was the momentum behind the Industrial Revolution, but pre-industrial laborcentric concepts were not able to provide a rational philosophy of technology; hence, enlightened, realistic human goals logically consistent with the tendency of technology were impossible to formulate. In the humanistic medieval world, toil had been only a means. Now in an industrial age where technology is eliminating toil, means has become elevated into end. Instead of toiling to live, man now finds himself obliged to live to toil. Under one-factor economic thought, technology itself must function to create toil, and the enormous evidence of the absurdity of this contention must be ignored, falsified, or rationalized away.

In his great quarrel with the medical traditionalists who upheld the doctrine of spontaneous generation, Louis Pasteur wrote that "the characteristic of erroneous theories is the impossibility of ever foreseeing new facts; whenever such a fact is discovered, those theories have to be grafted with futher hypotheses in order to account for them."

For the past forty-eight years, the public economic policies of the Western industrial nations, and the public philosophy advanced to justify them, have borne witness to the accuracy of Pasteur's observation, and demonstrated the theoretical inadequacy of one-factor economic thought. As expedients are grafted onto expedients, the official explanations of reality become more and more contrived; finally, the bonds of credulity are reached and overreached; the practitioners of the conventional wisdom are obliged to side-step reason entirely and resort to open intellectual fraud. In the United States, where advancing technology has created the widest gap between reality as it is and reality as it is interpreted through defective one-factor theories, the Federal Government spends an incalculable amount of manhours and money to persuade an increasingly skeptical and suspicious public that policies and goals which are irrational, dangerous and destructive are rational, effective and sound.

When an intellectually false theory persists against all evidence, it must be drawing sustenance from a live, powerful, non-rational source. We believe that the viability of the labor theory of value, the full employment goal and the Procrustean institutions built upon them can be traced to the Puritan ethic -- the idea that "if any would not work, neither should he eat." In essence, the Puritan ethic is a production ethic. Its meaning is that human beings ought to produce the wealth they wish to consume. This injunction is philosophically, economically, and morally sound. Experience shows that men hate being objects of charity just as much as they hate being the victims of parasitism; it is economically motivating both for people to produce the wealth they consume, and to receive the wealth they produce. In a pre-industrial world, where labor was the only active factor of production, it was natural that production was interpreted as synonymous with toil. The Marxian ethic is based on the identical assumption; it and the Purtian ethic are indistinguishable.

But what was practical common sense and moralistically sound in a pre-industrial economy becomes nonsense in an industrial one, not because the principal has changed, but because the environmental facts have changed. The rhetorical statement of the rationale of the Puritan ethic for a one-factor economy simply will not suffice in a two-factor economy; it does not accommodate itself to the changed facts. Indeed, a principle of unquestioned justice becomes a source of woeful injustice. In attempting to impose a one-factor ethic on a two-factor world, older generations are unconsciously seeking to make new generations suffer the same hardships that pre-industrial life forced on them and their predecessors. The poet Robert Frost understood the intent, if not the mechanics, of conventional economic policies that uncomprehendingly exort toil and self-denial in an age where technology has shifted most of the burden of production onto machines, and where mass consumption is essential to support the mass production which is the point of an industrial economy. Thus, a one-factor interpretation of the Puritan ethic threatens the very source of general affluence.

Institutional renewal and reform, we believe, must begin with the Puritan ethic. If its moral essence is not that men and women should toil for toil's sake, but that they should produce for production's sake, the question becomes: How are people to be economically productive in an age when wealth is chiefly produced by things? An updated Puritan ethic would hold that individuals produce just as legitimately through their ownership of productive things as they do through their personal toil (i.e., through their privately and personally owned labor power). In the economic sense, the owner of an equity interest in a oil pipeline, or gas pipeline, or petrochemcial production facilities is immeasurably more productive than the most skilled and industrious blacksmith in a pre-industrial village. Modern institutions must recognize this physical fact, and modern ethical and philosophical concepts must deal with it. Our reverence for toil is purely hypothetical -- what sane man, in real life, seeks to toil for the goods of subsistence? Much closer to reality is the historical fact that human slavery partially originated in man's revulsion for toil, and that moral sentiment was incapable of abolishing slavery until technology provided us with machines to take the place of the slave. Also much closer to reality than our pious affection for "full employment" is the historical use of hard labor as punishment for crime.

Until we understand the modern implications of the Puritan ethic, we shall not be able to design a rational economic system for a two-factor world. We shall continue to misuse, misdirect and waste technology; to concentrate its ownership into those who already own too much of it, and to deny those who need to own it but do not have any legitimate means of acquiring it; to squander resources, talent and human lives; to throw away man's opportunity for peaceful, affluent leisure in our political and institutional attempts -- futile, absurd and monstrously hypocritical -- to recreate the pre-industrial state of toil that management, engineering and technology constantly seek to destroy.

Not toil, but leisure; not the pinnacle affluence which has characterized all Western industrial societies to date, but general affluence -- these, we maintain, must be the goals of a rational industrial economy. Moreover, once recognized and acknowledged, they are goals that are easily achievable, as the proposed Alaskan feasability study will show.

Since affluence is not the product of the human factor, but the non-human factor, it is necessary to structure the economy so that a growing proportion of families, and eventually all families, produce an expanding proportion of their income through their private ownership of tools, machines, structures, facilities and productive land that produce wealth, and (under the irrefutable Say's Law) simultaneously generate exactly enough purchasing power to enable populations to consume it. For although the "boom-bust" cycles characteristic of industrial economies are caused by insufficient purchasing power (this is the defect Keynesian redistribution purports to correct), the physical fact is that every production cost in a market economy is the income of some participant in production. Thus, there could be no physical shortage of purchasing power in an economy where every household made a viable productive input and received the income its input produced.

The techniques involved in the General Stock Ownership Plan are techniques for connecting every household in the economy with the productive power of capital instruments, organized into productive entities through the instrumentality of the Alaskan General Stock Ownership Corporation. Today, under financing techniques inherited from the pre-industrial past, individual ownership of the non-human factor of production is concentrated in no more than the top five percent of U. S. families. Conventional business finance operates to shrink the proprietary base even further. Financing methods, such as the Employee Stock Ownership Plan (ESOP), the Consumer Stock Ownership Plan (CSOP) and the General Stock Ownership Plan (GSOP), developed by Kelso & Co., Incorporated finance capital ownership for individuals at the same time they finance corporate expansion. Thus financing techniques employing two-factor economic principals create new capital owners simultaneously with new productive power.

New productive power is an absolute requisite for general affluence, simply because -- the assertions of politicians and economists to the contrary -- no economy in the world today is physically capable of providing an affluent stream of goods and services to all the people in it, although the potential physical capacity to do so through accelerated growth of new capital formation is present in most of the world's economies. The "affluent economy" of the United States, we flatly assert, is illusory. But the United States, Canada and most of the Western economies have or have access to the physical ingredients necessary to produce general affluence within a space of two decades or so, and so does the State of Alaska. The limitations that bind them now are not physical, but institutional. What is lacking is an economic system built on the rationale of two-factor concepts that would build the economic power of the people to consume simultaneously with building the industrial power of their economies to produce general affluence.

In today's illogical economies, the corporate sector puts new productive power into place by means that channel the income it will produce to the already affluent few who perforce must invest it, rather than to the many, who will spend it, and in so doing, fully close the production-consumption circuit. Thus, consumption is increasingly achieved through coercive redistribution by government and organized power blocs in the private sector (with the blessing of government) and through that delusive doctrine, full employment. This we believe is the bitter fruit of an invalid corporate strategy. Since the corporate sector produces 87% of non-agricultural, non-governmental goods and services, it also generates 87% of the economy's purchasing power. In not structuring the invisible sector of enterprise so that a growing number of families are connected with the productive power of capital, management is neglecting one-half of its prime responsibility and opportunities. In so doing, it is spearheading the destruction of private property in the American economy, and hastening the totalitarian society in which the corporation will serve as the welfare arm of the state. The Alaskan General Stock Ownership Corporation can correct this for Alaskans, beginning in a very short time.

The proposed GSOP for Alaska should appeal to the three executive powers of modern society -- business, labor, and government -- to begin now to plan an economy in which every family has the opportunity to produce wealth in a way compatible with a technologically advanced economy: through employment (to the extent the legitimate demand for employment has not been technologically eliminated) and through its private ownership of the non-human factor of production. This is what the techniques of two-factor financing are designed to accomplish. Through updating the Puritan ethic to conform to the technological facts of production, we would be renewing our institutions in the spirit of the American ideal, rather than seeking, as do the proponents of the Negative Income Tax, the Guaranteed Annual Income, and similar schemes, to repeal the underlying ethical law. For American political institutions assume a citizenry which is economically independent and productive. The Founding Fathers knew that freedom is inseparable from property. On that premise they designed political institutions that were an inspiration to all mankind.

The State of Alaska has before it the opportunity to lead our nation and the world through economic change that would underpin our political heritage with economic insititutions designed to provide effective economic opportunity to the many in an industrialized world -- and to do it before time and hope run out.

31-01LH

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

AUDIT DIVISION
POUCH W—ALASKA OFFICE BUILDING

FINANCE DIVISION
POUCH WF—STATE CAPITOL

JUNEAU 99801

CONTRACT BETWEEN

STATE OF ALASKA
LEGISLATIVE FINANCE DIVISION

AND

KELSO & CO., INCORPORATED
111 Pine Street
San Francisco, California 94111

The parties to this agreement are (1) the LEGISLATIVE FINANCE DIVISION, hereinafter referred to as the "State", and (2) KELSO & CO., INCORPORATED, hereinafter referred to as the "Contractor".

THE PURPOSE OF THIS AGREEMENT is to provide the consulting services described herein to the Alaska State Legislature.

IT IS THEREFORE MUTUALLY AGREED THAT:

CLAUSE I - STATEMENT OF WORK

(A) The Contractor shall provide a design study for a General Stock Ownership Plan in the manner described in the Contractor's proposal to the State of Alaska, dated July 10, 1978, as amended by the deletions indicated on the attached copy of said proposal.

(B) The Contractor shall provide draft proposals of the State and Federal legislation necessary to implement the General Stock Ownership Plan developed in the design study.

(C) The Contractor shall provide an analysis of the possible adverse effect upon the flow of Federal aid due to the successful establishment of an Alaskan General Ownership Plan and recommendations for dealing with this potential problem.

(D) The Contractor may purchase the services and provide for the expenses of other consultants or professionals selected with the written approval of the Project Director.

(E) In the event of any conflict between the amended proposal and this agreement, this agreement shall govern.

CLAUSE II - PERIOD AND DATES OF PERFORMANCE

(A) The Contractor shall submit the study and proposed legislation on or before February 1, 1979. The report shall be submitted in duplicate in a form suitable for offset printing to the Project Director.

(B) The period of this contract shall begin on the date it is executed by all parties and terminate on February 1, 1979 unless extended or terminated by written agreement.

CLAUSE III - PRJECT DIRECTOR

The Project Director shall be Sen. Mike Colletta & Rep. Jim Duncan, c/o Legislative Finance Division, Pouch WF, Juneau, Alaska 99811.

CLAUSE IV - COMPENSATION AND METHOD OF PAYMENT

(A) Contractor's total compensation, including all expenses for the work described in Clause I, shall be $180,000, and shall be payable to the Contractor as follows:

(1) On the date this contract is executed - $30,000.

(2) The payment of the balance in monthly installments of $30,000 each, the first to be paid on the last day of the first full month subsequent to the acceptance of this proposal and the remaining installments in consecutive monthly payments.

(3) Out-of-pocket expenditures approved in advance by the State of Alaska will be billed monthly and due within 15 days of billing therefor by Kelso & Co.

CLAUSE V - PROGRESS REPORTS

The Contractor shall keep the Project Director informed as to the progress of the work performed under this agreement.

CLAUSE VI - RECORDS, DOCUMENTS, AUDIT

All documents, reports and writings produced in the course of the work performed under this contract are, upon delivery to the Agency or at the termination of this agreement, whichever occurs first, the property of the Agency. Contractor understands that State shall have an unlimited license, without further compensation, to reproduce and use all materials containing any claims of copyright by Contractor.

CLAUSE VII - ALL WRITINGS CONTAINED HEREIN

This agreement contains all the terms and conditions agreed upon by the parties. No other understandings, oral or otherwise, regarding the subject matter of this agreement shall be deemed to exist or to bind either of the parties to this agreement.

IN WITNESS WHEREOF, the parties have executed this agreement on the dates indicated below.

KELSO & CO., INCORPORATED
111 Pine Street
San Francisco, CA 94111

Louis O. Kelso

Louis O. Kelso
President & Chief
Executive Officer

September 1, 1978
Date

THE STATE OF ALASKA

Mike Colletta 25 Aug 78

Sen. Mike Colletta Date
Chairman, Legislative
Budget & Audit Committee

John C. Sackett

Sen. John Sackett Date
Chairman, Senate
Finance Committee

20 Sept 1978

Rep. Steve Cowper Date
Chairman, House
Finance Committee

Jim Duncan 1 Sept 78

Rep. Jim Duncan Date
Vice-Chairman, Legislative
Budget & Audit Committee

PROPOSAL TO THE STATE OF ALASKA TO PROVIDE A DESIGN STUDY FOR A GENERAL STOCK OWNERSHIP PLAN FOR USE IN FINANCING THE ACQUISITION AND/OR DEVELOPMENT OF SELECTED ENTERPRISES INVOLVED IN THE DEVELOPMENT OR EXPLOITATION OF THE RESOURCES OF THE STATE OF ALASKA IN SUCH MANNER AS TO MINIMIZE THE COSTS THEREOF AND TO BUILD THE OWNERSHIP OF SUCH ENTERPRISE, OR SIGNIFICANT INTERESTS THEREIN, INTO EVERY ALASKAN CITIZEN

July 10, 1978

INTRODUCTION

This proposal is a revision of our proposal of May 10, 1978 to the State of Alaska, forwarded in its original form under a cover letter addressed to The Hon. Steve Cowper, Chairman of the House Finance Committee of the State of Alaska. By this reference, our cover letter to Mr. Cowper of May 10, 1978, our proposal included therein and its enclosures (collectively referred to herein as the "May 10, 1978 Proposal") are incorporated herein for background purposes only, and without any intent thereby to enlarge the scope or proposed compensation contemplated by this proposal.

After conferences between representatives of the State of Alaska and officers of our firm, it has been concluded that the initial step in the overall project contemplated by the May 10, 1978 proposal should be the development of the economic and financial design characteristics, together with an analysis of the legislative, legal and economic requirements for enabling the State of Alaska and its citizens to take advantage of the resulting device, which we refer to in our proposal of May 10, 1978, and refer to in this proposal as "Alaska General Stock Ownership Corporation", or "AGSOC" for short. We understand that the State of Alaska will be under no obligation to implement the plan thus developed, or any variation of it that may, in the future, recommend itself.

The thrust of the work proposed to be undertaken pursuant hereto is the development of the design characteristics of an institution capable of being used by the State of Alaska to build into its citizens individually the equity ownership of some predetermined portion of the capital facilities developed or constructed from time to time to exploit and to realize the economic value of the resources of the State of Alaska. In this initial phase, we are not to concern ourselves with particular potential investments nor with specific activities designed to educate or test the opinion of particular groups of people on any of the aspects of the design which it is the purpose of our study to develop and recommend to the State of Alaska. The focus is to be upon design, and upon the identification and solution of legislative (state and federal), legal, accounting, tax, business, economic and finance problems foreseeably incidental to the implementation of the design so to be recommended.

In our work, we are to make the fullest feasible use of the facilities and talents that may be available to us through the Legislative Research Division and its staff of technicians, presently under the directorship of Mr. Greg Erickson.

PROPOSED FEE FOR OUR SERVICES IN THE ACCOMPLISHMENT OF THIS PROPOSAL

We propose as a fee for our services in developing and perfecting the design of an Alaskan General Stock Ownership Corporation, the sum of $180,000. This sum would cover not only our services and all of our out-of-pocket expenditures, but the services and expenses of consultants, selected with advance approval by the State's representatives, to participate in the project.

We propose that the fee would be payable as follows:

1. An initial retainer of $30,000 upon the execution on behalf of the State of Alaska of this proposal memorandum, thus establishing an agreement between our firm and the State of Alaska.

2. The payment of the balance in monthly installments of $30,000 each, the first to be paid on the last day of the first full month subsequent to the acceptance of this proposal and the remaining installments in consecutive monthly payments.

An increase in a particular monthly fee (thus shortening the overall payment period) will be considered by the State of Alaska in the event approved out-of-pocket expenditures, combined with compensation for the ongoing efforts of our firm, for a particular month are materially higher than the average contemplated over the performance period.

COMPLETION OF THE DESIGN STUDY

Completion of our design study contemplated by this proposal and the delivery of a final report embodying the results thereof and our recommendations thereon to you will be made on or before February 1, 1979, assuming this proposal or any variation of it that we may negotiate is accepted by August 1, 1978. Otherwise, our completed report and recommendations would be delivered to you on or before 180 days from the date of acceptance of this proposal or of some variation of it.

Specialized consultants and subcontractors employed with the approval of whomever the State of Alaska may designate as the proper person or agency to supervise the project, would be paid by us from monies received from the State of Alaska hereunder. We anticipate that these consultants would include persons or organizations having the highest qualifications in their fields, and that, among others, these would include legal counsel skilled in the interpretation of the Alaskan and U. S. Constitutions, municipal bond counsel (who in this case would be entering a new field of counseling with respect to the use of a State agency to facilitate the distribution of stock representing private capital), State tax counsel, Federal tax counsel, accountants and lawyers skilled in the particular disciplines pertaining to problems developed by the design analysis (some of which may well be available within the State government), and other specialized talents. We assume that in every case, where the necessary talents can be found within the State government, that these would be used to minimize costs.

LEGAL PROBLEMS

A number of critical legal problems will require at least preliminary examination by the most highly qualified available experts. These will include the design characteristics of AGSOC as an agency of the State of Alaska, though intended for use to build the private and individual ownership of productive capital into every Alaskan citizen. While the Legislature of the State can, and doubtless will for reasons of efficiency, confer exemption from State corporate income taxes and all State property and excise taxes upon AGSOC, and exemption from income taxes upon stockholders on account of dividends used to pay for stock subscribed to, careful attention in the legal and financial design of AGSOC and its relationship to its stockholders and stock subscribers will be required in order to bring such dividends within the mantle of protection of the State itself from federally imposed taxes. The theory behind the preliminary plan itself is the universally accepted financing strategy of business corporations that a sound and feasible investment is one that will pay for itself within a reasonable period of time and then, protected by good management, a sound research and development program to keep its products and services relevant to the available markets, and depreciation adequate to restore its capital instruments as they wear out, the investments will go on throwing off income virtually indefinitely. Obviously, however, capital will pay for itself much more efficiently if the buyer of capital receives the entire yield, after depreciation and operating reserves (including liquidity reserves, if necessary), than if a governmental body or bodies carve out, through corporate or personal income taxation or otherwise, income that could be used to enable the stock subscriber to pay for his stock. While it is both fair and equitable that Alaskan citizens who receive income from AGSOC stock that has already paid its acquisition costs should be taxed upon dividends they receive as spendable income, it is both rational and desirable that the rate of amortization of their non-recourse stock subscriptions not be delayed or retarded either by State or Federal income taxation. Opinions of qualified legal counsel on any relevant aspect of the Constitution of the State of Alaska or the U. S. Constitution, so far as such provisions may affect the legal or financial design of AGSOC would be obtained. Similarly, opinions of qualified tax experts on the steps needed to create a temporary immunity from Federal personal income taxation on dividends declared by AGSOC but applied by it to the payment of the subscription price on each subscriber's stock will be obtained.

It seems at the outset reasonably clear that at the most, exemption from Federal personal income taxation on dividends declared by AGSOC on its stock can be achieved only so long as neither the stock nor the dividend income itself is available for personal disposition by the subscriber or stockholder. Beyond that point, Federal legislation will be required, but it is submitted, an excellent foundation has been made for such Federal exemption. It is necessary to effectively broaden the capital ownership base of the American economy, and the Joint Economic Committee has already officially recommended, in its 1976 Annual Report to Congress, that the rate of new capital formation be accelerated and that the base of ownership be broadened. It should be pointed out that the availability or non-availability of the Federal personal income tax exemption would not necessarily affect the feasibility of the plan itself, but rather, the length of time required for each stockholder's stock to pay its purchase price out of its dividends.

MEANS OF IMPROVING THE PROBABILITY OF FAVORABLE FEDERAL PERSONAL INCOME TAX EXEMPTION ON DIVIDENDS USED TO PAY THE PURCHASE PRICE OF STOCK

The likelihood of obtaining Federal legislation within a period of four or five years, at most, during which, it is our preliminary opinion, such exemption can be achieved through the design of AGSOC as an agency of the State of Alaska, will be significantly increased if circumstances are such that similar legislation would be needed by and beneficial to the citizens of the other 49 states. Ideally, this requisite would be accomplished by the enactment by Congress of S.3223, introduced into the 95th Congress, Second Session, by the Hon. Mike Gravel, United States Senator from Alaska, on June 22, 1978 (see Congressional Record, volume 124, number 96).

SPECIFIC ADDITIONAL FEATURES TO BE ANALYZED IN THE DESIGN STUDY, WITH RECOMMENDATIONS THEREON IN THE FINAL REPORT

The definitive structure of AGSOC and the design of its trust division, within which the escrow accounts of all subscribers to its stock would be established, should be planned and analyzed. On the assumption that the General Stock Ownership Plan Trust of AGSOC would function as the exclusive, or perhaps primary market for the stock of AGSOC as it may be transferred because of the succession of generations, or for whatever reasons, then careful consultation with the best available expert on stockholder relations would be held in order to foresee and, so far as possible, to avoid functional problems. Advice of counsel on the implications of Alaskan inheritance laws and inheritance tax laws would be sought.

All steps necessary to acquaint the blue sky commission of the State of Alaska with the details of operation of AGSOC and to arrange in advance for compliance with the applicable requirements of that agency should be made.

The Securities and Exchange Commission would be brought into consultation to acquaint all interested divisions fully with the nature of AGSOC and its proposed operations to obtain, so far as possible, understandings as to the applicability of the securities laws under its jurisdiction to the activities of AGSOC and its stockholders. While there is not much precedent for ascertaining in advance the questions which may arise, the general interest of the Securities and Exchange Commission in investors, as distinguished from speculators, and its interest in broad-based capital ownership, provide assurances that these problems will be satisfactorily solved.

The full details of the GSOP itself must be delineated. These would include the drafting of a body of regulations acceptable to the representatives of the State with respect to the definition of "eligible citizens" under varying circumstances of residence, time of birth, change of residence, period of years of eligibility to bring about full vesting, the conditions of forfeiture of vested interests, the provisions for transfer of ownership through sale, gift, descent and distribution, or otherwise, must be included in such regulations, and their legal soundness tested from every standpoint. The question of whether such stock, until released from the GSOP trust, would be subject to "spend-thrift" restrictions must also be covered by regulations. Rights of first refusal, or provisions for calls or puts with respect to the stock by the GSOP trust under various circumstances, should be considered, and the resulting decisions embodied in regulations duly adopted by the Board of Directors of AGSOC.

The design study would include an analysis of any special rights or privileges that may be necessary or appropriate between AGSOC and the native tribes or their corporations.

We will, of course, be pleased to respond to any and all questions. If you decide to proceed with the Economic Design Study as outlined in this proposal, please provide authorization for Kelso & Co., Incorporated's services by execution of the acceptance hereof through signature by officers authorized to obligate the State hereunder and returning a copy of this memorandum to us with a check payable to our firm as our retainer hereunder for the sum of $30,000.

KELSO & CO., INCORPORATED

By______________________________
Louis O. Kelso, President and
Chief Executive Officer

LOK:ma

Synopsis of the letter from Louis O. Kelso
to Senator Mike Colletta and Representative Jim Duncan
dated September 26, 1978

Note: All conclusions of the letter seem to be based on the assumption that the tax environment will remain stable or will in fact, become more favorable in GSOP's.

1. It will be difficult to develop a GSOP emphasizing individual choice.

2. A GSOP can, under the proper federal regulations, allow the development of capital ownership by persons who can not develop this capital ownership under any other system given today's economic environment. The reasons for this phenomenon are as follows:

a. The GSOP operates on pre-tax dollars.

b. Presently under a GSOP a person is not taxed on the money financed to purchase the stock, nor is he or she taxed on the stock itself. If Federal and State tax laws are ultimately developed according to Kelso's recommendations; the GSOP will be taxed either at a regular income tax rate or at a capital gains tax rate when the stock is sold. According to two-factor theory there should be no tax on the stock at all. In a nut-shell, two-factor theory can be defined as allowing a person, on the basis of his or her good credit, to acquire stock; the person would then pay the purchase price of the stock off with the profits, or dividends of the stock.*

c. The theory of two-factor economics is based upon the following premise:
In the technological life style of today a person needs the "power of labor" AND the "power of capital" to acquire the productive power necessary to live.# The "power of labor" is acquired at birth since slavery is outlawed in the United States. The "power of capital" can not be acquired by more than a few under the present system. Due to the nature of our technological society the value of the "power of labor" is decreasing as compared with the value of the "power of capital." Therefore, a new system must be implemented to preserve the integrity of the US Constitution. A tenet of the new system, as proposed in two-factor economics, is the tax treatment of a GSOP. Since the stock is not earning income until the dividends have paid the purchase price, the stock should not be taxed until the consumer is in fact earning an income from his or her stock.

d. It is imperative that a proper tax and legal environment be maintained to assure the success of GSOP's. At the present time it will involve structuring or restructuring federal and state laws.

e. The most comprehensive plan developed to broaden the captial base is called the "Financed General Capital Ownership Plan" (FINGCOP) which is closely related to a GSOP.

f. The concept of a FINGCOP must be federally implemented to be effective. Following are some of the concepts which would have to be legislated or guarenteed to assure the FINGCOP's success.

1. Corporation's would have to guarentee that all profits, after debt service, depreciation and operating reserves, would be periodically declared as dividends rather than reinvested. Corporation's would have to have a guarentee of an assured source of similar financing by their lending institution and by the Federal Reserve Board of Governors as long as future capital requests are feasible and reasonable.
2. Individuals buying stock should not have to pay corporate income taxes on their purchase. Eventually all corporate income taxes should be eliminated leaving only individual income taxes.
3. Dividends applied to the purchase of the stock should not be taxed. Dividends received after the purchase price has been paid should be taxed only at the individual income tax rate. This tax should not be applied until the stock is sold, and only if it is not reinvested within 60 days in "income-yielding productive capital."
4. An insurance corporation (Suggested title: Capital Diffusion Insurance Corporation [CDIC]) must be formed to facilitate the confidence of the lending institutions. It would be comparable to the FHA insurance program; but the premiums should be cheaper. It could be done by either a public agency or private enterprise or by both.
5. The money for the purchase of the stock will be provided through lending institutions directly from the Federal Reserve Bank. The price of that money shall not exceed the administrative and policing costs of the FRB and the lending institution (estimated 3%). The loans would be made directly into escrows and the lending institution would provide counseling for the borrower. The loan could be refused by the lending institution if it found the diversification of the borrower's portfolio too narrow. Loan limits would be set by law, as would eligibility requirements.

g. It will be difficult to develop a GSOP emphasizing individual choice because of the present tight money situation (high interest rates), low potential dividends by corporations, and the present tax policies at the federal level. This situation is such that the stock purchaser could never pay off the loan. (Shades of 1929 stock market crash??)

Kelso stated that he will do his best to incorporate freedom of choice into the design study.

Enclosed in the correspondence from Louis O. Kelso was a letter from Louis O. Kelso, Inc. to President Gerald Ford concerning the present Keynesian Economic theory VS the concept outlined above. It also included a letter concerning Ford's summit conference on inflation and Kelso's proposal as given at that summit conference.

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* It sounds like the GSOP does to "capital" what the voluntary indentured servant did to "labor."

The Right to Life is guarenteed under the Constitution. The two-factor theory has defined "life" as living within a "reasonable life-style that suits him (any American citizen)."

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
POUCH WF–STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3795

October 3, 1978

M E M O R A N D U M

TO: The Honorable Mike Colletta
The Honorable Jim Duncan
GSOP Study Directors

FROM: Milt Barker MB
Legislative Finance Division

SUBJECT: Congressional GSOP Actions

Attached is an excerpt from the Congressional Record in which Senator Gravel describes the genesis and rationale of a General Stock Ownership Plan (GSOP) and which contains the provisions of S.3223 which would authorize the establishment of GSOP's. Also attached are a press release and committee report which describe an amendment to H.R. 13511 which would also authorize GSOP's and which was adopted by the Senate Finance Committee in reporting the bill out. The amendment would yet have to pass the hurdles of Senate floor action, approval by conference committee, approval of the conference committee report by both houses, and receive the President's signature.

The language of the amendment is not yet available. However, examining the committee report and press release reveals several significant differences from S.3223. The amendment allows for the chartering of a GSOP only by a state whereas S.3223 would permit political subdivisions of a state to do so. There is no provision in the amendment for a GSOP to use tax-exempt financing as there was in S.3223. Finally, the amendment would not permit another corporation to take a tax deduction for dividends paid to a GSOP as S.3223 would. In fact, the amendment specifically provides that a GSOP may not be affiliated with any other corporation.

Under the amendment, the GSOP would be a tax-exempt corporation with direct investments in various projects. Shareholders are taxed as in subchapter "S" corporations on a pro-rata share of the corporation's income.

Under S.3223, the GSOP would be a trust which could hold stock in various corporations which would be afforded the tax-exemption of their net income to the extent their dividends were paid to a GSOP trust. Trust participants would only be taxed based on actual distributions received.

MBB:pw
Attachments

cc: Steve Cowper
Budget & Audit Committee Members
Terry Gardiner

United States of America

Congressional Record

PROCEEDINGS AND DEBATES OF THE 95^{th} CONGRESS, SECOND SESSION

Vol. 124 WASHINGTON, THURSDAY, JUNE 22, 1978 No. 96

Senate

GENERAL STOCK OWNERSHIP PLANS

Mr. GRAVEL. Mr. President, the United States is the world's wealthiest Nation. Our net national worth has tripled since 1925 and now stands at over $6 trillion. This growth has been dramatic, but we should be concerned that a quarter of this growth, nearly $1 trillion of capital expansion, is owned by 1 percent of the population. This is the same 1 percent of our population which controlled 25 percent of our national wealth in 1925 and which today owns over half of all privately held corporate stock and more than 60 percent of all bonds.

Concentrations of wealth are not bad per se, but do create serious problems when many Americans find their labor income insufficient and must rely on Government subsidies for survival. In such a situation it is incumbent upon policymakers to review and correct structural defects which prevent the great majority of citizens from sharing in the Nation's growth.

There is continuing concern over the concentration of wealth in our economy. The Joint Economic Committee has recommended that the broadening of capital ownership be adopted as a national goal. Secretary of the Treasury Blumenthal and other Treasury officials have expressed concern over this concentration as well. But, in spite of this "gnashing of teeth" over the issue, little of substance has been accomplished. The great bulk of our national wealth is still controlled by a very few.

One of our greatest legislative failures is that we have not significantly broadened the ownership of American wealth during the past 50 years. In spite of all our income transfer programs and massive Federal deficits 25 percent of our wealth is still owned by 1 percent of the people. It would be a tragedy indeed if, through our own negligence, the future expansion of our capital stock is similarly concentrated. If it can be said in the year 2000 that 1 percent of our population controls 25 percent of our wealth it will be a great American tragedy and it will be our fault. The failure to insure broader participation in the economy will be laid at our doorstep and the epitaph of the capitalist system may well read, "In failing the people they themselves were doomed to failure."

IT TAKES MONEY TO MAKE MONEY

The old addage, "It takes money to make money," holds more than a grain of truth. To a great extent new wealth is a function of existing wealth. Wealth is generated either through credit or saving. Savings are invested to create new capital while debt may be used in the same way with the earnings of the investment amortizing the loan.

The poor and middle classes are precluded from accumulating wealth through either of these means. Because of our failure to provide access for the less affluent in our society to either existing wealth or debt for the generation of new wealth they are locked into their present status. The great bulk of our citizens cannot save enough from their incomes to generate capital wealth, they must consume what they earn. Neither can they finance new we lth through credit because that requires a guarantee for repayment. The lender needs assurances of repayment if the investment fails to throw off sufficient income to amortize the debt. Existing wealth performs this function for the rich, but the poor have no guarantee to support debt financed access to new wealth. The key to new wealth for the vast majority of Americans is the capacity to guarantee debt. I have structured a program which allows the citizens of a State, acting through their State government, to avail themselves of the guarantee power of the State itself to provide access to new wealth.

I want to emphasize at the beginning that this plan is not one designed to transfer the ownership of existing wealth. I do not propose to play Robin Hood, taking from the rich and giving to the poor. I do propose that more Americans be allowed access to the new wealth required by the future expansion of our economy. I am offering a vehicle through which we can involve all our citizens in the process of generating new productive capacity. By bringing more people into the capital formation process we also allow more people to share in the fruits of that capital, increased income.

ESOP'S: A FIRST STEP

Employee stock ownership plans were developed more than 20 years ago under the pension provisions of the Internal Revenue Code. They have recently received congressional attention and support beginning with the Pension Reform Act in 1974. In addition to its pension potential, the ESOP also provides a means for the diffusion of capital ownership. Through an ESOP employees can use the corporation's credit to guarantee their leveraged purchase of the company for which they work.

Under an ESOP the employer company establishes a tax exempt pension trust with its employees as beneficiaries. A loan to the trust is guaranteed by the company. The loan proceeds are used to purchase employer stock on behalf of the employees. The debt is repaid by the trust out of pension contributions made to the trust by the employer corporation. The employee receives the stock held for him by the trust either when he retires or terminates his employment.

The ESOP is a very important and useful device for spreading capital ownership, but its scope is severely limited. ESOP's are not available to those Americans who are not employed by corporations sponsoring such plans. Although some 10 million employees are covered by these plans we have neglected the welfare of hundred of millions of Americans. I would like to propose a program offering some opportunity for other Americans to share in our capital growth. My program is a parallel to the ESOP which would be available to all Americans.

THE GENERAL STOCK OWNERSHIP PLAN

Today I urge the adoption of legislation to enable the adoption by States of general stock ownership plans. This proposal finds its origins in the ESOP. It is designed to parallel the tax treatment of ESOP's while expanding the category of eligible individuals beyond the employees of a single company. As with the ESOP the key feature of the GSOP is a tax-exempt trust. However, the GSOP trust is sponsored by a State government with eligibility open to all residents of the State. Payments to the trust are deductible to corporations and tax free to the trust. The trust is required to distribute all its income annually either in repayment of debt or as dividends to the trust participants, the citizens of the State.

Before discussing the operation of GSOP's I should emphasize that the GSOP is not a vehicle for State ownership. In fact, the concept is offered as an alternative to State ownership. In Alaska we have been discussing the possibility of an Alaska State equity interest in the proposed gas pipeline. While such an investment is an exciting opportunity I am concerned about State ownership of private business. Under existing law it would be possible for the State government to make such an investment and pass the profits through to its citizens either in services or tax reductions.

However, I think it is important that ownership in such investments be held by the people directly rather than through the State government. Direct ownership puts spending decisions in the hands of the consumers. State ownership tends to concentrate both economic and political power in the same hands, an unhealthy combination. In addition bureaucratic spending decisions are not always consistent with the needs or desires of the people. Therefore, I think the people of the State should hold direct ownership of any equity interest the State chooses to make in private business. The GSOP can accomplish this goal by using the credit of the State to acquire interests on behalf of the State's citizens.

THE GSOP AT WORK

The GSOP provides an additional and expanded vehicle for capital diffusion. It creates a means for the transfer of what would otherwise be government-owned interests directly to the people. It can be used for the ownership of any revenue producing government project from a sports complex to a power plan. The GSOP puts the profits of operating these essentially private sector enterprises back into the hands of the people where they belong.

To form a GSOP the sponsoring government forms a GSOP trust and appoints trustees. Based on revenue and financial projections, and perhaps a guarantee by the sponsoring State government, the trust borrows money in the private market to make investments. In order to provide for allocation of ownership interests within the trust investment is limited to corporate stock. If the target project is one which is to be initiated by the GSOP a corporation is formed to hold the assets themselves.

Within the GSOP trust the newly acquired stock is allocated one share each to persons who have resided in the State for at least a year who choose to participate. All residents are eligible regardless of age and new residents may apply for participation once they have fulfilled the 1 year requirement. The stock of the corporation allocated to the trust participants is voted by them so that control of the investment is in the hands of the citizens and not the sponsoring State government.

The loan to the trust used to finance the purchase of stock must be repaid through the use of the investment proceeds. The corporation makes payments to the trust for this purpose which are deductible to the corporation up to its full taxable income. The trust, however, cannot accumulate income and must distribute out what it receives from the corporation either as loan payments, operating expenses or dividends to the participants. Cash dividends to participants are treated as dividends on corporate stock and taxed accordingly. Since this dividend amount is deductible to the corporation when paid to the trust we have effectively eliminated the double tax on corporate earnings.

The GSOP trust is designed not only to provide income for the participants, but to provide actual capital ownership as well. Without access to the GSOP stock the participant would be like the spendthrift nephew whose uncle provides a trust from which he can only receive the income. Despite his extreme need he cannot sell off the trust assets to pay his gambling debts and avoid the malice of his creditors. I believe that there are a minimum of never-do-well nephews in our society and that most Americans are capable of making their own spending and capital allocation decisions.

Without providing for direct ownership of the stock a plan such as the one I propose would be unduly paternalistic. Therefore, the GSOP trust must, upon request, distribute the stock held for a participant to him after 5 years of participation. Distribution of the stock to the participant will not preclude continuing integration of the corporate tax so long as the corporation continues to make its dividend payments through the trust. The stock is not taxed upon distribution to the participant, but if the participant sells the stock the proceeds are taxed as ordinary income. In addition to the tax consequences upon a sale of the GSOP stock no person may own more than 10 shares of any corporation's GSOP stock.

WHAT CAN A GSOP MEAN

In working with the GSOP concept I became curious as to what such a program might mean to individuals participating in the program. Using Alaska as an example I turned to our oil pipeline since State participation was being sought in the comparable gas pipeline. British Petroleum owns a 15.85-percent interest in the oil pipeline and their revenue and cost figures are available through testimony before the Federal Energy Regulatory Commission. Assuming a purchase price of $1.5 million with 100-percent financing through tax-exempt bonds over 20 years at 5.5 percent interest this asset could produce $500 annually in 1978 dollars for every citizen of the State of Alaska and more than $800 annually after the debt is retired; $2,000 per year for a family of four is a substantial amount for citizens in parts of Alaska where median income is less than $3,000 per year.

I am not suggesting that GSOP's are appropriate for all State owned and operated activities or that they constitute the whole solution to the problem of capital concentration. However, they can and will provide an additional tool available to assist the broad mass of Americans to participate in capital ownership.

Mr. President, I would ask unanimous consent that my bill be reprinted in the RECORD.

There being no objection, the bill was ordered to be printed in the RECORD, as follows:

S. 3223

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. GENERAL STOCK OWNERSHIP TRUSTS.

Subsection (c) of section 501 of the Internal Revenue Code of 1954 (relating to list of exempt organizations) is amended by adding at the end thereof the following new paragraph:

"(22) A general stock ownership trust which is established in writing by the United States or the government of a State or a political subdivision of a State exclusively for the purpose of broadening stock ownership and integrating the corporate income tax by purchasing, receiving, holding, pledging, and distributing securities (within the meaning of section 251(b)) of one or more corporations, and which is empowered to receive, hold, and distribute amounts paid to the trust by corporations whose securities are held by the trust (or trust participants) and incur, amortize, and guarantee indebtedness in furtherance of the trust purposes, but only if the trust—

"(A) provides for participation by all residents of the sponsoring jurisdiction as of the date each such resident completes at least 12 consecutive months of residency within the jurisdiction,

"(B) provides for the allocation of one share of each issue of securities held by the trust to the account of each participant (within the meaning of section 251(b)) as of the last day of the trust year in which the individual initially becomes a participant in the trust in a manner which does not discriminate among such participants on the basis of race, sex, age, income, or ownership of property,

"(C) provides that each participant has a nonforfeitable right to any stock allocated to his account, but that no stock allocated to a participant's account may be distributed to the participant from that account before the last day of the trust year next following the trust year of the participant's death or, if earlier, the last day of the trust year next following the later of—

"(i) the participant's completion of 5 years of participation in the trust, or

"(ii) the participant's attainment of 18 years of age,

"(D) provides that all amounts received by the trust will be distributed not later than the due date for the filing of the trust's information return under section 6033 for the trust year in which such amounts are received,

"(F) provides that no person may purchase or otherwise acquire except by gift or devise from any participant directly or indirectly more than ten shares of any security held by or upon which dividends are distributed through the trust, and

"(G) meets such other requirements as the Secretary may be regulation prescribe.".

SEC. 2. INCOME TAX TREATMENT OF DISTRIBUTIONS FROM GENERAL STOCK OWNERSHIP TRUSTS.

Securities (as defined in section 251 (b) of the Internal Revenue Code of 1954) transferred to a participant or to the account of a participant in a trust described in section 501 (c) (22) of the Internal Revenue Code of 1954 shall not be considered income of the participant under the Internal Revenue Code of 1954 until such time as the participant sells or exchanges such a security. Amounts paid by the trust in connection with securities held by the trust in the account of a participant shall not be considered income of the participant under the Internal Revenue Code of 1954 until actually received by the participant and, at such time, shall be treated, for purposes of such Code, as dividends.

SEC. 3. CORPORATE DEDUCTION FOR AMOUNTS PAID TO GENERAL STOCK OWNERSHIP TRUSTS.

(a) In General.—Part VIII of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to special deductions for corporations) is amended by adding at the end thereof the following new section:

"SEC. 251. AMOUNTS PAID TO A GENERAL STOCK OWNERSHIP TRUST.

"(a) GENERAL RULE.—In the case of a corporation there shall be allowed as a deduction an amount equal to the amount paid for the taxable year by such corporation to a trust described in section 501 (c) (22), not in excess of the amount determined by multiplying the corporation's net taxable income (determined without regard to any deduction allowable under this section) by a fraction, the numerator of which is the total number of shares of the corporation's securities held by the trust (including shares held by participants in the trust which were acquired, other than by purchase, from the trust) and the denominator of which is the total number of shares of the corporation's securities outstanding. Amounts paid to the trust not later than the date established by law for filing the corporation's return of tax for a taxable year, including any extension thereof, shall be treated as paid for that taxable year.

"(b) DEFINITIONS.—For purposes of this section and sections 4975(c)(4) and 501(c)(22)—

"(1) Distributed.—The term 'distributed' means actually paid to the participants of the trust, paid as ordinary and necessary expenses of trust operation, or paid in retirement of debt principal and interest incurred in furtherance of the trust's purposes.

"(2) Participant.—The term 'participant' means any individual for whom an account is maintained under a trust described in section 501(c)(22), for whose benefit allocations are made under the trust, and to whom benefits are distributed from the trust, and any individual who succeeds to the interest of a participant in a transaction in which gain is not recognized.

"(3) Securities.—The term 'securities' means common stock issued by a corporation with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock issued by the corporation.".

(b) CLERICAL AMENDMENT.—The table of sections for such part is amended by adding at the end thereof the following new item:

"Sec. 251. Amounts paid to a general stock ownership trust.".

SEC. 4. FAILURE TO DISTRIBUTE.

Section 4975(c) of the Internal Revenue Code of 1954 (relating to prohibited transactions) is amended by adding at the end thereof the following new paragraph:

"(4) Special rule for general stock ownerships trusts.—It shall be a prohibited transaction within the meaning of this section for a trust described in section 501(c)(22) to fail to distribute all amounts transferred to it as required by section 501(c)(22)(E).".

SEC. 5. EXEMPTION OF GENERAL STOCK OWNERSHIP TRUSTS FROM TAX ON UNRELATED BUSINESS INCOME.

Section 511(a)(2) of the Internal Revenue Code of 1954 (relating to organizations subject to tax) is amended by inserting "or in section 501(c)(22)" after "section 501(c)(1)".

SEC. 6. ELIGIBILITY FOR INDUSTRIAL DEVELOPMENT BONDS.

Section 103(b)(3) of the Internal Revenue Code of 1954 (relating to exempt persons) is amended by adding at the end thereof the following new subparagraph:

"(C) an organization described in section 501(c)(21).".

SEC. 7. EFFECTIVE DATE.

The amendments made by this Act, and the provisions of section 2 of this Act, shall apply with respect to taxable years beginning after December 31, 1978.

PRESS RELEASE

FOR IMMEDIATE RELEASE
September 21, 1978
P.R. #74

UNITED STATES SENATE
COMMITTEE ON FINANCE
2227 Dirksen Senate Office Bldg.

FINANCE COMMITTEE ACTS ON CAPITAL GAINS, OTHER PROVISIONS IN TAX CUT BILL (H.R. 13511)

General Stock Ownership Plans

Under present law, income of a corporation, less allowable deductions and exclusions, is generally taxable to the corporation and, if distributed to shareholders as dividends, is taxable to the shareholders in the year in which it is received.

It is possible to establish a special "subchapter S" corporation which is subject to different tax treatment. Where an eligible corporation elects under the subchapter S provisions of the Internal Revenue Code, the income or loss (except for certain capital gains) is not taxed to the corporation, but each shareholder reports a share of the corporation's income or loss each year in proportion to his share of the corporation's total stock outstanding. However, treatment as a subchapter S corporation is restricted to situations in which there are a limited number of shareholders.

The Committee agreed to provide special income tax treatment to certain State-chartered corporations established within a five-year period. These corporations would be exempt from Federal income taxation. Shareholders of these corporations would be taxed currently on their pro rata share of the corporation's taxable income (computed with receipts and deductions netted at the corporate level) in a manner similar to that available to subchapter S corporations under current law. However, unlike a subchapter S corporation, there would be no numerical limitation on the number of shareholders in these State-chartered corporations. Also, losses incurred by these corporations would not flow through to shareholders; instead they could be used by the corporations as net operating loss carryforwards against future income.

At least 90 percent of the income of these corporations which is not used to pay corporate operating expenses would be required to be distributed to the shareholders each year. However, these distributions would not be eligible for any exclusion for dividends received and would not constitute earned income for purposes of the maximum tax on earned income.

All residents of a State which charters such a corporation are eligible to become shareholders in the corporation and would be allocated a stock interest in the corporation. No shareholder who is allocated stock in such a corporation may sell or otherwise dispose of this stock for five years after receiving it. Any one individual may not purchase or otherwise acquire more than 10 shares of stock in any one such corporation. Only citizens within the State which charters such a corporation may acquire these shares of stock, whether they are obtained from the corporation or a shareholder.

Any State which charters such a corporation must report to the Congress each year during which the corporation is in existence and must file a final report to the Congress at the end of five years.

THE FOLLOWING DOCUMENT(S) MAY NOT FILM LEGIBLY BECAUSE OF POOR QUALITY OF THE ORIGINAL.

J. General Stock Ownership Corporations

(Sec. 201 of the bill)

Present law

Under present law, there are no special provisions relating to the establishment of a private corporation for the benefit of the residents of a State.

Reasons for change

The committee believes that many citizens should have a greater ownership stake in the private enterprise system, and that this would lead to better understanding of the system and would encourage individuals to invest in other business enterprises. Also, in the case of individuals now receiving various forms of transfer payments from Federal, State, or local governments, the receipt of dividend income from a General Stock Ownership Corporation (GSOC) would, to some extent, reduce the need for such payments. The committee believes that an experimental program permitting States to form such private corporations for the benefit of their citizens may enable the Congress to study a method of replacing transfer payments with dividend income.

Explanation of provisions

General.—Under the committee bill, a State would be authorized to establish a GSOC for the benefit of its citizens. It is anticipated that the GSOC would be authorized to borrow money to acquire business enterprises. The cash flow from the operation of the business would be used to pay the loan, and the corporate revenues would be distributed to the GSOC shareholders (i.e., the citizens of the State).

Definition of GSOC.—The bill provides that a corporation must meet certain statutory tests in order to be treated as a GSOC. First, the corporation must be chartered by an official act of the State legislature or by a State-wide referendum. Second, the GSOC's corporate charter must provide for the issuance of all authorized shares to eligible individuals provided that at least one share is issued to each eligible individual, and such eligible individual does not elect within one year after the date of issuance not to receive such share, and provides for certain restrictions on the transferability of the share. The transfer restriction must provide that the share cannot be transferred until the earliest to occur of (1) the expiration of 5 years from issuance,

[1] This rule applies to an election made under either subdivision (i) or (ii) of Treasury Regulations § 1.701-2(b)(2), relating to the method of electing not to be treated as a partnership.

(2) death or (3) failure to meet the State's residency requirements. In no event may shares of stock of a GSOC be transferred to nonresidents. Also, an individual may not acquire more than 9 shares by purchase. Third, the charter must provide that the GSOC is empowered to invest in properties (not including properties acquired by it or for its benefit through the right of eminent domain). Fourth, the GSOC may not be affiliated with any other corporation. Fifth, the GSOC must be organized after December 31, 1978, and before January 1, 1984. An eligible individual is any individual who is a resident of the chartering State as of the date specified in the corporate charter. A State may define a resident for purposes of its GSOC so long as such definition is consistent with constitutional principles.

Election.—A GSOC must make an election to obtain the special statutory treatment provided for by the amendment. The election is effective for the taxable year for which it is made on a timely filed tax return. The manner in which the election is to be made would be determined by regulations. The election once made is irrevocable unless terminated with the consent of the Secretary of the Treasury.

Effect of election.—The effect of the election would be to exempt the corporation from Federal income taxation. Instead, the shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

Treated as a private corporation.—A GSOC would be treated as a private corporation.

Computation of GSOC income.—The GSOC would compute its taxable income in the same manner as a regular corporation with certain modifications. The GSOC would not be eligible for a dividends received deduction nor any tax credits.

Net operating loss deduction.—The shareholders of a GSOC would not be eligible to report any portion of a GSOC net operating loss on their individual income tax return. Instead, the GSOC would be entitled to a 10-year carryover of any net operating losses.

Investment tax credit and recapture of investment tax credit.—Under the bill, shareholders of the GSOC would be entitled to their pro-rata share of the GSOC's investment tax credit. The shareholders would also be personally responsible for any recapture of such investment tax credit. Neither the corporation nor its shareholders would be entitled to the foreign tax credit.

Taxation of shareholders.—Under the bill, each shareholder would include in his gross income his daily prorated portion of the GSOC's taxable income. Such income would be included in the shareholder's gross income for the taxable year in which or with which the GSOC's taxable year ends. The income in the hands of the shareholder would be treated as ordinary income and would not be eligible for either the partial dividend exclusion (sec. 116) or the maximum tax of earned income.

Shareholders would increase the tax basis of shares of stock in the GSOC to the extent they reported income from the GSOC. Distributions from the GSOC out of such previously taxed income would decrease the tax basis of such shares.

Taxation of GSOC distribution.—Under the bill, distributions from a GSOC's taxable income previously taxed to a shareholder would be treated as a tax-free distribution. Any distribution in excess of such previously taxed income would be taxed in the same manner as a distribution from a regular corporation (sec. 301(c)).

Audit adjustments and amended tax returns.—Any audit adjustment resulting from an Internal Revenue Service determination would be reflected in the GSOC's taxable year in which such adjustment is made (and not the taxable year to which it relates). The amount of such adjustment would be subject to an interest charge in an amount computed as though the income had been taxed to a nonelecting corporation.

Reporting requirements.—Under the bill, a GSOC would be required to file a Federal income tax return and a computer-coded data showing information reported to each of its shareholders. The corporate tax return would be required to meet the same timing requirements as a regular corporation. In addition, a GSOC would be required to give each shareholder a Form 1099. The Form 1099 would report (1) the shareholder's pro rata income for the taxable year, (2) tax-free distributions for the year, (3) the tax treatment of other distributions, and (4) the amount of any investment tax credit and recapture thereof for such year, and (5) any amounts withheld for Federal income tax purposes.

Distribution requirements.—A GSOC would be required to distribute 90 percent of its taxable income to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the deficiency (i.e., the difference between the required distribution and the actual distribution) would be imposed on the GSOC. The amount of such tax would be allowed as a deduction to the GSOC for the year in which it is paid.

Withholding requirements.—The bill requires the GSOC to withhold an amount equal to 25 percent of every distribution made to its shareholders. The amount of such withholding would be allowed as a refundable credit to the shareholder. The Treasury would be authorized to issue regulations providing a certification procedure for individuals who are nontaxpayers under which they may be exempted from the withholding requirement.

Studies.—It is expected that a study would be made of the effect GSOC's have on competition with regular private corporations. It is also anticipated that a study would be made of the GSOC as a form of full corporate integration.

Taxable year end of GSOC.—The bill requires a GSOC to adopt a taxable year end of October 31. It is anticipated that most GSOC's would elect an October 31 year end. This would enable them to close their books and meet their shareholder reporting requirements by January 31 of the next succeeding year.

Effective date

The provision applies to corporations chartered and organized after December 31, 1978.

Revenue effect

The revenue cost of the proposal is expected to be negligible during the next few years. However, the long-run cost could be substantial.

THE PRECEDING DOCUMENT(S) MAY NOT FILM LEGIBLY BECAUSE OF POOR QUALITY OF THE ORIGINAL.

Two-Factor Theory And ESOP Financing

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

And

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

°The Most Potent Instrument For The Purpose

°The Most Advantageous To The Corporation

°The Most Beneficial To Employees

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Investment Bankers
Specialists in ESOP Financing
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Although two-factor economics is a new and fundamental concept, it is simple and straightforward. The reasoning runs as follows:

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

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

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

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

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

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

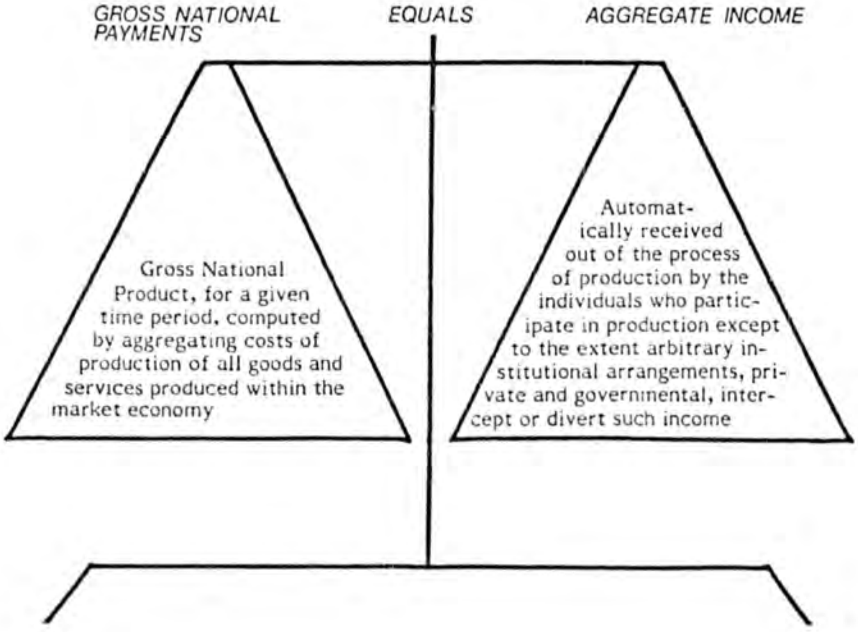


Figure 2: *SAY'S LAW ILLUSTRATED ON THE BASIS OF 1973 STATISTICS (IN BILLIONS)*

Gross National Product

Less adjustments for capital consumption allowances, indirect business tax and non-tax liability, business transfer payments and other minor adjustments.

CONSUMER COSTS OF:

Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9
Services	133.6
Government and government enterprises	162.9
Foreign trade and transactions	9.6
	$1,054.3

Pre-tax Income

Pre-tax Income Automatically Arising out of Production and Received by the Participants in Production

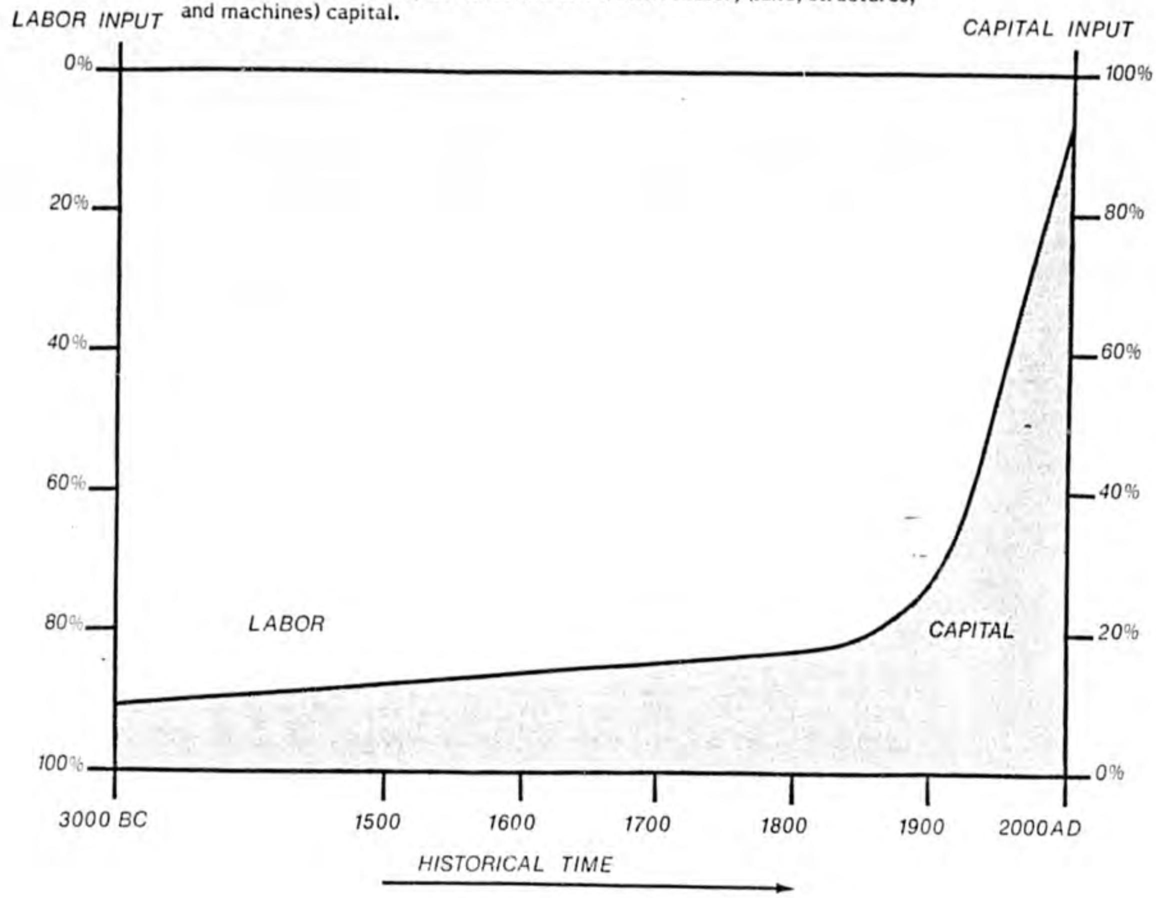
INCOME OF PARTICIPANTS IN:

Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9
Services	133.6
Government and government enterprises	162.9
Foreign trade and transactions	9.6
	$1,054.3

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

Figure 3: *THE FUNCTION OF TECHNOLOGICAL CHANGE*

The function of technological change is to shift the burden of production off the human factor, labor, and onto the non-human factor, (land, structures, and machines) capital.



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

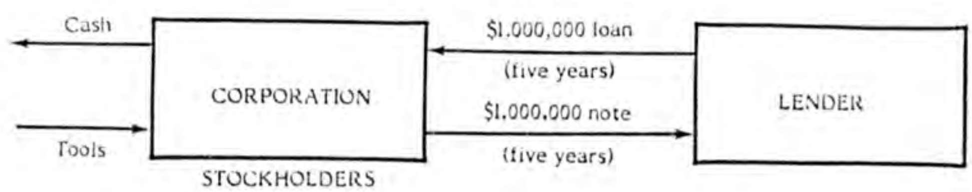
The costs of all such efforts enter into the costs of production, directly or indirectly, and thus are inflationary precisely because they are not reflected in the increased production of goods and services by labor. Such costs, neither representing increased labor input nor labor shortages, are, in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

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

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

Figure 4: *CONVENTIONAL CORPORATE FINANCE*

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

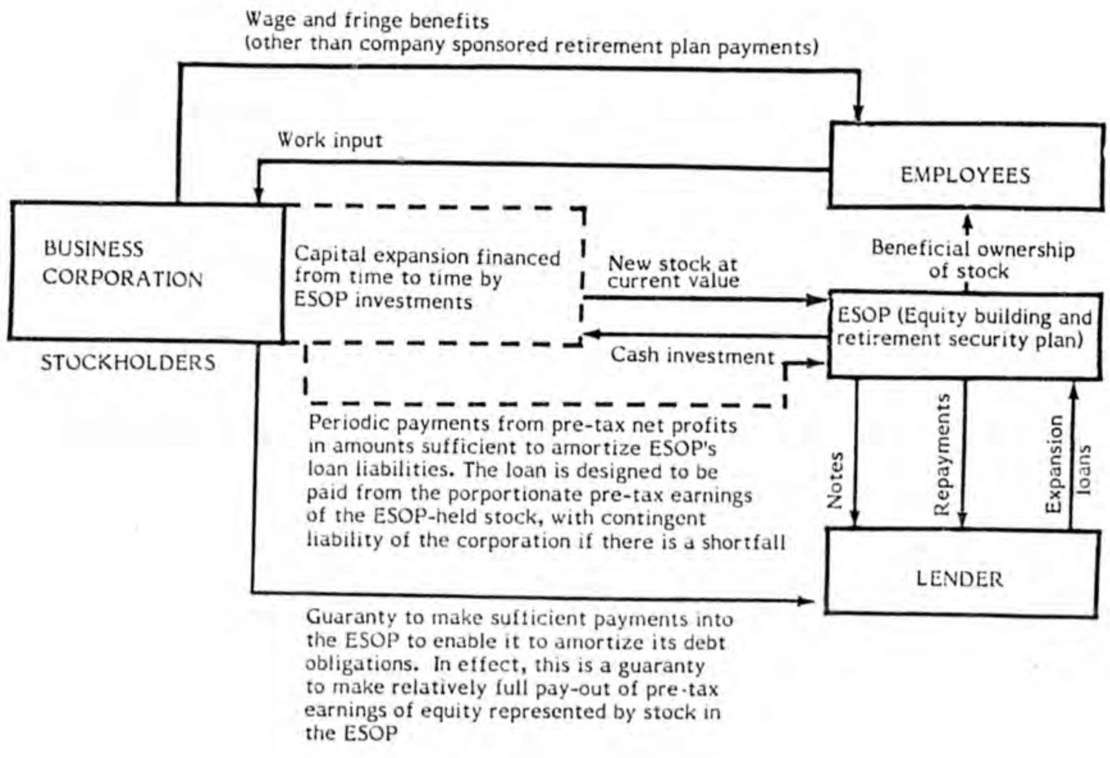


These methods of financing new capital formation have one common characteristic: they do not create a single new stockholder. The portion of new capital formation (about 2%) financed by sale of equity stock to the public does not alter this propensity. Every qualitative study of stock ownership to date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

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

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

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



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

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

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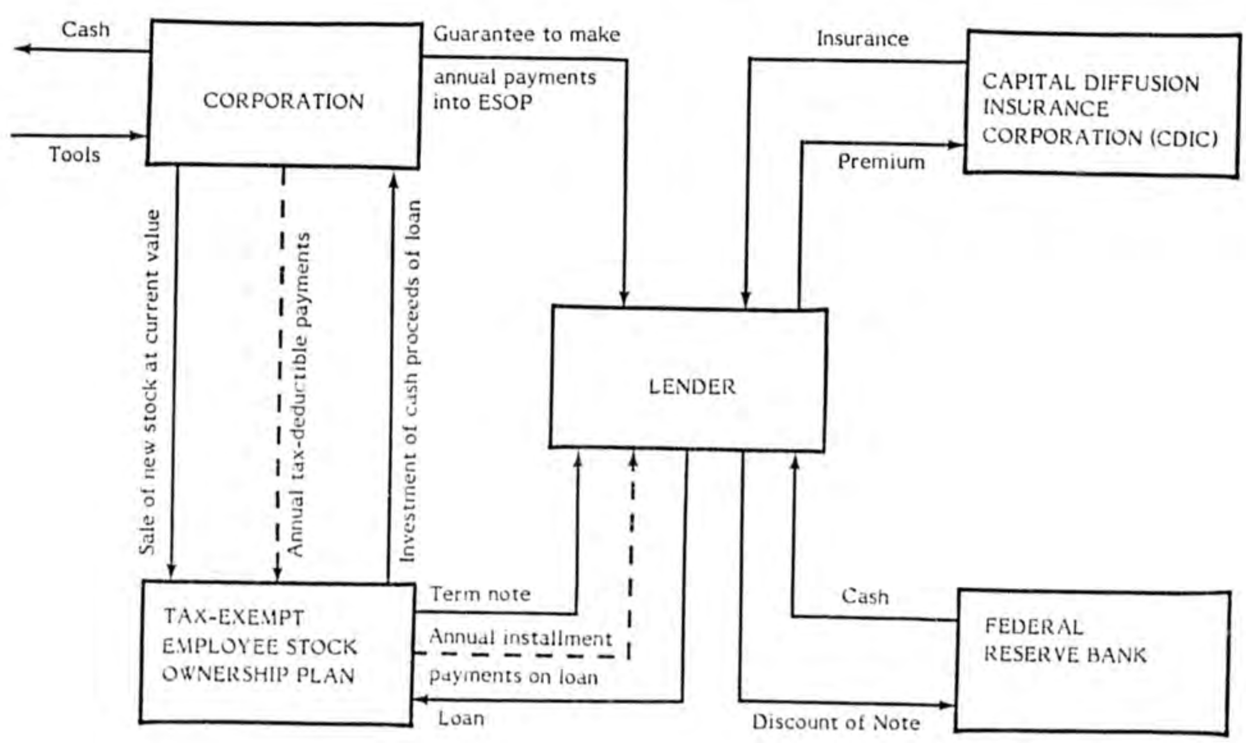
*Where the stock in the ESOP pays a dividend, the plan often provides that, after each particular share of stock is paid for, the dividends on it shall currently pass through the trust into the workers' pockets.

Figure 6: *FINANCING ECONOMIC GROWTH*

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

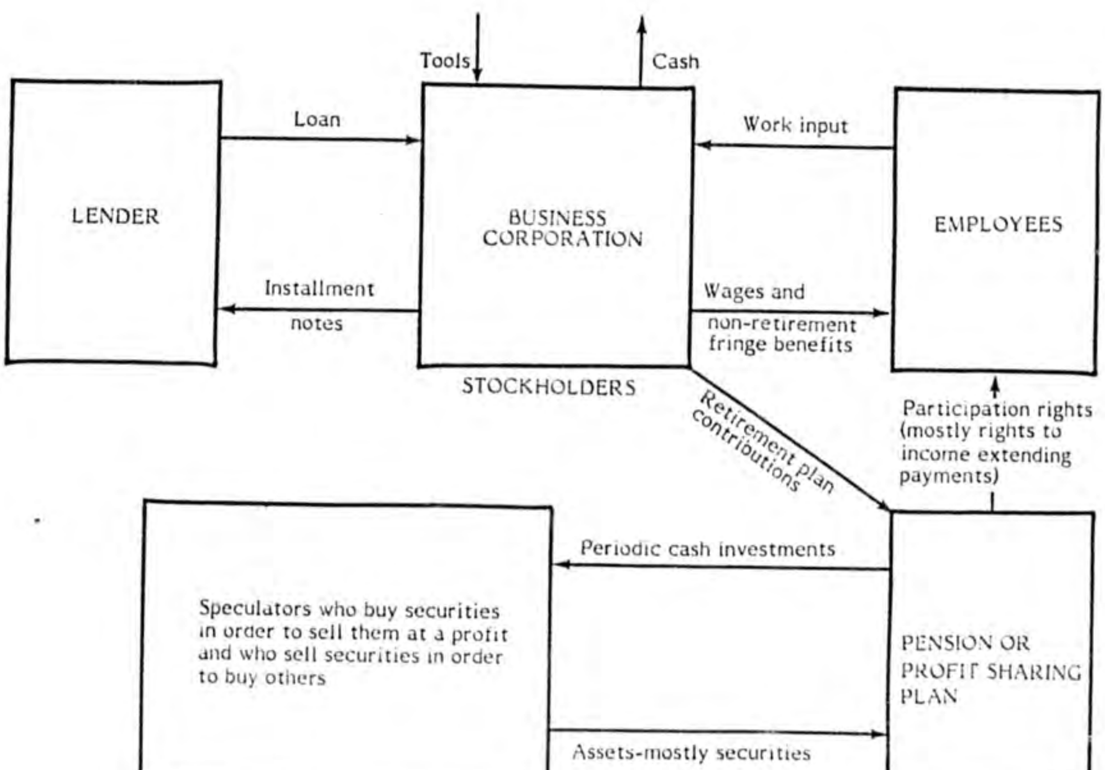


12. Inflation is eliminated. Institutional barriers, such as lack of "money" to finance solid, self-liquidating economic growth are eliminated; legitimate leisure, built upon the ownership of a holding of productive capital that will enable a man or woman to produce a viable income, becomes possible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

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

Figure 7: *CONVENTIONAL FINANCING OF A BUSINESS CORPORATION*

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

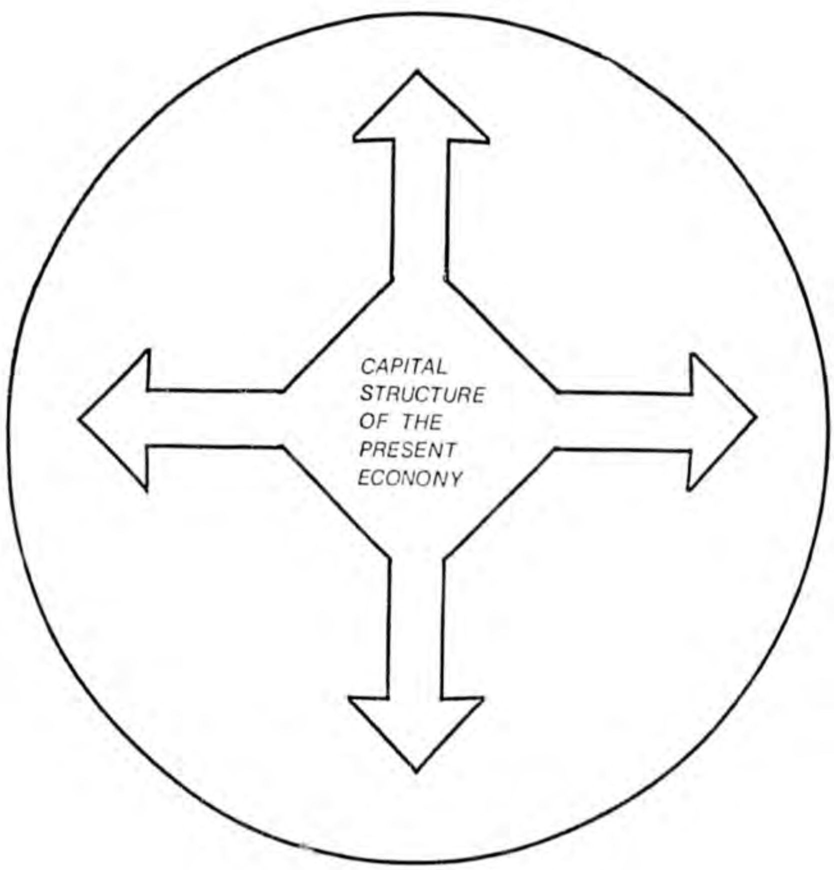


Compared with the ESOP (see Figure 5), not only does the identical dollar paid by the corporation to build stock ownership into employees also finance corporate growth, but corporate growth can be accomplished on pre-tax dollars. By comparing the ESOP (Figure 5) with conventional economic security-building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

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

Figure 8: *OBJECTIVE OF TWO-FACTOR ECONOMICS*

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



GSOP file

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

October 6, 1978

ALASKA GENERAL STOCK OWNERSHIP CORPORATION

Preliminary Identification of Work Details and Assignment of Responsibility Therefor Pursuant to the Contract Between the State of Alaska Legislative Finance Division and Kelso & Co., Inc. dated September 1, 1978

Introduction

This preliminary table of work details, of timing and sequence thereof, and of responsibility for the accomplishment of such details has been structured upon the assumption that the legislation concerning "General Stock Ownership Corporations", introduced into the Senate and preliminarily approved by the Senate Finance Committee as part of the general tax bill under consideration in Congress at this time (it is presently included as Section 201 of the bill and would add a "Subchapter U" to the Internal Revenue Code) will be enacted in such form that advantage can be taken of its provisions by the proposed Alaskan General Stock Ownership Corporation (AGSOC). In its present form, this legislation, if enacted by Congress, would give exemption from corporate income taxes at the Federal level to a General Stock Ownership Corporation either specially chartered by the legislature of a state, or brought into existence by state referendum. Senator Mike Gravel is seeking to have changes made in the bill that are probably indispensable if the legislation is to meet the basic requirements for AGSOC. Specifically, while a qualifying General Stock Ownership Corporation that elects to take advantage of Subchapter U becomes thereby exempt from Federal corporate income taxes, its stockholders -- the residents of the state as defined by the state legislature -- would be essentially taxed like the stockholders of a Subchapter S corporation under present law. This only partially answers the requirements, however, since stockholders of a Subchapter S corporation and their corporation can only make capital investments in after-tax (personal income tax) dollars. We believe that to be successful, however, over any extended term, it is imperative that the stockholders of AGSOC be put in the position of employees under an Employee Stock Ownership Plan (ESOP). In that position they are able, in ordinarily successful enterprises, to acquire capital ownership and to pay for it out of the capital represented by the shares they acquire. The reasoning behind this conclusion is elaborated in our letter of September 26, 1978, to the Finance Division, Budget and Audit Committee, directed to the attention of Senator Mike Colletta and Representative Jim Duncan. We have provided Senator Gravel's staff with specific language needed to obtain this change in the present legislation and they are cautiously optimistic that it can be obtained. Several possibilities would exist if satisfactory GSOP legislation is not enacted by Congress this year. AGSOC could elect to take advantage of the proposed Subchapter U for a year or two without any major adverse effects while a major effort is being made to get the legislation amended. The Subchapter U election can be made on a year-by-year basis.

However, we have estimated that the structure of AGSOC could be such as to give it full immunity from Federal taxation as an agency of the sovereign State of Alaska, at least up to the point where it begins to pay dividends to its stockholders. Since the corporate income of AGSOC in its first several years may well be devoted fully to payment of the purchase price for productive assets which it acquires, this might impose no inconvenience. It is possible, too, that election to take advantage of Subchapter U might be inimical to the "state agency" status of AGSOC if it later elected not to be taxed under Subchapter U.

This preliminary memorandum is prepared on the assumption that the Subchapter U legislation presently under consideration by Congress will be amended to give the citizen stockholders of AGSOC the same tax status as employee stockholders under an ESOP. Should this not turn out to be the case at the conclusion of the present Second Session of the 95th Congress, then revision of this outline of work details will be made to conform to this fact and a new memorandum to take the place of this one will be prepared and submitted to the Budget and Audit Committee for discussion at that time.

Date	Action To Be Taken	Assignment of Responsibility
09/01/78	Execution of contract between the Legislative and Finance Division of the State of Alaska and Kelso & Co., Inc. for the legal and financial design of a General Stock Ownership Corporation to be known as Alaskan General Stock Ownership Corporation or "AGSOC"	Individuals Designated by the Legislative Finance Division and Representatives of Kelso & Co.
09/01/78 to 10/10/78	Liaison with the Finance Committee of the U.S. Senate and its staff and particularly with U.S. Senator Mike Gravel and his staff in connection with the formulation of proposed Subchapter U providing for special tax treatment for General Stock Ownership Corporations	Kelso & Co.
10/09/78	Meeting in Anchorage, Alaska, between members of the Budget and Audit Committee and staff and representatives of Kelso & Co., Inc., including Messrs. Louis O. Kelso and John A. Miskimen, for the purpose of reviewing and revising a preliminary Time and Sequence Table; obtaining the initial policy decisions of the Budget and Audit Committee on policy points raised by the preliminary Time and Sequence Table or otherwise; establishing procedures for communications and for future meetings on the progress and implementation of the work covered by the contract of September 1, 1978, and such other matters as may come before the meeting	Members of Budget and Audit Committee and Their Staff and Representatives of Kelso & Co.
10/11/78 to 10/15/78	Representatives of Kelso & Co., Inc. engage in preliminary fact finding conferences for the purpose of identifying sources of information that will be required by the project; making arrangements for the obtaining of such information where possible; and establishing contact with the potential sources of such information	Representatives of Kelso & Co., including Messrs. John Miskimen and Leonard Gregory
10/09/78 to 11/01/78	Laying out the economic and legal design of AGSOC; identifying and analyzing the possible sources of its financing under various assumptions, including the cataloging of all possible State and Federal funding guarantee and insurance programs usable by such an entity; preparing for the	

Date	Action To Be Taken	Assignment of Responsibility
	Budget and Audit Committee an analysis of alternative forms of stock ownership; preparing an analysis and report on the possible alternatives in identifying the stockholder constituency of the initial AGSOC, for example, making only voting-age adults eligible vs. making all residents or citizens of the state as of a particular date eligible; determining whether stock allocation by AGSOC should be on an individual or on a "consumer unit" basis and preparing recommendations for the Budget and Audit Committee thereon; ascertaining the sources of information presently available or that might be developed to identify all eligible stockholders, once their qualifications have been established as a matter of policy; obtaining policy determination from the Budget and Audit Committee as to whether the burden of identification of eligible stockholders should be upon AGSOC or upon each individual qualified person; preparing recommendations for policy decision by Budget and Audit Committee with respect to the legal and economic characteristics of the stock of the initial AGSOC, including the time of its issuance, whether issued initially in escrow and if so what escrow conditions, whether par or no par stock, and the events triggering its issuance	
10/09/78 to 11/11/78	Kelso & Co. and such consultants as it may employ with approval of the Budget and Audit Committee will study and analyze the relevant facts, laws and institutions and will prepare reports, memoranda or recommendations to the Budget and Audit Committee on the following basic subjects requiring policy guidance from the Budget and Audit Committee: -- The appropriateness of a vesting schedule with respect to the ownership of AGSOC stock and the characteristics of such vesting schedule, if deemed desirable; -- The transferability rights of holders of AGSOC stock including transferability under the laws of decent and distribution, by will, by gift, by sale, or otherwise; -- The power of a person not eligible initially to acquire AGSOC stock to subsequently	

Date	Action To Be Taken	Assignment of Responsibility

acquire such stock, as, for example, a non-resident beneficiary of a will or a non-resident purchaser;

-- The possible use of prohibitions in the stock structure against certain types of transfer, either through giving a right of first refusal to AGSOC, or possibly making it the sole market in the event of any transfer, or perhaps any transfer other than one taking by will, gift, or the laws of decent and distribution, etc.

-- The alternatives with respect to a market or markets for AGSOC stock, including the liquidity problems involved in the event AGSOC should be made the sole market for its stock; the method and basis for valuation of AGSOC stock in the event AGSOC becomes the sole market for such stock and the methods of handling the incidental liquidity problems for AGSOC;

-- The rights of AGSOC to dispose of stock which it might acquire if it is given rights of first refusal or exclusive market purchase rights and the relevant and necessary sources of funding therefor;

-- Whether the initial AGSOC should be a single-investment instrumentality or whether it should be entitled to acquire a series of investments and what the limiting criteria should be;

-- Whether the initial AGSOC should be the first of a series of such instrumentalities in order to periodically include persons who become eligible to be stockholders, except for the date on which such eligibility is determined, and the criteria for determining the cut-off point for further investments by a particular AGSOC;

-- The management structure of AGSOC and the method and times of holding elections for directors; the qualifications of directors and their emoluments;

-- The management structure of AGSOC and the general criteria for determining possible conflicts of interest on the part of management personnel;

Date	Action To Be Taken	Assignment of Responsibility

-- The constitutionality under Alaskan law of incorporating AGSOC as a special corporation rather than under general corporation laws of the State and the existence of any constitution limitations upon the functions of such a corporation or upon the right of the Alaskan legislature to give it special characteristics and its stockholders special rights;

-- The rights of stockholders who have ceased to be residents of Alaska, if stock ownership by non-residents is permitted under any circumstances, to vote such stock;

-- The appropriate tax characteristics of AGSOC and its stockholders under existing or future tax laws of the State of Alaska, including in particular the right of such stockholders to pay acquisition costs, if any, from dividends paid by AGSOC on such stock free of State corporate or personal income taxes;

-- The relationship of AGSOC and/or its stockholders to various other institutions existing within the State, such as the native corporations, the Alaskan Permanent Fund, the various regulatory agencies, etc.;

-- If escrows are required in connection with the issuance of AGSOC stock, whether an escrow division should be incorporated into the structure of AGSOC with full necessary trust powers, or whether any banking firm or trust firm doing business in the State of Alaska (or elsewhere) should be authorized to establish such escrows, and whether the fees applicable to such escrows should be regulated by AGSOC or otherwise;

-- Whether the passage of an examination intended to demonstrate a reasonable level of economic literacy should be required to remove stock from escrow by a stockholder and, if so, the general contents of such economic literacy test;

-- The overall appropriate policy with respect to the degree to which the ownership of capital arising out of the develop-

Date	Action To Be Taken	Assignment of Responsibility
	ment of Alaskan resources should be financed through one or a series of AGSOCs and, depending upon the policy selected, the sources of funding of such AGSOCs and their relationships with the business community in general; -- The appropriate policy with respect to continuing shareholder communications	
11/09/78 to 12/09/78	Kelso & Co., Inc., with the assistance of such consultants as it may, with the approval of the Audit and Budget Committee, determine to be necessary and desirable, and in collaboration with the Attorney General of the State of Alaska, will draft legislation intended for recommendation by the Budget and Audit Committee to the State Legislature, for the purpose of implementing the policy decisions reached in the design stages of the development of AGSOC	
11/09/78 to 12/09/78	Kelso & Co., Inc., together with such consultants as it may, with the approval and consent of the Budget and Audit Committee, determine to be necessary and desirable, will fully explore the relationships between AGSOC and its stockholders and the Securities and Exchange Commission and laws which it administers, and under the Blue Sky laws of the State of Alaska, with a view to taking advantage of any necessary investor-protection provisions under any of said laws, but beyond that, avoiding unnecessary or burdensome regulations that may impair the effectiveness of AGSOC	
01/15/79	Kelso & Co., Inc. submits final report to Budget and Audit Committee and participates in such hearings thereon and such public discussions thereof as mutual conferences may determine to be in the public interest. While this is earlier than the deadline required by the contract of September 1, 1978, it is felt to be desirable to target an earlier delivery date in the hope that this can be met, without prejudicing the rights of Kelso & Co., Inc. to make timely delivery of the final report by February 1, 1979	

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

September 26, 1978

The Legislature of the State of Alaska
Finance Division
Budget and Audit Committee
Pouch WF - State Capitol
Juneau, Alaska 99811

Attention: The Hon. Mike Colletta, Project Director
The Hon. Jim Duncan, Project Director

Re: The Alaskan General Stock Ownership Plan

Gentlemen:

We have received and reviewed your letter of September 7, 1978, and have given much thought to the ideas expressed therein.

In this letter, we will first set forth our reasoning for our conclusions that there will be difficulties in accomplishing fully what, on its face, would seem to be a simple request. We will then assure you of our best efforts to satisfy your requests.

To understand the key problem, please consider the following. Why should we hold forth the promise that under a GSOP, structured in accordance with two-factor economic principles, it will be possible for qualified individuals over a reasonable time period to acquire significant capital ownership, when it is quite apparent that under existing techniques of finance, the rich (with surplus funds and credit to finance investments) can acquire more productive capital, but the non-rich majority (about 95% of consumer units) cannot acquire it at all?

These are the reasons:

1) The GSOP operates on pre-tax dollars.

2) Under a GSOP, the individual whose capital ownership is being financed is not taxed, either under State or Federal income tax laws or under any other tax laws as the result of the acquisition of the capital he invests in, or on the funds used to effect the acquisition. He will be taxed, as we believe State and Federal tax laws will stand when our ultimate recommendations are implemented, at either ordinary income tax rates or at capital gain tax rates on his sale of the capital thus acquired. Our firm is urging the ultimate adoption of legislative changes to eliminate even this type of taxation. It is based on a misinterpretation of two-factor economics. Capital acquisition by individuals using two-factor methods involves the individual's acquisition of access to credit on terms where the capital (or stock representing capital ownership) can be purchased from the yield of that capital, distributed in a manner to accomodate the credit terms so made available.

3) Two-factor economics is based on one premise that is critical here: the right to life, a right which our Constitution guarantees each person within its jurisdiction, implies the right legitimately to acquire productive power adequate to enable him to pay for the means of enjoying a reasonable life style that suits him. Each person legitimately acquires ownership of his own labor power at birth and over the course of his growing to maturity simply because slavery of American citizens and residents is prohibited. But labor is only one of the two factors of production. With the advance of technological change which, at an accelerating rate, alters the input mix of the factors of production, constantly increasing the use of capital and diminishing the use of labor, it is imperative that our institutions make it both possible and effective for each consumer unit to legitimately* acquire ownership of sufficient capital to make up for its normal inability to produce an adequate income through sale of its labor power; indeed to increase that productiveness so as to enable it to enjoy its reasonable share of the goods and services made possible by technological advance. There are thus profound and compelling reasons why no government should treat the yield of capital devoted

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* i.e., consistently with the protection of the sanctity of private property.

to pay its purchase price for a financially under-powered or potentially financially under-powered consumer, be treated as taxable income. This is a purchase transaction, and only when payment of the purchase price is completed and the newly acquired capital begins to produce income for its new owner, to the extent that such income in fact is paid, that it should be treated as ordinary income and subjected to income tax like any other ordinary income.

4) There are many reasons why the concepts of two-factor economics cannot be used to bring about this result in any case except where the relevant laws and financing institutions are structured -- or sometimes restructured -- consistently with two-factor economic principles to facilitate capital acquisition by the poor or previously capital-less. This structuring and restructuring has taken place, at least to a workable degree, in the case of ESOPs. But the ESOP can be used only to enable employees of a corporation to acquire stock in their corporate employer or its corporate affiliates. Such structuring and restructuring also enabled us to establish one CSOP (Consumer Stock Ownership Plan), named Valley Nitrogen Producers, Inc., in California. That enterprise was designed to enable its more than 12,000 farmer owner-customers to lower the effective cost to them of chemical fertilizers to a small fraction of their previous costs. But its powerful competitors persuaded Congress to alter the tax laws, so that Valley Nitrogen's establishment could not be duplicated again today without eliminating the legal obstacles placed in the way. That this will be done at the Federal level in the near future, so that the principal of financing the types of enterprise that lend themselves to the CSOP technique can be implemented in the next two or three years, I regard as a certainty.

5) In <u>The New Capitalists</u>, published by Mortimer J. Adler and myself in 1961, with additional references made to it in my testimony before the Heineman Commission (1969) and in <u>Two-Factor Theory: The Economics of Reality</u> (co-authored with Patricia Hetter, 1967), we put forward the most comprehensive of general capital financing and capital-broadening plans, one which I will now call the Financed General Capital Ownership Plan (FINGCOP). It

differs from, though is closely related to, the GSOP that is the subject of our present design study.

6) The FINGCOP must be implemented primarily at the Federal legislative level. That this is so can be readily seen from the mention of only a few of the changes required in present laws and financing practices that prevail today:

- Corporations seeking to take advantage of this means of financing their growth must commit themselves to a full periodic payout of their net earnings to their shareholders, after debt service, depreciation, and operating reserves only, in exchange for the assurance from their investment bankers, bankers (or other lenders) and from the Federal Reserve Board of Governors, that their feasible and reasonable future capital requirements will be similarly financed if they so request. This is simply a restoration of private property to capital stock which does not have that right today.

- The wages of capital (capital net income) must be free of corporate income tax to the extent that it is applied upon the purchase price of the stock by individual stock buyers. Eventually the corporate income tax should be eliminated entirely and the income tax shifted to individuals.

- The wages of capital, to the extent applied on the purchase price of capital stock for an individual, must be free of the individual's income tax, and taxable as ordinary personal income only after such purchase price is paid. Only on subsequent sale of the stock so purchased by an individual would he be taxed at ordinary income rates on his gain (from a zero basis), and only then if he failed within 60 days to reinvest the proceeds in income-yielding productive capital.

- A Capital Diffusion Insurance Corporation (CDIC), the capital financing equivalent of FHA Insurance Program in the housing finance field, would be established to lower resistance of lendors to make FINGCOP loans. Since such loans are on assets intended to pay for themselves, the premiums of such insurance should be lower than FHA insurance premiums. CDIC could be established as a public agency or by private insurance companies, or both. (See the letter to President Ford and its enclosure attached hereto).

- The loan paper for FINGCOP financing should be made directly discountable at the Federal Reserve Bank at a price not exceeding the administrative costs of the costs of the Fed. I estimate this should not exceed 1/4 of 1%. If lenders then take their usual spread -- 1-1/2% to 2% -- for their initial feasibility analysis of the loan and for their policing of the loan covenants until it is repaid, an effective interest rate to individual citizen borrowers should not exceed 3%. At the National Monetary Policy level, this amounts to shifting from the monetization of welfare, as we do today, to the monetization of self-liquidating productive capital. Loans would be limited by law. Eligibility of capital buyers under this plan would, as in the case of a GSOP, be determined from time to time by law. Loans would be made into escrows established with any eligible bank or trust company of the borrower's selection. Trust officers or investment counsellors would guide the borrower on the selection of a reasonably diversified portfolio and could refuse the loan if not satisfied with the diversification.

7) From the discussions of the FINGCOP concept, it should be clear that difficulties are involved in designing a GSOP that would permit an individual to select various stocks in various corporations of his choice:

- To pay the cost of the stocks he would buy, he would have to use the dividends that are voluntarily paid by the issuing corporations, and then only after being reduced by his personal income tax, State and Federal. Such dividends are rarely as high as 25% of the corporation's pre-tax net income, and, after payment of individual income tax on them, would normally be less than the rate of interest on loan financing at the present or foreseeable future time, say 10%-12%, or more. So such stocks would <u>never</u> pay for themselves.

However, we do understand from your letter that the Committee is interested in maximizing the freedom of the individual to select his investments and to achieve diversification, and we will do our best to accommodate these interests of the Committee in our GSOP design study.

Sincerely,

Louis O. Kelso

Louis O. Kelso
President

LOK/lrh
cc: Milt Barker

Enclosures

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

FINANCE DIVISION
POUCH WF-STATE CAPITOL
JUNEAU, ALASKA 99811
PHONE: (907) 465-3795

September 7, 1978

Mr. Louis O. Kelso, President
Kelso & Co., Inc.
111 Pine Street
San Francisco, California 94111

Dear Mr. Kelso:

As you begin your study of General Stock Ownership Plan (GSOP) options for Alaska, we would like for you to include an examination of an alternative that would retain the investment decision with the individual. In other words, an individual would decide what common stock to purchase. Perhaps an approved list of corporations with good dividend records, mutual funds, or outright diversification requirements would be stipulated for allowable investments to ensure prudence on the part of individuals.

Basically, the concept we have in mind is very close to that developed in your published works such as Two Factor Theory. The thrust is to retain the wisdom of the free market in the investment decision. We recognize that Senator Gravel's bill as introduced does not offer this flexibility.

To the extent possible within the existing contract amount, please provide us with your analysis of this type of GSOP structure.

Very truly yours,

Mike Colletta

Mike Colletta, Project Director

Jim Duncan

Jim Duncan, Project Director

cc: Members, Budget & Audit Committee
Representative Steve Cowper
Milt Barker

DILH

Two-Factor Theory And ESOP Financing

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

And

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

°The Most Potent Instrument For The Purpose

°The Most Advantageous To The Corporation

°The Most Beneficial To Employees

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Investment Bankers
Specialists in ESOP Financing
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Although two-factor economics is a new and fundamental concept, it is simple and straightforward. The reasoning runs as follows:

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

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

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

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

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

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

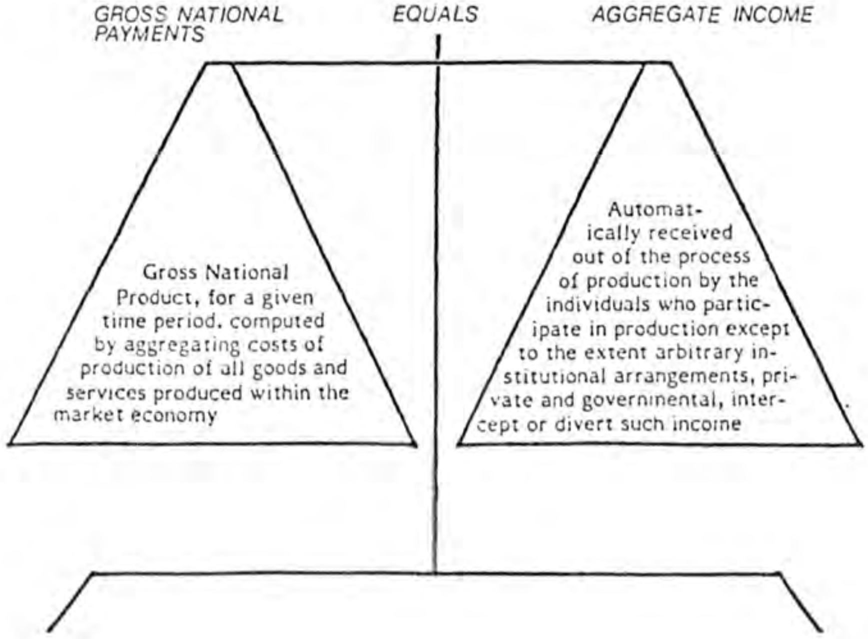

Figure 2: *SAY'S LAW ILLUSTRATED ON THE BASIS OF 1973 STATISTICS (IN BILLIONS)*

Gross National Product

Less adjustments for capital consumption allowances, indirect business tax and non-tax liability, business transfer payments and other minor adjustments.

CONSUMER COSTS OF:	
Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9
Services	133.6
Government and government enterprises	162.9
Foreign trade and transactions	9.6
	$1,054.3

Pre-tax Income

Pre-tax Income Automatically Arising out of Production and Received by the Participants in Production

INCOME OF PARTICIPANTS IN:	
Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
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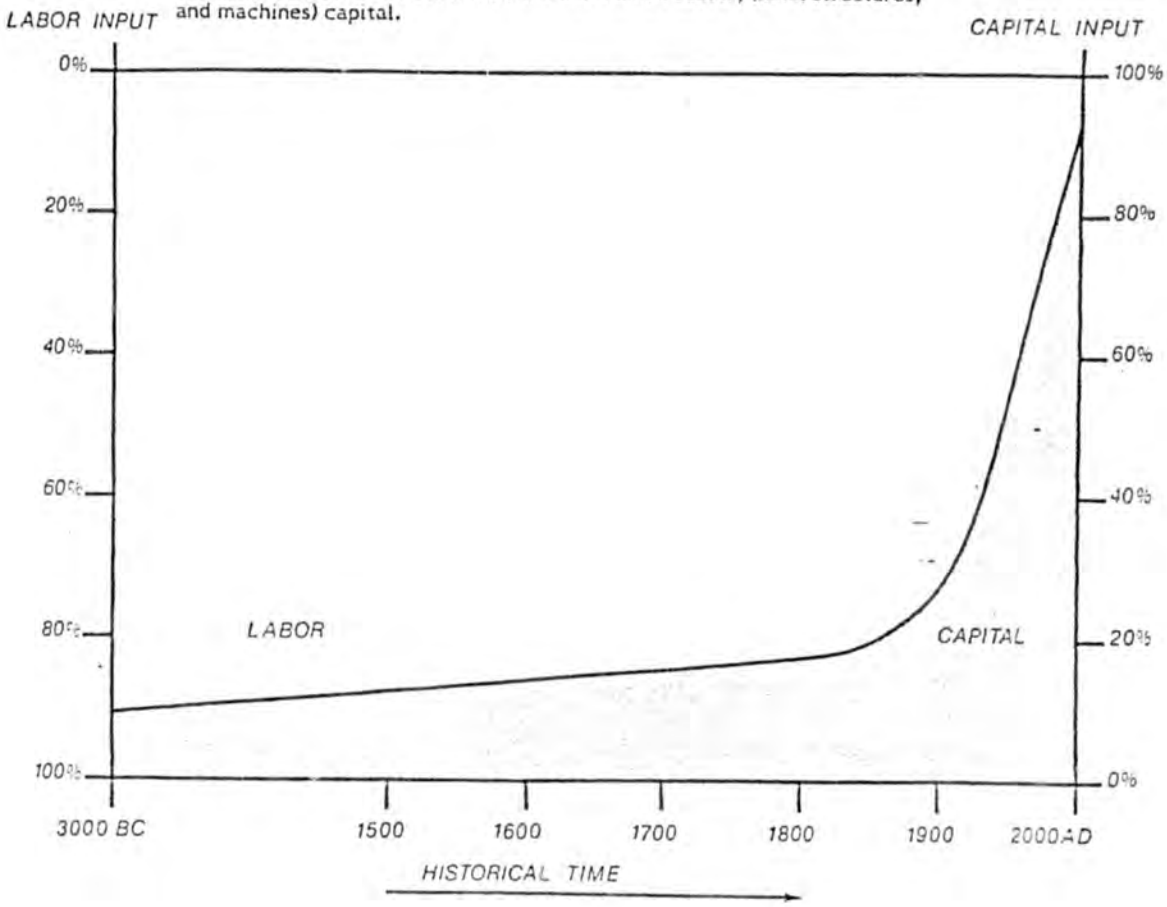
5. Technological advance, which is the phenomenon responsible for the Industrial Revolution, as well as our own automation revolution, and all of the intermediate revolutions brought about by science and technology, changes, and is intended to change, the input mix. It shifts the burden of production off labor (the human factor) and onto capital (the non-human factor). Technological change does not operate directly on labor. It cannot increase the productiveness of an individual worker. It increases the productiveness of machines, tools, structures, land and processes. The economic productiveness of human workers--what they can accomplish with their unaided muscles or minds has not changed during the course of history, if the value of that productiveness is determined objectively and competitively by the free operation of the law of supply and demand.

Figure 3: *THE FUNCTION OF TECHNOLOGICAL CHANGE*

The function of technological change is to shift the burden of production off the human factor, labor, and onto the non-human factor, (land, structures, and machines) capital.



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

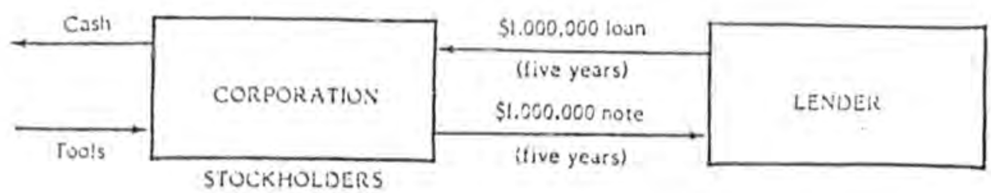
The costs of all such efforts enter into the costs of production, directly or indirectly, and thus are inflationary precisely because they are not reflected in the increased production of goods and services by labor. Such costs, neither representing increased labor input nor labor shortages, are, in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

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

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

Figure 4: CONVENTIONAL CORPORATE FINANCE

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

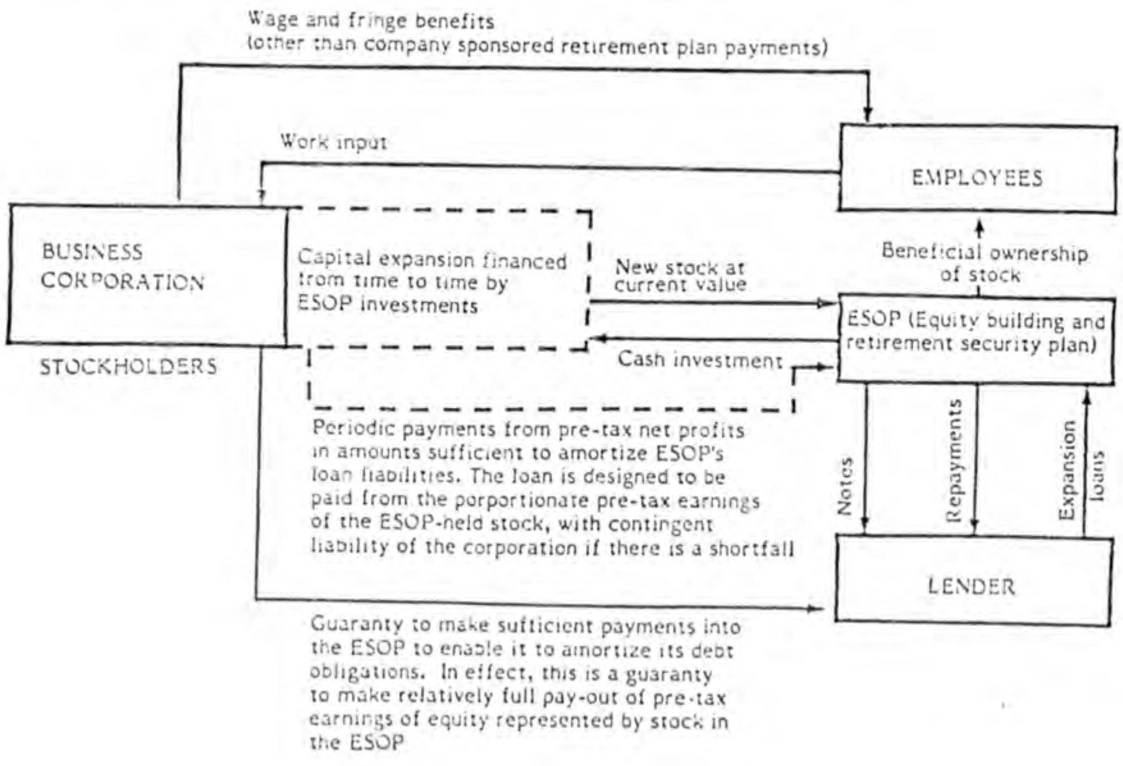


These methods of financing new capital formation have one common characteristic: they do not create a single new stockholder. The portion of new capital formation (about 2%) financed by sale of equity stock to the public does not alter this propensity. Every qualitative study of stock ownership to date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

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

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

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



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

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

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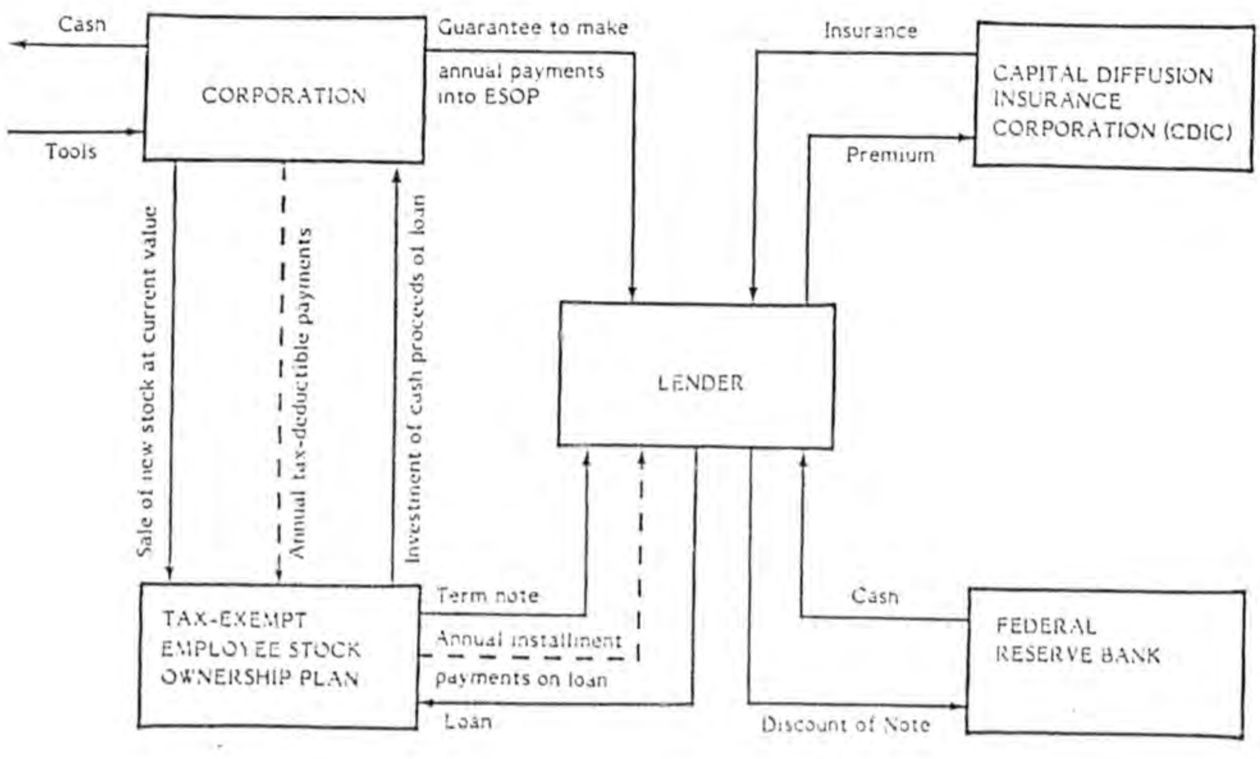
*Where the stock in the ESOP pays a dividend, the plan often provides that, after each particular share of stock is paid for, the dividends on it shall currently pass through the trust into the workers' pockets.

Figure 6: *FINANCING ECONOMIC GROWTH*

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

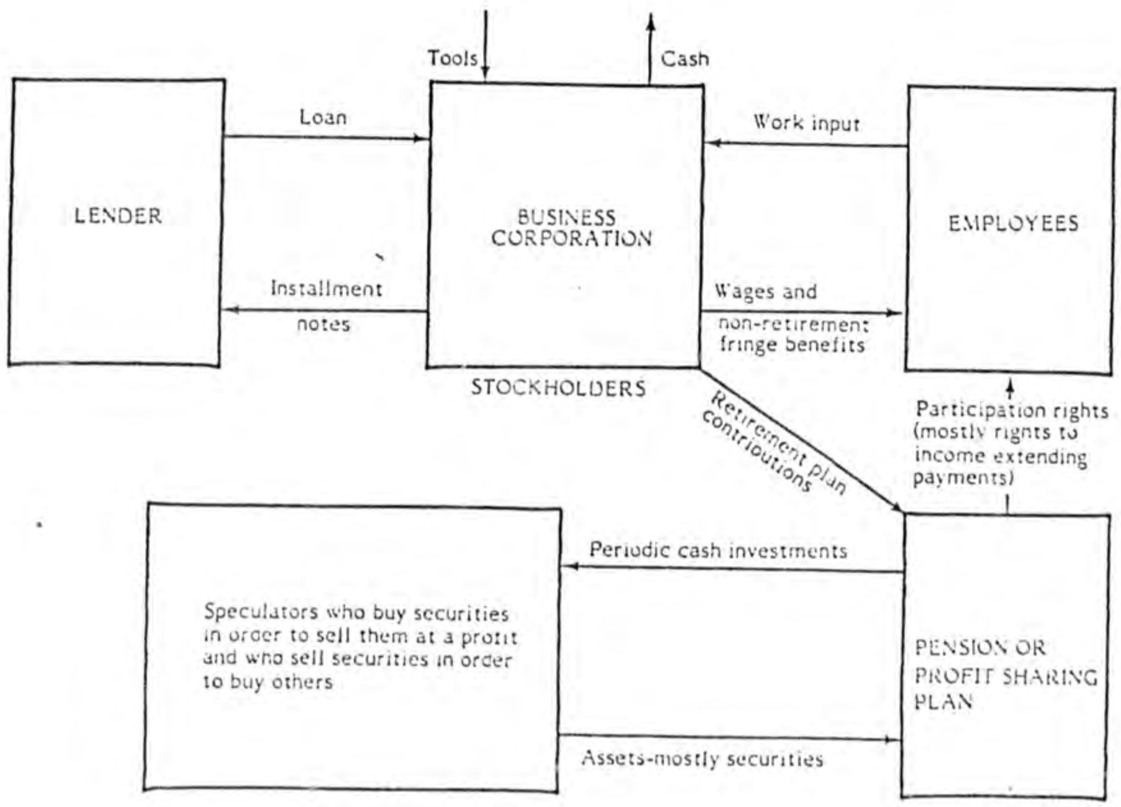


12. Inflation is eliminated. Institutional barriers, such as lack of "money" to finance solid, self-liquidating economic growth are eliminated; legitimate leisure, built upon the ownership of a holding of productive capital that will enable a man or woman to produce a viable income, becomes possible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

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

Figure 7: *CONVENTIONAL FINANCING OF A BUSINESS CORPORATION*

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

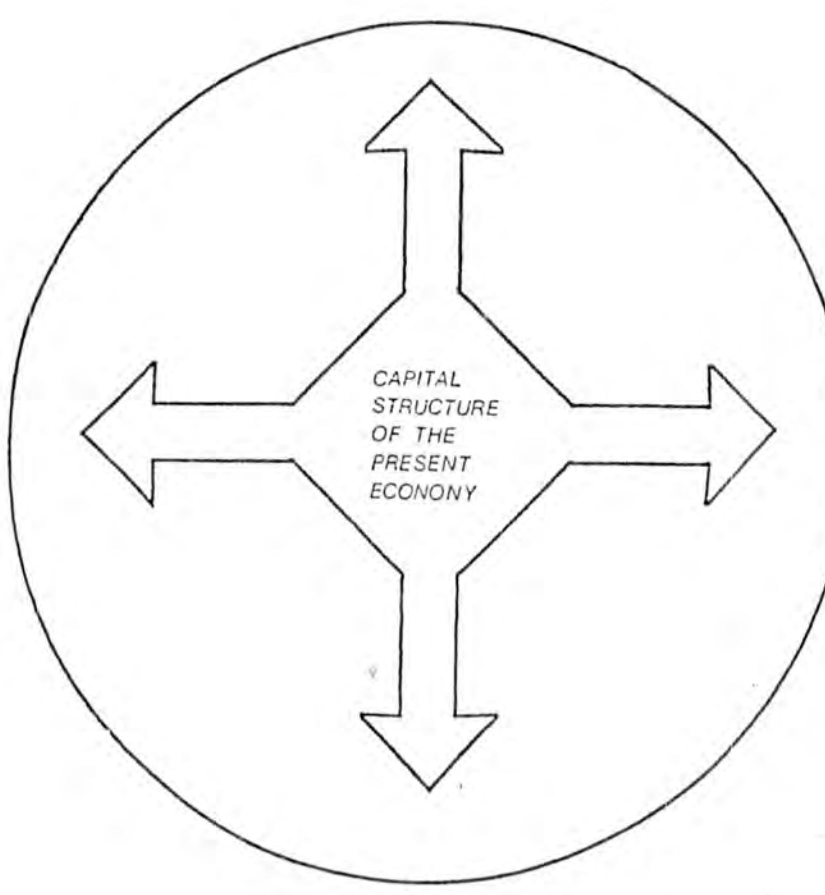


Compared with the ESOP (see Figure 5), not only does the identical dollar paid by the corporation to build stock ownership into employees also finance corporate growth, but corporate growth can be accomplished on pre-tax dollars. By comparing the ESOP (Figure 5) with conventional economic security-building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

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

Figure 8: *OBJECTIVE OF TWO-FACTOR ECONOMICS*

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



SUGGESTED READING ON TWO-FACTOR ECONOMICS

Books

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

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

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

Testimony

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

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

Reports and Publications

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

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

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

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

FOR FURTHER INFORMATION CONTACT:

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