



HSA 240 (FILE NO. 2)

HB

240

#2

THE FOLLOWING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

THE RELATIONSHIP
BETWEEN
CASH FLOW AND TAXABLE INCOME
IN
GENERAL STOCK OWNERSHIP CORPORATIONS

Senator Mike Gravel

CONTENTS

Executive Summary	(a)
The Potential Problem	1
When Can the Problem Occur	2
Non-deductible Expenditures	3
Taxable Income Without Cash Flow	5
Depreciation Recapture	5
Investment Credit Recapture	7
Installment Sales	9
Protection for Shareholders	10
The Election	10
Management	13
Termination of Election	14
Revocation of Charter	16
Conclusion	17

EXECUTIVE SUMMARY

The Potential Problem

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

When Can It Occur

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

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

Shareholder Protection

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

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

Conclusion

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

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

THE POTENTIAL PROBLEM

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

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

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

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

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

WHEN CAN THE PROBLEM OCCUR

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

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

Non-deductible Expenditures

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

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

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

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

Taxable Income Without Cash Flow

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

Depreciation Recapture

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

Depreciation recapture may occur where a taxpayer elects to use accelerated depreciation. Accelerated depreciation

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

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

John owns a rental apartment for which he paid \$100,000. The unit will last for 20 years. John takes a depreciation deduction each year equal to one-twentieth of his investment or \$5,000. This uniform annual depreciation deduction is known as straight line depreciation. After 20 years John will have taken depreciation deductions equal to the \$100,000 he paid for the apartment. He will have recovered his investment through income on which he paid no tax.

To encourage investment in rental housing the law allows John to recover his investment in a shorter period of time through accelerated depreciation. In some cases John can elect to take twice the normal depreciation deduction. If he takes a \$10,000 depreciation deduction in the first year he will shelter \$10,000 from tax. If he then sells the property

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

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

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

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

Investment Tax Credit Recapture

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

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

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

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

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

Installment Sales

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

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

PROTECTION FOR SHAREHOLDERS

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

The Election

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

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

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

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

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

2. Chartered by legislation or initiative,
3. Charter providing-
 - Only one class of stock
 - Issuance of at least one share to each resident
 - Issuance of shares only to "eligible individuals"
 - Election to reject shares
 - Transfer restrictions
 - Intent to qualify as a GSOC
4. Limitations on use of state's condemnation powers, and
5. Affiliated group limitations.

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

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

the special tax status subsequent to that date.

Management

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

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

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

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

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

Termination of Election

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

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

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

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

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

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

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

Revocation of Charter

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

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

CONCLUSION

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

THE PRECEDING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

BCRIC

1979 ANNUAL REPORT

BRITISH COLUMBIA RESOURCES INVESTMENT CORPORATION

British Columbia Resources Investment Corporation



INCORPORATED IN THE PROVINCE OF BRITISH COLUMBIA

B2197166

CUSIP 110721 10 7

BEARER SHARE CERTIFICATE

TWO HUNDRED THAT THE BEARER OF THIS CERTIFICATE IS THE HOLDER OF
 FULLY PAID AND NON-ASSESSABLE COMMON SHARES WITHOUT PAR VALUE IN THE CAPITAL OF
 BRITISH COLUMBIA RESOURCES INVESTMENT CORPORATION.

The bearer of this certificate, if qualified under the British Columbia Resources Investment Corporation Act, is entitled, on presentation at the offices in Vancouver, Calgary, Winnipeg, Toronto and Montreal, of Montreal Trust Company of the certificate together with suitable and share certificates of the Corporation representing (including this certificate) at least 100 common shares of the Corporation to have issued in exchange thereof a certificate for the appropriate number of such common shares in the name of the bearer, and to be registered in the appropriate register of the Corporation as such member holding such shares. The common shares represented by this certificate are transferable by delivery of this certificate.

In Witness Whereof the certificate is signed of its duly authorized with its common seal.

This Corporation has caused this certificate to be signed by its president, secretary and to be sealed.

DATED AUGUST 7, 1979



John H. Smith

Printed

4
5
6
7
8
9
10
11
12
13
14
15

16
17
18
19
20
21
22
23
24
25

THE ANNUAL REPORT IN SUMMARY

- Consolidated net earnings were \$40,757,000 on total revenues of \$359,465,000 for 1979.
- Drilling on gas and oil lands resulted in the discovery of four gas wells and one oil well.
- Forest products performed reasonably well, and all three forestry companies have embarked on long-range strategic planning to improve their positions within the industry.
- The Company's short term investment portfolio, which consisted primarily of the \$487.5 million raised during the public share offering, benefited from high interest rates.
- BCRIC plans to participate actively in energy exploration and expects to commit \$170 million to this sector over the next five years. Other investment areas are also being closely examined.

BCRIC has an estimated 2 million shareholders, of which 136,143 were registered shareholders at December 31, 1979. The geographical distribution of registered shareholders and the number of shares held was as follows:

	Number of registered shareholders	Number of shares held
British Columbia	129,728	74,292,744
Alberta	3,600	2,437,206
Saskatchewan	287	132,860
Manitoba	295	790,344
Ontario	1,619	5,822,711
Quebec	412	570,837
New Brunswick	47	20,700
P.E.I.	6	6,900
Nova Scotia	54	28,945
Newfoundland	7	2,800
N.W.T. and Yukon	33	19,692
Other Canadians residing elsewhere	55	40,891
	136,143	84,166,630
Bearer shares		12,076,605
Total shares outstanding		96,243,235

INDEX

	Page
Highlights	1
President's Letter	2
Review of Operations	5
Financial Statements	10
Corporate Information	inside back cover

ANNUAL GENERAL MEETING

The annual meeting will be held at the Orpheum theatre, Vancouver, B.C. at 10 a.m., March 27, 1980 unless adjourned automatically to the Pacific Coliseum, Exhibition Park, Vancouver, B.C. at 10 a.m., April 7, 1980.

FINANCIAL AND OTHER HIGHLIGHTS

		<u>1979</u>	<u>1978</u>
Consolidated net earnings		\$ 40,757,000	\$ 15,922,000
Consolidated financial position at year end:	short term investments	\$517,505,000	\$ 9,787,000
	working capital	559,719,000	77,822,000
	shareholders' equity	683,161,000	15,922,000
	total assets	940,720,000	425,068,000
Additional Company information:	cash from issue of common shares	\$487,459,000	—
	interest income from short term investments	\$ 32,511,000	\$ 155,000
	expenditure on petroleum and natural gas rights and exploration	\$ 7,527,000	\$ 63,000
	number of employees at year end	42	22
	Common share data:	price (August 7 to December 31, 1979):	
	HIGH	\$9.25	
	LOW	\$5.87	
	CLOSE	\$7.10	
	trading volume:	VANCOUVER	TORONTO
	number of shares	18,055,964	7,003,774
	dollar value	\$130,325,018	\$ 51,934,743

Certain 1978 comparative figures are not for a full year. See Note 10 to the financial statements for details.

These Highlights, the President's Letter and the Review of Operations and Activities constitute the Directors' Report to the shareholders for the year 1979.

TO OUR SHAREHOLDERS

1979 has been an exciting year for British Columbia Resources Investment Corporation. This, our first annual report as a public company, highlights the activities of 1979 and, where possible, indicates our direction for 1980. You should be aware that a real difficulty for us in this report is that the information as written is two months old by the time it is released, and two months is a long time in the short history of BCRIC.

At the start of 1979, BCRIC was a wholly government-owned corporation controlling some resource oriented activities with little resultant cash flow and relatively modest investment plans. As a result of the overwhelming desire of British Columbians to participate in direct ownership of BCRIC, the Company has been transformed during the year into a major Canadian public company with new share capital of \$487.5 million and a consequent requirement to completely reassess investment plans.

The response for shares by nearly 2,000,000 citizens who applied for their 5 free shares from the British Columbia Government and by the 200,000 who purchased additional shares from BCRIC, was far beyond any expectation. It clearly demonstrates the desire of most individuals to have a chance to share directly in the ownership of the present and future holdings of the Company by a method that was made as easy as possible for that participation. At the same time, that response vastly changed the horizons and possibilities for BCRIC and dictated the need for more time to develop strategic objectives in keeping with the new circumstances.

Establishing these objectives must be done thoroughly and it is not easily undertaken nor quickly accomplished. In fact, it has already taken longer than we had anticipated. This work is still in progress as we enter 1980 and we recognize that the delay might cause some shareholders to become impatient as they await major investment announcements from BCRIC. Compounding the difficulties is the fact that BCRIC has come into being at a time when more rapid and dramatic fluctuations than ever before are occurring in such important areas as interest rates, stock prices and commodity values. Furthermore, the outlooks for the economies of Canada and the United States are more uncertain than they have been for many years due to high inflation, recessionary influences and international political conflicts. Turbulent periods such as these are frequently followed by a period of hindsight when one is tempted to question the need for long term investment planning because short term trading gains might have appeared a more profitable objective. However attractive short term speculation may appear, it is our firm conviction that the long term interests of our shareholders will best be served by prudent deliberation in developing an effective, long term investment strategy. Shareholders must be convinced that their investment in this Company is not a short term proposition and be prepared to allow the Directors and management the necessary time to make prudent decisions for the future of the Company.

BCRIC has a number of general objectives upon which its investment strategy is being built. Foremost among these is our original objective to operate profitably and to maximize the value of BCRIC for the benefit of its shareholders, through growth in earnings and asset values.

The Company intends to achieve this growth through long term investment, primarily in the natural resource industries of Western Canada. Pending such long term investment, the Company's funds have been invested in quality short term money market securities which, in addition to very attractive interest returns, provide the Company with the liquidity necessary for long term investment activities.

In assessing various long term opportunities, the criteria against which investments are being measured include current income, potential future asset values, participation with partners who have expertise in a given field, use of BCRIC's own financial and other expertise, and the opportunity for a degree of participation sufficient for profits and cash to flow directly to BCRIC.

Within the framework of these objectives, the Company has been focusing attention on all natural resource areas, but because of our existing holdings in the gas and oil and forestry sectors we felt you would be particularly interested in our conclusions in those areas.

Following acquisition of the Licenced Lands as one of our founding assets, the initial strategy for BCRIC's gas and oil division was to obtain agreements with operating and drilling firms for exploration on these Lands and to pursue on its own a modest level of exploration expenditure and commitment. The program prior to the share offering was to acquire further land and undertake exploration totaling \$8 million for 1979 and \$55 million for the five year period ending in 1983.

After completion of the share offering, it was obvious that BCRIC had the capacity to increase its expenditures in the gas and oil sector. About the same time, the gas and oil division had achieved its initial objective of farming out virtually all of the Licenced Lands.

It also expanded programs to pursue exploration prospects through farmins with partners and through the purchase of additional lands to partially offset the dilution of the land inventory which resulted from farmout agreements on the Licenced Lands.

In mid October, the Board of Directors approved a \$30 million exploration budget for the gas and oil division for 1980. Accompanying this budget was a preliminary estimate that exploration expenditures for the five year period ending in 1984 would total \$170 million. The attainment of this five year estimate would result in a minimum total investment by BCRIC in the gas and oil sector of approximately \$220 million to the end of 1984. These expenditure levels were proposed in the context of the following strategy statement for the gas and oil division:

"To maximize expected return on investment by committing future investment into 'grass roots' exploration and development based upon acquisition of land, primarily wildcat acreage, and the expansion of in-house geological and geophysical skills and capacity in order to originate and manage plays on these lands."

It is a strategy which involves a high level of risk and deferred returns. The degree of success which may be achieved may not be measurable for several years and realized returns on funds committed most likely will not be significant for at least five years. This is a long term strategy which, once initiated, will involve additional expenditures over future years due to continuing participation commitments with partners and the desire to preserve full returns on our investment in successful ventures.

In the forestry sector, BCRIC already has substantial investments through its initial ownership positions in Canadian Cellulose, Kootenay Forest Products and Plateau Mills. In 1979, a major effort was made to encourage the development of long-range strategic planning within these subsidiary companies, so they can plot where they are going relative to their position within the British Columbia forest industry. The initial efforts are encouraging though the profit results may not be seen for several years and all three companies have been committing a high proportion of recent earnings to expenditures aimed at future benefits. Examples of this are the sawmill modernizations at both Kootenay and Plateau and the purchase by Canadian Cellulose of Price-Skeena Forest Products Ltd. which owns a sawmill in Terrace, B.C.

At CanCel, 81% owned by BCRIC, a number of organizational changes were made during the year and a number of senior employees added, which should considerably strengthen the management team.

At both Kootenay and Plateau, which are wholly owned, much more detailed assessments were undertaken of both management and general business and marketing practices. A number of changes were made and we are confident that both organizations are now better positioned and organized to capitalize on future opportunity.

In the broader forestry sector context, BCRIC has been assessing the optimum balance of a forest products position in terms of fibre supply, conversion facilities and markets. Some improvements are needed in our present balance and BCRIC will make additional investments in the forest products industry to achieve a stronger position.

Our investment plans concerning Westcoast Transmission Company Limited are still undetermined largely due to the uncertainty surrounding the 36% control block position held by Petro-Canada. Because of this we continue to regard this holding as part of our investment portfolio. The future outlook for Westcoast is good and we are pleased with the capital appreciation potential and dividend income received.

In any company, but particularly in a new and emerging company, the role of its employees is critical to its well-being. I want to pay tribute to our employees for their determination and effort in getting the Company successfully launched and into business.

In conclusion, it is most fitting to pay tribute to our founding shareholders for their support not only of BCRIC itself, but for the concept of BCRIC and the individual ownership that it represents. Our registered shareholders have increased from the original 128,346 to 136,143 and we continue to be delighted at the expressed interest of shareholders through telephone calls and letters. Testimony of that interest is that our Shareholder Information Service responded to 11,817 telephone enquiries between August 7 and December 31.

It is our commitment to make ownership in BCRIC both a profitable and proud experience.

Sincerely, and on behalf of the Board,



David L. Helliwell
President and
Chief Executive Officer

Vancouver, B.C.
January, 1980.

REVIEW OF OPERATIONS AND ACTIVITIES

Forest Products

BCRIC forest products holdings include: Canadian Cellulose Company, Limited, (CanCel) (81 per cent), which operates two kraft pulp mills, at Prince Rupert and Castlegar, B.C., and logging divisions and lumber mills in the northwest and southern interior of British Columbia; Kootenay Forest Products Ltd. (100 per cent), a lumber and plywood manufacturer at Nelson, B.C.; and Plateau Mills Ltd. (100 per cent), a lumber manufacturer near Vanderhoof, B.C.

The Company's forest products interests are an important component of its current holdings. In 1979, forest products consolidated earnings of BCRIC totalled \$21.8 million, representing 53.5 per cent of the Company's consolidated earnings for the year.

In 1979, CanCel had net earnings of \$15,832,000 on net sales of \$263,213,000 compared to \$6,774,000 and \$175,490,000, respectively, in 1978.

The significant improvement in earnings over 1978 largely reflects improved prices for bleached softwood kraft pulp, higher pulp sales volume and a higher foreign exchange premium on sales in U.S. dollars.

These factors were partially offset by inflationary cost increases, interest costs for a full 12 months for capital borrowed to finance the sulphite-to-kraft mill modification project completed late in 1978, and production lost at the Prince Rupert pulp mill as a result of labour disputes.

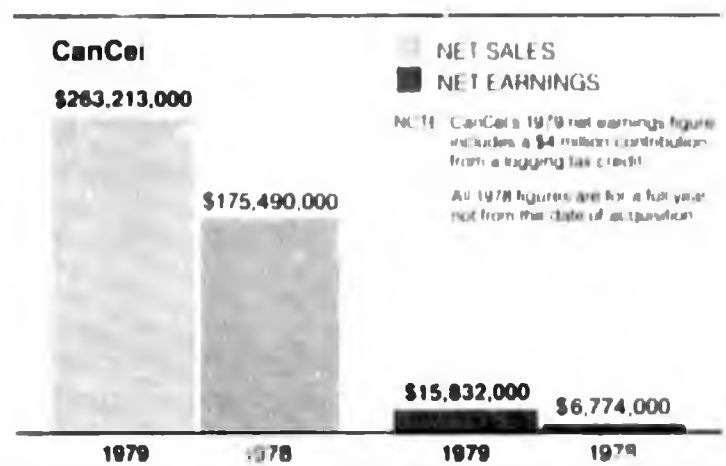
The price of bleached softwood kraft pulp continued to strengthen in 1979 from about the U.S. \$400 per tonne level prevailing in the first quarter of the year to U.S. \$465 per tonne in most markets by year end. On January 1, 1980, the price of kraft pulp was increased to U.S. \$490 per tonne. Lumber prices, on average, were also higher in 1979, notwithstanding a decline in the latter part of the year.

Capital spending by CanCel on property, plant and equipment totalled \$15.6 million in 1979. Early in the year the company completed the re-construction of its lumber facilities at Castlegar that were partially destroyed by fire in June, 1978.

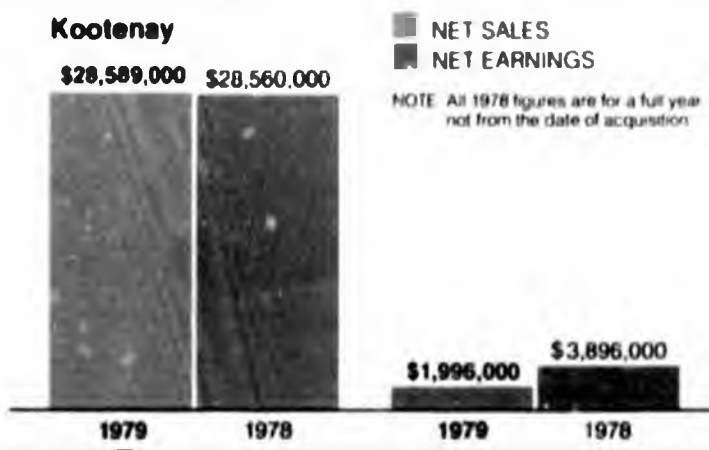
For 1980, CanCel plans significant capital expenditures for additions to property, plant and equipment, including approximately \$14 million for the purchase of Price-Skeena Forest Products Ltd. which owns a sawmill in Terrace, B.C. and holds related Crown timber rights.



CanCel's modified Prince Rupert, B.C. kraft pulp mill.



Kootenay Forest Products recorded net earnings of \$1,996,000 on net sales of \$28,589,000 in 1979 compared to \$3,896,000 and \$28,560,000, respectively, in 1978. 1979 earnings were lower than those of 1978 largely due to reduced shipments of lumber and plywood and higher manufacturing costs, partly offset by improved lumber prices. The lower volume of shipments resulted from lower product demand in the last half of the year. Lower production volume, inflationary cost increases and higher stumpage expenses contributed to the higher production costs.

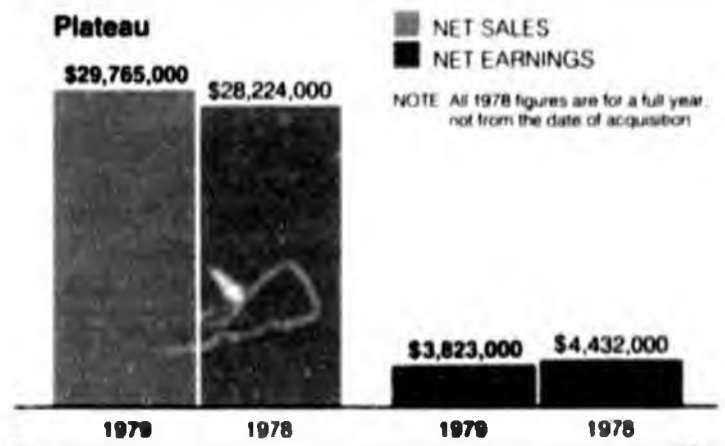


In 1979, capital spending by Kootenay totalled \$7.2 million, including \$5.7 million for the new log infeed and debarking systems for both the plywood mill and adjacent sawmill, and for major electrical upgrading. For 1980, Kootenay plans capital expenditures of approximately \$4 million for additions to property, plant and equipment, including \$1.2 million for the completion of the log infeed systems.

At Plateau, 1979 earnings amounted to \$3,823,000 on net sales of \$29,765,000 compared to \$4,432,000 and \$28,224,000, respectively, in 1978. The reduction from 1978 earnings largely

reflects lower production and sales volumes and higher manufacturing costs, offset, in part, by higher sales prices for lumber and a higher foreign exchange premium on U.S. sales. The lower production volume and higher manufacturing costs resulted from the protracted start-up difficulties of the new sawmill combined with inflationary cost increases and higher stumpage expenses.

Plateau completed a major expansion program during the year involving one of its two sawmills. In mid May, the older mill was shut down. Although the new mill encountered major start-up problems, the project has now enabled Plateau to improve timber utilization and productivity.

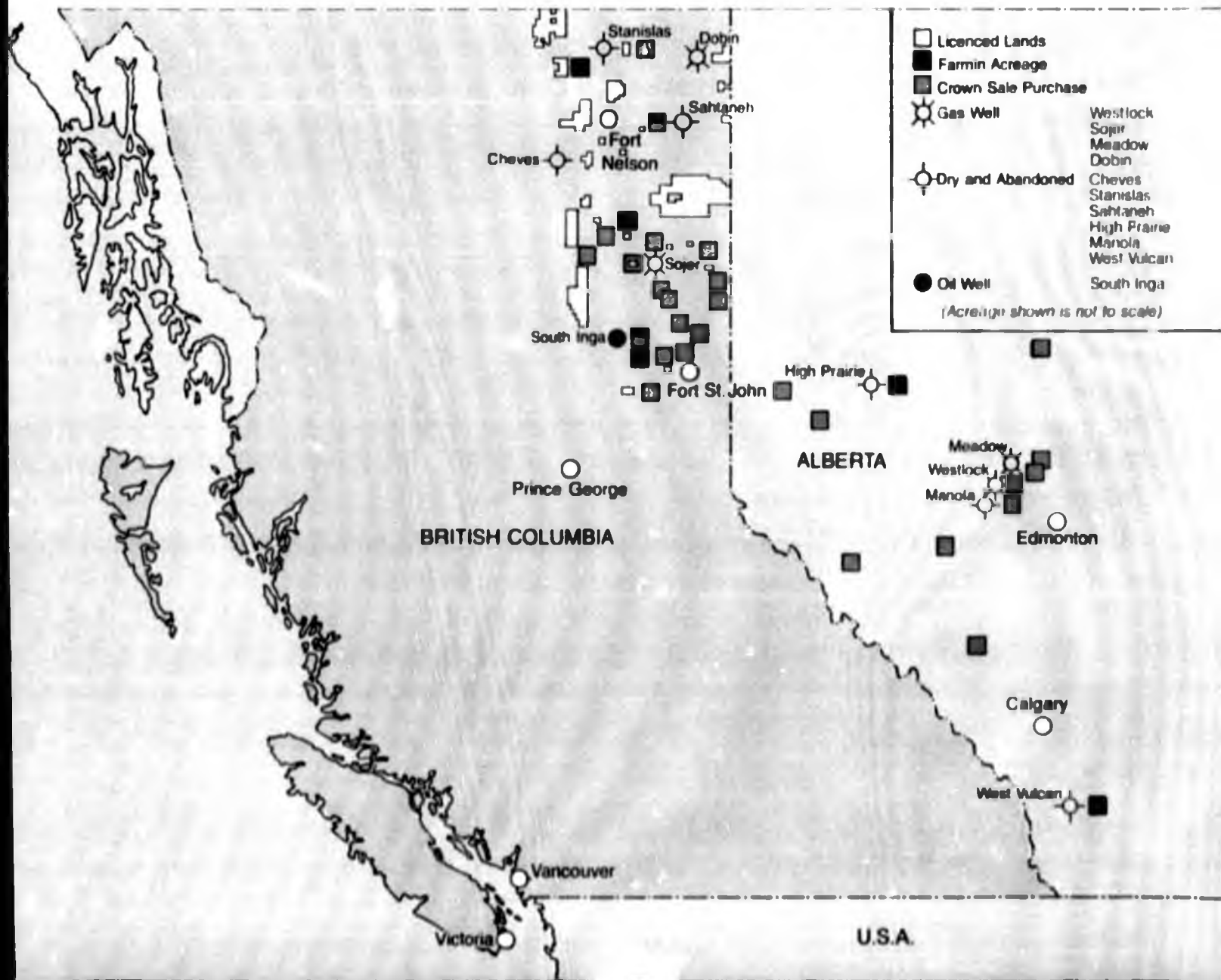


In 1980, Plateau plans to spend \$5 million on capital projects, including \$1.7 million for a new wastewood burner which would provide heat for all six lumber drying kilns and mill buildings. Some additional engineering improvements are required to the current pilot model before going ahead with this project. Pioneered by Plateau, the current pilot model has enabled the Company to significantly reduce natural gas purchases, thereby conserving hydrocarbon energy and reducing costs.

Gas and Oil

BCRIC's gas and oil interests include: Petroleum and natural gas licence to explore 948,500 gross hectares (2.3 million gross acres) of Crown land in north-eastern British Columbia; other land holdings involving 43,635 gross hectares (13,577 net hectares) in British Columbia and 21,412 gross hectares (7,686 net hectares) in Alberta. (1 hectare = 2.471 acres and 1 kilometre = 0.621 miles)

During 1979 BCRIC successfully entered into exploration agreements with a wide range of exploration companies on the original Licenced Lands acquired from the Province of British Columbia. Exploration consisted of 2,147 kilometres (km) of seismic programs, purchasing and reprocessing 236 km of seismic data, a 400 km gravity survey program and 8,564 metres of hole drilled. Of the four wells drilled on these lands during the 1978-1979



exploration program, there were two natural gas discoveries.

The extensive seismic programs completed in 1979 have provided a preliminary basis for determining the gas and oil potential of these Licenced Lands. Exploration commitments for 1980 include a possible 595 km of seismic programs and a concentration on drilling of prospects determined from the evaluations of the 1979 geophysical data. Twelve wells will be drilled on the Licenced Lands in 1980, triple that of 1979. Depending on the election of rights in 1980 of the exploration companies involved, 18 wells may be drilled on the Licenced Lands in 1981.



Energy exploration drilling in northeastern British Columbia

As a result of the Company's decision to expand its activities beyond the Licenced Lands beginning at a basic grass roots exploration level, BCRIC entered into a land acquisition program in 1979. This involved spending \$6.2 million at Crown land sales. Including farmin agreements with other companies, BCRIC acquired additional gas and oil rights totalling 13,577 net hectares in British Columbia and 7,686 net hectares in Alberta.

The exploration programs undertaken on these lands during 1979 amounted to \$1.3 million and consisted of 87 km of seismic surveys, 613 km of seismic data purchased and reprocessed and 10,590 metres drilled in one development well and six exploration wells. Of the seven wells drilled, two were gas wells, one was an oil well, and four proved unsuccessful. During 1980 the Company will be participating in the drilling of 15-20 wells on these lands and approximately 500 km of seismic work.

The total established reserves resulting from the discoveries to-date can only be determined through the drilling of additional delineation wells and further technical testing. Gas discoveries will not generate current revenue until sales contracts are concluded.

The gas and oil division has expanded its professional staff and budgeted \$30 million for an aggressive land acquisition and exploration program in 1980 on its own and in conjunction with partners. Such a program involves financial commitments over several years and BCRIC estimates that such exploration expenditures to the end of 1984 could approximate \$170 million.

Investments

At December 31, 1979, BCRIC's investments consisted of \$517 million placed in various short term money market securities and 3,471,375 common shares of Westcoast Transmission Company Limited.

The Company's strategy in managing the \$487.5 million in gross proceeds invested by its founding shareholders, as a result of the successful public issue completed in June, 1979, has been to achieve maximum short term returns. Consequently, BCRIC's interest income in 1979 on these and other funds totalled \$32,511,000. Cash dividends of \$2,777,000 were received in 1979 from Westcoast Transmission.

The short term investment policy established by the Company for its cash resources has been designed to ensure maximum returns and a high degree of liquidity so that funds are available when required for long term investments and projects. In keeping with this policy, BCRIC's short term investments at December 31, 1979 consisted of the following:

- \$12 million (2 per cent) Government of Canada and Crown corporation obligations.
- \$20 million (4 per cent) deposit securities of credit unions.
- \$149 million (29 per cent) deposit securities of Canadian chartered banks.
- \$336 million (65 per cent) short term notes of Canadian financial and industrial corporations.

The Company's short term investment transactions are executed in financial centres across Canada, with the majority taking place in Vancouver and Toronto.

With the rapid rise in interest rates in the latter half of 1979, the rate of return on the short term investment portfolio increased from about 11.1 per cent in June to 13.8 per cent in December as maturing investments were reinvested at higher rates. As a result, the Company achieved an over-all yield of 11.9 per cent on its short term investment portfolio over the period from June to December, 1979.

While short term interest rates remained at historically high levels at the end of 1979, the outlook for 1980 remains uncertain.



Westcoast Transmission pipeline is laid in northern British Columbia.

CONSOLIDATED STATEMENT OF EARNINGS

For the year ended December 31, 1979

(Comparative figures — see Note 10)

	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Revenue		
Sale of forest products	\$321,567	\$202,659
Interest on short term investments	33,114	303
Other (Note 8)	4,784	10,657
	<u>359,465</u>	<u>213,619</u>
Expenditure		
Cost of forest products sold	256,634	184,130
Selling and administration	16,023	9,603
Interest on long term debt	16,048	4,715
Other	3,215	1,694
	<u>291,920</u>	<u>200,142</u>
Earnings before the undernoted	67,545	13,477
Provision for income taxes (Note 9)	23,780	303
Earnings before minority interest and extraordinary item	43,765	13,174
Minority interest in earnings of a subsidiary	3,008	494
Earnings before extraordinary item	40,757	12,680
Recovery of logging taxes (net of minority interest of \$758,000)	—	3,242
Net earnings	<u>\$ 40,757</u>	<u>\$ 15,922</u>
Weighted average shares outstanding (Note 7)	59.2 million	
Net earnings per share	\$0.69	

See accompanying notes

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

For the year ended December 31, 1979

(Comparative figures — see Note 10)

	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Retained earnings at beginning of the year	\$ 15,922	\$ —
Net earnings	40,757	15,922
	<u>56,679</u>	<u>15,922</u>
Share issue expenses (net of \$9,320,000 income tax reduction)	12,510	—
Retained earnings at end of the year	<u>\$ 44,169</u>	<u>\$ 15,922</u>

See accompanying notes

CONSOLIDATED BALANCE SHEET

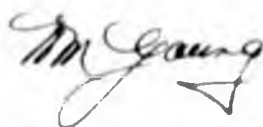
December 31 1979

(With prior year's figures for comparison)

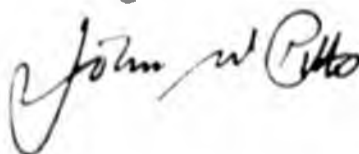
	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Assets		
Current		
Short term investments	\$517,505	\$ 9,787
Accounts receivable (Note 2)	39,641	52,040
Inventories (Note 3)	83,513	75,475
Other	1,387	1,328
	<u>642,046</u>	<u>138,630</u>
Investments and advances (Note 4)	41,877	41,067
Property, plant and equipment (Note 5)	252,981	239,732
Other	3,816	5,639
	<u>\$940,720</u>	<u>\$425,068</u>
 Liabilities and Shareholders' Equity		
Current		
Bank demand loans	\$ 12,357	\$ 7,017
Accounts payable and accrued charges	59,006	14,507
Current portion of long term debt	8,264	9,284
Deferred income taxes	2,700	—
	<u>82,327</u>	<u>60,808</u>
Long term debt (Note 6)	132,591	168,247
Promissory note payable to the Province of British Columbia	—	151,533
Deferred income taxes	17,213	5,492
Minority interest in a subsidiary	25,428	23,066
	<u>257,559</u>	<u>409,146</u>
Shareholders' equity		
Share capital (Note 7)	638,992	—
Retained earnings	44,169	15,922
	<u>683,161</u>	<u>15,922</u>
	<u>\$940,720</u>	<u>\$425,068</u>

See accompanying notes

Approved by the Directors:



Director



Director

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

For the year ended December 31, 1979

(Comparative figures — see Note 10)

	<u>1979</u>	<u>1978</u>
	(Thousands of dollars)	
Source of funds		
From operations	\$ 76,217	\$ 24,552
Share subscriptions received	487,459	—
issue of shares on conversion of promissory note	151,533	—
Working capital of subsidiary companies acquired	—	51,551
Issue of long term debt	—	79,998
Recovery of logging taxes	—	4,000
Other	1,335	1,162
	<u>716,544</u>	<u>161,263</u>
Application of funds		
Conversion of promissory note to share capital	151,533	—
Additions to property, plant and equipment	27,694	77,606
Investment in petroleum and natural gas rights and exploration	7,527	63
Long term debt reduction	34,636	5,031
Share issue expenses (net of income tax reduction)	12,510	—
Other	747	741
	<u>234,647</u>	<u>83,441</u>
Increase in working capital	481,897	77,822
Working capital at beginning of the year	77,822	—
Working capital at end of the year	<u>\$559,719</u>	<u>\$ 77,822</u>

See accompanying notes

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS December 31, 1979

1. SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared within the framework of the accounting policies summarized below:

CONSOLIDATION

The consolidated financial statements include the accounts of the Corporation and its subsidiaries (see Note 13).

TRANSLATION OF FOREIGN CURRENCIES

Transactions in foreign currencies are translated at rates in effect on the dates of the transactions. Assets and liabilities, principally receivables and long term debt, carried at current prices are translated at the year end rate. Unrealized gains or losses are included in income except for those related to long term debt which are amortized over the remaining term of the debt.

INVENTORIES

Logs, wood chips and other raw materials are valued at the lower of average cost and replacement cost. Finished products (pulp, lumber and plywood) are valued at the lower of average cost and net realizable value.

INVESTMENTS AND ADVANCES

Investments and advances are stated at cost.

PROPERTY, PLANT AND EQUIPMENT

These assets are stated at cost less accumulated depreciation, amortization and depletion. Depreciation, amortization and depletion are computed as follows:

Asset	Rate and Method
Pulp mills	4% composite rate straight-line
Sawmills	4% to 6% composite rate straight-line on certain mills and 4% to 20% diminishing balance on others
Logging equipment	10% to 20% rate diminishing balance
Timber cutting rights, roads and related facilities	Unit of production method, using current log production as a percentage of estimated total log production available from such assets

Petroleum and natural gas properties are accounted for using a form of the full cost method of accounting whereby all acquisition, exploration and development costs are capitalized as incurred. Costs related to the petroleum and natural gas rights over 2.3 million gross acres, originally acquired under agreement with the Province of British Columbia, are being amortized over the periods during which exploration activity in each area of interest is expected to continue.

INCOME TAXES

Earnings are charged with income taxes at the effective rates applicable to the Company and its subsidiaries. Differences between this provision for income taxes and the amounts currently payable are reflected in deferred income taxes.

2. ACCOUNTS RECEIVABLE

	(Thousands)	
	1979	1978
Trade	\$33,823	\$40,700
Insurance claims	985	5,112
Other	4,833	6,228
	<u>\$39,641</u>	<u>\$52,040</u>

3. INVENTORIES

	(Thousands)	
	1979	1978
Logs, wood chips and other raw materials	\$55,151	\$48,877
Pulp, lumber and plywood	18,536	18,106
Supplies	9,826	8,492
	<u>\$83,513</u>	<u>\$75,475</u>

4. INVESTMENTS AND ADVANCES

	(Thousands)	
	1979	1978
Investment in Westcoast Transmission Company Limited (quoted market value of \$49,901,000 which does not necessarily reflect the realizable value of this investment)	\$37,364	\$37,364
Investment in an associated company, at cost plus equity in earnings less dividends received	3,101	2,117
Other	1,412	1,586
	<u>\$41,877</u>	<u>\$41,067</u>

5. PROPERTY, PLANT AND EQUIPMENT

	(Thousands)	
	1979	1978
Forest Products:		
Pulp mills	\$331,474	\$325,876
Sawmills	77,475	64,466
Timber cutting rights, roads and related facilities	65,120	58,722
Logging equipment and other facilities	21,097	21,369
	<u>495,166</u>	<u>470,433</u>
Less accumulated depreciation, amortization and depletion	290,465	272,956
	<u>204,701</u>	<u>197,477</u>
Land	1,260	1,296
	<u>205,981</u>	<u>198,773</u>
Petroleum and Natural Gas:		
Property rights	47,173	40,959
Exploration and development costs	1,313	—
	<u>48,486</u>	<u>40,959</u>
Less accumulated amortization	1,486	—
	<u>47,000</u>	<u>40,959</u>
	<u>\$252,981</u>	<u>\$239,732</u>

Depreciation, amortization and depletion charged to earnings during the year amounted to \$21,653,000 (1978: \$12,207,000). This amount has been reduced by \$2,735,000 (1978: \$2,300,000) for the amortization of the excess of the book value of net assets of Canadian Cellulose Company, Limited, Kootenay Forest Products Ltd., and Plateau Mills Ltd. over the consideration paid for these subsidiaries.

6. LONG TERM DEBT

	(Thousands)	
	1979	1978
Canadian Cellulose Company, Limited		
6 $\frac{1}{8}$ % Bonds due January 2, 1981 with annual principal payments (U.S. \$8,000,000)	\$ 9,372	\$ 14,202
5 $\frac{3}{8}$ % Bonds due July 1, 1985 with annual principal payments (U.S. \$20,000,000)	23,430	26,664
10 $\frac{1}{2}$ % Promissory notes due December 15, 1992 with annual principal payments commencing December 15, 1983 (U.S. \$50,000,000)	58,575	59,288
11 $\frac{1}{2}$ % Promissory notes due December 15, 1992 with annual principal payments commencing December 15, 1983	20,000	20,000
Bank loans on revolving credit facilities, with interest at various rates	25,000	50,000
Other	448	527
	<u>136,825</u>	<u>170,681</u>
Other Subsidiaries		
Term bank loan	—	2,200
Term loan with quarterly principal payments to 1986 with interest at bank prime plus $\frac{1}{2}$ %	4,030	4,650
	<u>140,855</u>	<u>177,531</u>
Less amounts due within one year	8,264	9,284
	<u>\$132,591</u>	<u>\$168,247</u>

Canadian Cellulose Company, Limited (CanCel) has bank lines of credit of \$45,000,000 on a revolving credit facility with any loans at June 30, 1981 converting into term loans, repayable over periods of up to nine years, in equal semi-annual or annual instalments, and, subject to certain restrictions, an additional \$20,000,000 on a revolving credit facility

repayable by December 15, 1980. At December 31, 1979 the outstanding loans under these facilities totalled \$25,000,000.

The bonds, promissory notes and bank loans on revolving credit facilities are unsecured. Certain assets have been pledged as collateral for the term loan.

CanCel's trust deed relating to its bonds and the agreements relating to its promissory notes, in general terms, restrict dividends and certain other payments by CanCel to a maximum of \$4,000,000 plus 50% of its net earnings after December 31, 1976.

The amount available for payment of dividends at December 31, 1979 was \$10,281,000.

Principal payments required on long term debt in each of the next five years, with the United States dollar component translated at the December 31, 1979 rate of exchange, are:

1980	\$ 8,264,000
1981	\$ 9,436,000
1982	\$ 7,512,000
1983	\$15,390,000
1984	\$15,390,000

7. SHARE CAPITAL

During the year the Company increased its authorized common shares without par value to 100,000,000. The Province of British Columbia received 15,000,000 common shares in exchange for the promissory note of \$151,532,930. In addition 81,243,230 common shares were issued at a price of \$6 per share for a total cash consideration of \$487,459,380, resulting in 96,243,235 shares outstanding at December 31, 1979 (1978: 5 shares).

The weighted average of shares outstanding was calculated on the basis of 15 million shares outstanding January 1, 1979, with the balance assumed to be outstanding on the dates the Company received the share subscriptions.

8. OTHER REVENUE

	(Thousands)	
	1979	1978
Insurance proceeds relating to loss of earnings due to a fire at the Castlegar sawmill ...	\$ 774	\$ 3,570
Income related to cancellation of a sales contract	—	3,370
Equity in earnings of an associated company	1,070	1,104
Dividends from Westcoast Transmission ...	2,777	2,394
Other	163	219
	<u>\$ 4,784</u>	<u>\$10,657</u>

9. INCOME TAXES

The Corporation and two of its subsidiaries were exempt from income taxes during 1978 and part of 1979 because not less than 90% of their outstanding shares were owned by the Province of British Columbia. Effective April 25, 1979 the companies became taxable and commenced providing for income taxes on earnings from that date.

The consolidated effective income tax rate for the year was 35.2%. A reconciliation between income taxes provided at that rate and at the basic rate of 51% for Canadian federal and provincial income taxes is as follows:

	(Thousands)
Tax on reported income at 51%	\$34,448
Less reduction in income taxes due to:	
Tax exempt period	(4,466)
Nontaxable dividends received	(1,416)
Manufacturing and processing credits and inventory allowances ..	(2,574)
Other	(2,212)
Deferred income taxes provided	<u>\$23,780</u>

CanCel has made fixed asset acquisitions qualifying for federal investment tax credits which will enable it to reduce income tax expense by approximately \$7,000,000 if sufficient income taxes become payable prior to December 31, 1984. The benefits will be recorded as and when they are realized.

AUDITORS' REPORT

10. COMPARATIVE FIGURES

The figures provided for comparison in the Consolidated Statement of Earnings, the Consolidated Statement of Retained Earnings and in the Consolidated Statement of Changes in Financial Position are those for the period from incorporation, February 22, 1978 to December 31, 1978.

11. COMMITMENTS

Rental obligations under long term leases amount to approximately \$3,500,000 in each of the years 1980 and 1981, \$2,800,000 in 1982, \$1,900,000 in 1983 and \$1,800,000 in 1984.

12. REMUNERATION OF DIRECTORS AND SENIOR OFFICERS

The aggregate direct remuneration paid or payable by the Company and its subsidiaries to directors and senior officers of the Company amounted to \$522,892 (1978: \$262,684).

13. SUBSIDIARY COMPANIES

Canadian Cellulose Company, Limited
(81% owned)

- Calum Lumber Limited
- Canadian Cellulose International S. A.
- Celgar Properties Limited
- Celtran Equipment Limited
- High Arrow Limited
- Pohle Lumber Co. Ltd.
- Twinriver Timber Limited

Kootenay Forest Products Ltd. (100% owned)

Plateau Mills Ltd. (100% owned)

- Plateau Timber Ltd.
- Nechako Valley Pulp Mill Ltd.

14. SUBSEQUENT EVENT

On January 10, 1980, CanCel agreed to purchase Price-Skeena Forest Products Ltd., which owns a sawmill in Terrace, British Columbia and holds related Crown timber rights, for approximately \$14,000,000.

TO THE SHAREHOLDERS OF BRITISH COLUMBIA RESOURCES INVESTMENT CORPORATION:

We have examined the consolidated balance sheet of British Columbia Resources Investment Corporation as at December 31, 1979 and the consolidated statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Corporation as at December 31, 1979 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding period.

Vancouver, Canada
January 21, 1980

Clarkson Gordon
Chartered Accountants

CORPORATE INFORMATION**Board of Directors**

John W. Pitts
Chairman, President and
Chief Executive Officer
Okanagan Helicopters Ltd.

* David L. Helliwell
President and Chief Executive Officer
British Columbia Resources Investment
Corporation

* Trevor W. Pilley
Chairman and Chief Executive Officer
Bank of British Columbia

John W. Poole
President and Chief Executive Officer
Daon Development Corporation

Charles N. W. Woodward
Chairman and Chief Executive Officer
Woodward Stores Limited

* W. Maurice Young
Chairman and Chief Executive Officer
Finning Tractor & Equipment
Company Limited

* Member of Audit Committee — Chairman, W. Maurice Young

Officers

Richard A. D. Commerford
Vice President

Robert G. S. Currie
Vice President, Gas and Oil Division

David L. Helliwell
President and Chief Executive Officer

G. Buchan McIntosh
Secretary

Michael G. McKibbin
Vice President

Dougal M. Meekison
Treasurer

David J. R. Petitpierre
Assistant Secretary

John W. Pitts
Chairman

John R. Redworth
Controller

Shareholder Information Service

WRITE: British Columbia Resources
Investment Corporation,
2600-1177 West Hastings Street,
Vancouver, B.C. V6E 3Y3

PHONE: Within Greater Vancouver area
669-4443. Outside Greater
Vancouver and within B.C. call
toll free (112) 800 663-9123. North
of Stewart and Wonowon, B.C.
call collect 669-4443.

Share Transfer Agent and Registrar

Montreal Trust Company, 466 Howe Street,
Vancouver, B.C. V6E 2A8
Telephone (604) 688-4411
Also in Calgary, Winnipeg, Toronto, Montreal.

Shares Listed

Vancouver Stock Exchange
The Toronto Stock Exchange

Duplicate Reports

While every effort is made to avoid sending more than one copy of the annual and interim reports to each shareholder, duplicate mailings will occur when shares are listed under different first names or initials. Shareholders who do receive more than one report are asked to contact Montreal Trust Company to have their shares registered under the exact same name to avoid the cost of duplicate mailings.

BCRIC

AGSOC proposal near collapse → Good

by Ray Tyson
Juneau Bureau

Juneau — U.S. Sen. Mike Gravel's proposed Alaska General Stock Ownership Corporation is on the brink of collapse in the Legislature.

Lawmakers are looking on AGSOC with increasing skepticism and it faces constitutional questions.

House Speaker Terry Gardiner, Ketchikan, an original sponsor of the AGSOC House bill, and other key legislators now question whether the plan can stand on its own without massive state financial commitments.

Senate President Clem Tillion, K-Baraboo Cove, has his suspicions, too.



GRAVEL

"The bill needs some changes," Tillion said. "Unless the House makes the changes, why should the Senate bleed?"

Sen. Bettye Fahrenkamp, D-Fairbanks, a major backer of an initiative drive



TILLION

to place AGSOC on the ballot in November should it fail in the Legislature, agrees the proposal has little chance of making it through the Legislature this year.

"That's the reason I worked as hard as I did last summer," Sen. Fahrenkamp said. "I knew the leadership was against it and I wanted to get it to the people for a vote."

The lieutenant governor's office Monday certified the AGSOC initiative, sponsored by Gravel, for the November ballot.

But even if it is approved by voters, AGSOC might face trouble in the Legislature when it comes back for appropriation of startup money.

And it could be shot down in court on issues of constitutionality.

on the Legislature if the voters approved it (the initiative), but it still has the constitutional question," Gardiner said.

Identical AGSOC bills are locked in committees in both houses, although the House State Affairs Committee is expected to decide Friday whether to move the bill out.

AGSOC is billed by its advocates as a private corporation that would invest in major development projects on behalf of all Alaskans, who in turn would receive dividend checks.

Its major feature is that it would be separated from state government, although proponents are asking for a \$5 million state loan for startup costs.

Rep. Mike Miller, D-Juneau, chairman of the State Affairs Committee, said economists testifying before his panel question "whether AGSOC can get 100 percent private financing (for projects) unless it gets state guarantees."

As Gardiner put it: "Then it becomes a whole different beast, if the government winds up owning it."

One proposal is that AGSOC could buy into the trans-Alaska oil pipeline.

"There's no doubt it would take a vote of the public if not a constitutional amendment to permit the state to invest in AGSOC," Gardiner said.



FAHRENKAMP

State law prohibits the state from indebting itself without a vote of the people. Bonds can only be used to finance capital improvement projects.

It is doubtful whether AGSOC constitutes a capital improvement project, the attorney general's office says.

"There's no question there are serious constitutional questions," said Rod Piques, an assistant attorney general. "A loan guarantee is a conditional debt. And the state cannot have a constitutional debt except for capital improvement projects."

AGSOC would have to stand on its own financially. "There's no hint in the plan that the state would finance AGSOC. If the AGSOC portfolio could not stand in the bond market, naturally the bonds wouldn't sell."



GARDINER

Even if the bill moves out of Miller's committee, it would face tough sledding in the House Finance Committee, said Rep. Russ Meekins Jr., D-Anchorage, the committee chairman.

If AGSOC makes it to the House floor, Gardiner said, it doesn't stand

much chance of passing "unless Gravel starts strong-arming people."

Gardiner questions Gravel's motives regarding the proposal. "The Legislature gave him every consideration, and when the Legislature didn't do what he wanted he got an initiative" to put on the ballot. "A lot of legislators feel abused."

Gardiner said Gravel, who is up for re-election this year, is using AGSOC as a campaign tool. "I don't really think he cares about the issue."

Yukon Territory is expected to become Canada's 11th province by '83.

3/1/80 Notes

Now here's another grandiose scheme to "get something for nothing". Why? Well, first each Alaskan gets a "free" share of stock in AGSOC, and second AGSOC's profits and bonds are both tax free (Wow!), and third a \$5 million State "loan" (non-repayable?) is required for startup costs, and fourth AGSOC's borrowing will probably require State guarantees (which means if AGSOC can't pay it's debts, the State must—and who's going to oppose that with every Alaskan a stockholder) and fifth grandstander Gravel desperately needs a give-a-way proposal to soothe the voters — Right?

With a tax-free, State backed set up like that, how can private enterprise (the large corporations who put the daily bread on our table), co-exist in Alaska with a monster like AGSOC? Well, the majority of free-loading Alaskans will probably approve it by referendum anyway, while they're in the present mood to "get all you can for nothing", but I hope our state Supreme Court has the good sense to shoot it down afterward.

Cheers from the richest, greediest, and most socialist State in the Union.

Charlie Parker

Charlie Parker, Box 349, Soldotna, Ak.

O.O. to others to use as they see fit.

THE FOLLOWING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

*file
AGSOC*

Dear Fellow Legislator:

Attached is some information that I have put together regarding the issue of AGSOC. I think you will find it both interesting and pertinent.

Regards,



Dick Randolph

Alaska State Legislature

Libertarian
Representative
RICHARD (DICK) L. RANDOLPH
1105 Cushman St.
Fairbanks, Alaska, 99701



While in Juneau
POUCH V
Juneau, Alaska
99801

House of Representatives

Dear concerned Alaskans,

Senator Gravel is energetically promoting his AGSOC proposal. In typical Gravel fashion he is employing every technique of professional "con-ism" available. Please do not swallow his big lie. AGSOC is not free enterprise! It is not capitalism of any kind! It is complete and total collectivism and it must be stopped!! I can appreciate the appeal of something-for-nothing "professtations," but it's full of holes, it won't work, and it will commit at least one and maybe many generations of Alaskans to its cruel hoax.

Gravel's altar-ego, Louis O. Kelso, has been promoting this "economic idiocy" for over 20 years and in Gravel he has finally found a politician who is politically oriented enough to promote it. It is a scheme completely void of any redeeming values to a free society.

I appreciate that this is a harsh indictment, but one which is completely defensible. I will, between now and however long it takes to expose and defeat this sham, provide information and leadership to those who agree with this indictment.

To begin with, it is important that we understand Kelso's so-called "economic theories" from which AGSOC is derived. Toward that understanding I have enclosed two critiques of his book, The New Capitalists.

The first critique was recently produced by Robert Shelley, a life-long Alaskan, attorney, and presently my administrative aide in Juneau. Bob does an excellent job of tying Kelso, Gravel and AGSOC together and pointing out their fallacies.

Percy L. Greaves, a free-market economist, in his critical analysis of this work comments: "This small book contains more economic fallacies than it does pages. The basic assumptions upon which it is built cannot withstand the light of careful scrutiny. Furthermore, the alleged facts are not documented and the logic employed is extremely loose. Its strong effect on the casual reader rests largely upon the repeated assertion of seemingly plausible statements

AGSOC
Page 2

which, upon close analysis turn out to mean almost the exact opposite of what they first seemed to say.

Any attempt to put the book's proposals into effect would immediately reduce the incentive to produce and result in a rapid paring down of the American standard of living. At the same time, it would set up an economic dictatorship which would select the management of the nation's industries and determine all production goals. In short, it is an unwitting blueprint for the establishment of a Socialist America."

Please carefully read both, and then compare the AGSOC proposal in detail against this background. I am convinced that anyone who understands and believes in true free enterprise and capitalism will agree that this sham does not qualify in any aspect!

I would not dignify this proposal with a response if it were not apparent that many fine and normally right-thinking Alaskans are being drawn in by the insidious lure of this bankrupt proposal.'

It is my commitment to provide a well studied, articulate defense of the free market as opposed to this vicious, fraudulent misrepresentation of the facts! I am absolutely convinced that the adoption of the AGSOC proposal would have the most negative economic and social impact on the traditional Alaskan lifestyle conceivable.

I sincerely and emphatically request that you study the enclosed material and the other information which I will provide you from time to time. If you agree and want to help, let me know. Together we can expose and defeat this fraud and save 450,000 Alaskans from inadvertently creating a socialist Alaska!!

Freedom is the issue,



Dick Randolph
Alaska's Libertarian Legislator

AGSOC -- A FOOL'S PARADISE

prepared for

Representative Dick Randolph (L)

by

Robert Reed Shelley

AGSOC - A FOOL'S PARADISE
by
Robert Reed Shelley

In order to understand the meaning of the Alaska General Stock Ownership proposal presently before the legislature and the people of Alaska, it is necessary to become more familiar with the philosophy of its creator and to test some of the premises upon which its foundation is built.

Certainly any discriminating thinker who has encountered the AGSOC concept has realized that there must be more to the proposal than meets the eye. This is primarily because rarely in human experience does one get something for nothing. Try to picture Senator Gravel performing his political song and dance version of Jiminy Cricket's "Oh the World Owes Me a Living" on the Gong Show. Then compare The Sound of Music in which Julie Andrews sings, "Nothing comes from nothing, nothing ever could." Which one would you believe?

The creator of this attractive sounding 'horn of plenty' is a man named Louis O. Kelso who, along with myself, has combined the two professions of which the discriminating thinker is most skeptical, Economist and Lawyer, to form his background. From that point on, however, Mr. Kelso and I seem to diverge in our approach to human nature and the application of human nature to the economics of man.

Among Mr. Kelso's publications are two books with rather deceiving titles. The first in order is one entitled The Capitalist Manifesto, and its sequel is one called The New Captalists. This paper is primarily con-

cerned with The New Capitalists, with references made therein to The Capitalist Manifesto. It's the inclusion of the term 'capitalist' which makes these titles so deceiving. Upon close scrutiny it is clear that Mr. Kelso is to capitalism what Benedict Arnold was to the American revolution.

Webster's Dictionary (1979 Ed) defines 'capitalism' as: "the form of economic, industrial, and social organization of society involving ownership, control, and direction of production by privately owned business organizations" (as opposed to the government). In other words, capitalism means free enterprise without government interference in the economy. Mr. Kelso, on the other hand, has the audacity to try to pawn off his plan for governmental direction of the economy to unsuspecting readers as 'capitalism.' If he and Senator Gravel (Kelso's political promoter) are successful, they should be named the flim-flam men of the century.

Basically, Mr. Kelso sees only two factors in production: 1) Physical labor and 2) Capital goods (those goods which produce other goods). It is his contention that capital produces 90 percent of the gross national product in our economy, and that all but a small fraction of the capital instruments are owned by 5 percent of the households of the economy. In addition, he claims that despite this "concentration of ownership of capital, "70 percent of income produced is distributed through labor.

It is important to critically examine these contentions because they are the basic assumptions upon which his entire theory rests.

Any reasonably astute person knows that the initial factor in any kind of production is an 'idea.' While ideas are not exactly physical labor, they are essential to production. When physical labor and capital are added

to ideas, we may have production. Mr. Kelso seems to practically ignore ideas as the factor of production which is uniquely human. Instead, he classifies the factors of production into physical labor (his "human" factor) and capital (his "nonhuman" factor). One might wonder how capital can be termed "nonhuman" since it is only by human conception, creation, and operation that capital exists.

At any rate, contrary to Kelso's views, each factor of production is not mutually exclusive. Neither ideas, physical labor, nor capital can produce anything by itself. It is ludicrous to attempt to determine what percentage of any finished product was the result of the idea, the physical labor, or the capital goods used to produce it. We could argue forever as to how much of the production of the Wright Brothers' first plane at Kitty Hawk was the result of their idea, their physical labor, or their capital. For each item of capital produced, it takes ideas and labor to put it together, to operate it and to maintain it. Then, once the capital produces something, it takes ideas and labor to distribute and market the product. Mr. Kelso has conveniently determined, in an effort to support his theories, that 'capital' is responsible for 90% of all production. So much for the first of Mr. Kelso's premises.

Next, Mr. Kelso claims that this 'capital' is almost totally owned by only 5% of the households in America. While it is undoubtedly true that some Americans own more capital than others, Mr. Kelso's estimate is obviously misleading. The number of stockholders of publicly held corporations listed on the New York Stock Exchange now exceeds 20 million, or one out of every six adults in the United States. In addition, Kelso seems to ignore the multitude of privately owned closed corporations, partnerships, sole proprietorships, house ownership, real

estate holdings, life insurance and other forms of capital. The most important point to make is that a large extent of what capital concentration does exist in the United States is the result of government control of the economy, which results in political rather than economic allocation of available resources. In other words, through subsidies, regulation, and huge government spending, government, through politics, helps some wealthy people to unjustly remain wealthy and even become wealthier. In any case, it is the divergence in wealth between people in a free society that has given the world its highest standard of living and which makes life interesting. It is the opportunity to better one's well-being that stimulates all production. The extent of that opportunity should not be limited. Variance in wealth should not be disdained in itself as Mr. Kelso seems to do.

The third 'statistic' which Mr. Kelso uses to further his plans is that 70% of all income produced is distributed through labor. While one might be able to come up with such an estimate, careful thinking would certainly question the accuracy of such a figure. For instance, is the board member of a large corporation really earning \$500,000 worth of labor in his salary, or is this a payment in lieu of dividends which could be taxed as high as 70%, whereas earned income has a 50% maximum tax rate? Even assuming Kelso's 70% of all income being distributed through labor, one could argue that this refutes his previous assumption

that capital produces 90% of all production, since one would assume that each factor would be rewarded in relation to its worth. Kelso, however, argues that this disparity between 10% of production being caused by labor and 70% of income being distributed to it proves that American labor is composed of primarily lazy people who just take up space and time but don't really produce anything. Kelso says that unemployment in a capitalist system is both desirable and inevitable. He supposes that soon machinery will do everything and humans will do nothing. This concept is so naive that it barely rates refuting. While it is true that capital equipment may eventually produce more products which were produced previously by labor, so far no machine can replace man's unique ability to reason and create new ideas. In addition, it will always take human physical labor to get the resources, to build the new capital equipment, to operate it, to maintain it and to distribute the product which it produces. In addition, it will be a long time before machines totally replace humans in the service industries. Perhaps technology has allowed mankind to concentrate on mental labor rather than physical labor, but even physical labor will never be totally eliminated. Kelso says his plan would cast out the irrational doctrine of full employment, indicating the people wouldn't have to work. As he says, "unemployment is natural and desirable in a technically advanced economy." Until human needs are totally satisfied, there will always be a demand for new and better products at a lower price, and this will keep most of us employed (if we so choose) through the next major evolution of man.

From these "statistics" as to production and the distribution of income, Mr. Kelso comes up with some incredible conclusions and recommendations.

One such conclusion is that the rich get richer and the poor get poorer. Mr. Kelso reasons that since "labor is being replaced by capital as the total factor of production," soon those who currently own capital will be the only ones who will survive economically. He further argues that it's nearly impossible to accumulate capital unless you already have capital. This, he says, is causing an increasing concentration of wealth in the country. Then Kelso wonders what these wealthy capitalists do with all of their extra capital. He comes to the conclusion that they just make themselves wealthier by re-investing it, with no benefit to anyone else. This is a distorted conclusion indeed. Because when that 'extra' capital is reinvested, many people become employed, and we can assume that somebody's need will be fulfilled if the product sells. On top of that, it is true capitalist economic theory to believe that because of the increased supply of products on the market, the added competition by the new business venture, and the added growth to the wealth of the economy, both the particular price of that product and the general price level of the economy would fall to some extent. In turn, this lowering of prices and increased availability of goods on the market make almost everyone else in the economy better off (wealthier). It is clear, then, that Mr. Kelso's conclusion should have been that the rich get richer (assuming they make productive investments) and so do the poor. Everyone is made better off by the reinvestment of the capital which the wealthy man did not consume himself.

What's wrong with some rich people getting richer in relation to some poor people? In my view, nothing. In Mr. Kelso's view, however, it is somehow unfair, and he claims it will soon lead to socialism since the relatively less rich will use government to control the economy, and redistribute the wealth. The incredible inconsistency

in Mr. Kelso's thinking occurs when in the next breath he suggests the creation of a new governmental agency that would virtually take over the banking system and control the entire economy. This he calls the Capital Diffusion Insurance Corporation (CDIC).

Although Kelso doesn't like his plan to be associated with the redistribution of wealth, he believes that the government needs to take an active role in redistributing wealth so that there are many little "capitalists" rather than just a few. It shows his lack of understanding of capitalism that he should use the concepts of redistribution of wealth and capitalism in the same breath. In addition, Kelso defines a capitalist as "a member of a household which derives not less than half the amount the household spends on consumption from the ownership of capital." Under this definition, Leonid Breznev would be one of the biggest capitalists in the world (although he steals it) and an average American with a business, a house, a retirement system, and a small portfolio of common stock probably would not qualify (although he probably earned it honestly). Of course, when this average American retires and lives off the return on his investment rather than labor related income, he can suddenly call himself a capitalist even though he might do virtually nothing.

Kelso says government's objective should be to make sure that technological unemployment falls on those who can afford it (the wealthy). Does he actually advocate government retirement of successful people so that others can take their place?

The Capital Diffusion Insurance Corporation (CDIC) is the governmental mechanism by which Kelso plans to "create" lots of little "capitalists" out of nothing. In Kelso's view, the only thing that is preventing more

little "capitalists" from popping up is the present free market system of capital formation financing. Under the current system, someone who doesn't own capital can only get it in one of two ways: 1) forego consumption and accumulate savings (capital), or 2) find someone who will lend you money (capital) so that you can reinvest it and make a higher return. Kelso argues that most people can't afford to forego consumption so as to accumulate capital, and that this wouldn't be good anyway because it would cause a decrease in the demand for consumer goods and the economy would collapse. Again, Kelso fails to see that as the economy expands because of capital investment, the entire populace benefits due to more and better products at lower prices. If the average American of today was compared to the average American of 100 years ago, there is little doubt that today's subject is much better off economically than yesterday's. As the man of today rises higher and higher above a subsistence living, he ends up having more wealth to spend on both consumption and capital investment, thereby both keeping up the demand in the economy and giving himself more opportunity to own capital. Again, Kelso leaves out the Human idea factor of production. He almost assumes that an investment is just an investment. The truth is that a man with a big idea and little capital can make more wealth than a man with a small idea and lots of capital. Therefore, Kelso's view that there is no upward mobility in our society and that one can only acquire capital if he already has capital, is not entirely correct.

Kelso astutely observes that those lending capital to others want some insurance that they will be repaid. Under the current system of financing, this means that the lender will want collateral in the form of a claim upon the currently held assets of the borrower. Kelso claims those without currently held capital will then not

be able to get a loan to acquire their own capital. He fails to see that at some point all of us must forego some consumption (save) in order to borrow to accumulate capital. (Unless it's given to us, of course.)

In order to provide those who lack collateral with capital-producing potential, Kelso's CDIC would guarantee, in the name of the government, loans by commercial banks to borrowers who would otherwise be poor credit risks. These loans would not even provide for the personal liability of the borrower. Responsibility is totally removed for the borrower. Kelso compares his plan to the federal FHA program, which is noted for its bankrupt failings.

By the government becoming involved in capital financing, all of us, including those who make successful investments, would be paying for the mistakes of those who didn't deserve a guarantee in the first place and who would go belly up in their investment. There are only two ways the government could pay off such guarantees. 1) raise taxes on everyone else; or 2) start up the printing presses and pay the claims off in phony dollars thereby feeding fuel to inflation. Neither method is fair or honest.

But the fact that such a government program is not fair because it would force innocent people to pay for others' mistakes is only a small part of the real evils that such a scheme would create. In describing CDIC still further, Kelso discusses what 'policy' factors should go into the manner in which CDIC decides who should get the guarantee and in what business ventures these borrowers should be able to invest.

Included in these proposed policies are the following:

1. Anti-Monopoly Policy: This would be left to the political whim of bureaucrats who would likely insure through government power that the rich and powerful were well protected. Still Kelso calls

- his plan capitalism.
2. Promotion of technological improvement policy: There could be no more detrimental effect on technological change than to misallocate resources for such change by political (government) means rather than by the free market. Leave it to competition! Still Kelso writes of capitalism?
 3. Increase the number of capital owning households policy: This basically means redistribution of wealth by transferring opportunity and risk from those who deserve it to those who don't. The New Capitalists?
 4. Investment preferences for new capital estates policy: Another form of the redistribution of wealth. Capitalist?
 5. Prevention of speculation in stocks policy: Let's say goodbye to the New York Stock Exchange. Kelso fails to see that stock speculation is the incentive for persons to first put money into a proposed development. He still refers to his plan as capitalist!
 6. Coordination of consumer demand and new capital formation policy: This is plain and simply a planned economy proposal. Kelso the capitalist?
 7. Inflation control and reduction of consumer credit policy: There are several reasons why Kelso's plan would in fact be inflationary. First, the misallocation of resources from the free market to borrowers with a poor credit risk will adversely affect economic expansion while the money supply either remains constant or expands. Second, it is likely that the government would honor guarantees made by CDIC by printing dollars (a hidden tax) rather than by raising actual taxes.

Additionally, once the government, through CDIC has guaranteed a major portion of outstanding loans

in the economy, it will have even a more vested interest in promoting inflation as a way to make the loans easier to repay.

8. Personal aptitudes and education requirements policy:

This is perhaps the most appalling of the powers Kelso wants to place in government hands. Under this policy, a bureaucrat would direct the economy by giving preferences on loans to only those with a particular level of education or background. This would be a very hard part of Kelso's planned economy to swallow. I can just see a father telling his son that he must become an artist in order to get started in the world because that's what the CDIC decided he should be.

It is inconceivable to me that any reasonable person after reading Kelso's proposed policies could not see his plan as pure socialism -- governmental control of the means of production. This is definitely not capitalism.

A good rule of thumb is that any government policy means government control -- unless that government policy is freedom. Kelso's "new capitalism" is in fact a blueprint for a totally socialist society. The most incredible thing is that he claims to propose his plan to avoid socialism.

The CDIC would have to make countless arbitrary rules about who was eligible for the program and who wasn't. By Kelso's own description, bankers would basically become government agents interpreting regulations and helping to operate a government program. Their decisions would be based on political governmental edict rather than good solid business factors.

Only a fool would believe that CDIC guaranteed loans would not soon permeate the capital market, drying up available capital to non-government approved enterprise. Eventually, anyone not qualifying for the CDIC program would be at a tremendous competitive disadvantage to those using

the program. Why should anyone strive for financial well being if government programs will eventually discriminate against them?

Creating the CDIC would substitute a political economy for a free market economy. It would open the whole system up to graft and corruption both in terms of bureaucrats wielding undeserved power and in terms of crafty entrepreneurs ripping off a shoddily run government program.

Eventually, the government, through CDIC, will literally be controlling the economy by deciding who's going to get loans, and for what purpose. No better plan could be conceived to destroy free enterprise and substitute socialism in the name of "capitalism."

Even beyond Kelso's CDIC blueprint for socialism, he advocates several changes in free market corporate operations. For instance, Kelso wants some kind of legal requirement that all earnings of corporations be paid out in dividends rather than allow investment for future expansion. This goes right along with his plans to eliminate speculation on resale of stock certificates. He wants an end to consumer credit so that people will be forced to become capitalists by foregoing consumption. (This is despite his fear that less consumption will hurt the economy.) Even if all corporate earnings were paid out in dividends, there is no assurance that people would spend the money on capital investment rather than consumption. The fact is that the government would get a larger part of it since dividends are taxed as non-earned income, and the sale of speculated stock is taxed at capital gains rates.

As an additional tool for the redistribution of wealth (which Kelso claims he does not advocate) he suggests major increases in inheritance tax rates. This proposal would give even less incentive for a man to build up his capital estate.

So as to not let Mr. Kelso off the hook too easily, let's look at some additional inconsistent remarks made by him which indicate a lack of understanding about capitalism and the free market.

At one point Kelso remarks that in Russia, industrialization is achieved at the cost of totalitarianism. Actually, industrialization isn't achieved very well in Russia, and even then only by almost completely foregoing consumption. In addition, Kelso is promoting totalitarianism here by creating an economy based on politics rather than the free market.

Kelso also claims that "conventional business financing falls far short of satisfying the basic principles of economic justice." The truth is that the free market finance system is the only one which does create economic justice. Justice means no more nor less than one deserves. Kelso's plan would, through government intervention, give some more than they deserve at the expense of others. At another point, Kelso says wealth should be distributed to those who produce, yet he comes up with plans like CDIC, and increased inheritance taxes.

Consistent with Kelso's something for nothing theory, he attempts to create capital wealth for those who he thinks don't have it by bookkeeping entries brought about by government guarantees without any abstaining from consumption. This is economically ridiculous and amounts to government increasing the money supply without additional wealth, thereby fueling inflation.

Placing his personal value judgment on everyone else, Kelso states that "society's first economic duty to its citizens is to enable them to be or become productive." True capitalism, meaning economic freedom, is the only way that individuals will have the opportunity to be or become productive. "Society" is a group of individuals, and individuals should have no duty to anyone other than

those they choose to contract with. It is individual freedom that sparks economic growth even for less productive people. Kelso's meddling in the economy is nothing but anti-productive.

Elsewhere, Kelso states that we "need even more intensive efforts by government and government supported power blocs to divert the wealth produced by capital to those who do not own capital." If this isn't a proposal for the redistribution of wealth and socialism, then neither was the Communist Manifesto.

Later Kelso states "every major increase in new capital formation that is not accompanied by an increase in the number of new 'capitalists' is a leap in the direction of socialism." Not only is this an untrue statement in itself, but if there is any leap to socialism, it would be to adopt Kelso's proposals.

While Kelso indicates that it's impossible for those without capital to become capitalists, he complains that "today owners of a hotel suddenly become owners of a chain of hotels" and says the same about restaurants and warehouses. This only points out the fallacy of his theory. If someone has a good idea, and foregoes a little consumption, then there's no reason why he couldn't become a wealthy capitalist. If someone doesn't do that, it's primarily because they don't have the qualities necessary to be capitalists. One of the most dangerous aspects of Kelso's theory is that he wants to make the government the insurer for people who probably don't have the qualities to be capitalists, are poor credit risks, and don't deserve loans.

At another point, while speaking woefully about inevitable socialism if we don't adopt his plan, Kelso states "socialist methods of new capital formation are more efficient and quicker than traditional methods of business finance now employed by the free world." This

is called talking out of both sides of your mouth.

Kelso virtually ignores that there is a skill involved in choosing good capital investment which should be rewarded. Instead, he figures that by putting capital into anyone's hands, benefit will result.

In short, Kelso's theory closely follows that of another economist who advocated, 'from each according to his ability, to each according to his need.' Kelso further admits the failure of his theory by stating that, with it in effect, "the government would wield considerable power."

It is unfortunate indeed that so many pages of words need to be produced describing Kelso's illogical economic theory, but when the legislature and the people of Alaska are asked to swallow the demagogic AGSOC proposal of Senator Gravel, they should know what the ultimate theory is behind the AGSOC plan. After examining Kelso's inconsistent and illogical reasoning, it would be incredible that any legislator could lend their support to AGSOC. Let's look at how the AGSOC proposal fits into Kelso's overall plan, and why certain parts of Kelso's plan are conveniently being left out at the initial stages of AGSOC.

In brief, AGSOC would hand out shares of stock "free" to most every Alaskan. The corporation would be formed by the initial appropriation of millions of your tax dollars by the government, with no guarantee or liability by the state or the stockholders (at least for the time being). One indicator of the deception built into AGSOC is that while its initiative literature only mentions initial government aid to the project, the Alaska House State Affairs Committee and Senate Finance Committee plans call for the likely guaranteeing of loans to AGSOC by the state. Ownership of the "free" shares would have all kinds of restrictions including the number of shares, how and when they could be sold, and who could own them. Then, this paper corporation would supposedly be able to

to borrow all kinds of capital to invest in money-making projects that would make us all wealthy since it would be required to pay all hoped-for earnings out in dividends without investing in itself. Even though there is talk of AGSOC buying various companies, one might wonder at the viability of such companies if they're willing to sell to AGSOC.

Comparing such a plan to Kelso's theory, it's easy to see what essential feature of Kelso's plan is missing from AGSOC. That missing piece is CDIC and the government guarantee of any part of the operation.

The question might be asked how could such a plan work when even Kelso admitted that some kind of a guarantee or collateral is absolutely essential to the formation and acquisition of capital? The answer is that it won't.

For AGSOC to go begging to a lender for money would be ridiculous. Can you imagine yourself, or any other intelligent person, readily lending huge amounts of capital to some immature youngster with no experience, no well-formed ideas, no collateral, no guarantee, and no strong sense of direction? Of course not. And this is exactly what AGSOC will be when it attempts to get a loan.

The only reason anyone would lend money to such a scheme would be if there were some hidden factors involved. I can immediately see at least one possibility of such a hidden factor.

The most dangerous of such hidden factors would be the unwritten assumption that based on political experience, the government, (State of Alaska) would eventually step in and guarantee, loan, or subsidize to AGSOC if it should ever find itself in bad finances (which it is doomed to from the outset). Any astute political observer (such as Senator Gravel) knows very well that if the state had already invested millions into AGSOC's start-up costs, had

perhaps lent money to AGSOC, if powerful legislative political figures had supported the AGSOC concept, and if politically appointed 'leading citizens' had been appointed to its directorship -- then the State of Alaska would politically be forced into saving the sinking ship of AGSOC before it went totally under. Such a bail-out of AGSOC by the state would be inevitable, and would complete Kelso's blueprint for socialism. There is no way that those demagogic promoters of AGSOC would allow AGSOC to go under, and if there's one attribute which politicians like to maintain, it's the characteristic of infallibility. Senator Gravel's primary concern is getting re-elected in 1980. The AGSOC 'something for nothing' appeal might get him over that hurdle and set him up for another six years, by which time he would find another distraction with which to attempt to fool the voters.

It would be this unwritten, but politically sound assumption of bail-out by the wealthy state of Alaska that might actually find someone willing to 'risk' a loan to AGSOC. An analogous situation would be a child's (AGSOC's) first loan, with the father (politicians) winking in the background that he will actually guarantee the loan even though it's not on paper. Such a risky loan would particularly be possible by the application of political pressure or offer of political gain by a powerful promoter of AGSOC to some government protected holder of extra capital which could be loaned to AGSOC (political payoff).

The next question to ask is, why wouldn't the AGSOC proposal include government subsidy, loans, and guarantees right from the beginning? The answer is simple. It would be easier for Kelso and Gravel to hold AGSOC up as "capitalistic" and not socialistic if they can minimize the aspect of government involvement. They may also be clever enough to realize that it wouldn't be necessary to include government guarantees at the outset. If they just feed

AGSOC to the people a little at a time, they'll be hooked by the time it's too late to do anything about it. Promoters of AGSOC would know that once the corporation was created on paper, and stock was issued to all Alaskans, it will be easy to get the missing government guarantees and subsidies worked into the picture later on. When those subsidies and bail-outs occur later on, individual owners of AGSOC shares may not be personally liable as stockholders, but they would certainly be liable as taxpayers.

In addition to the possible devious scheme behind AGSOC, there are many other aspects of it which make it undesirable. For instance, promoters claim that the fact that AGSOC would not be subject to taxes on its earnings (even though shareholders would be on their dividends) will make it attractive enough for investors to lend to it. That not only points out the ridiculous level to which taxation has risen in this country, but it should be obvious to the observer that by exempting AGSOC from taxation, the government is actually subsidizing it, since all of us will probably have to make up the revenue lost by tax exemption.

Another aspect of AGSOC is its political control from the outset. Politicians would be appointed to its board of directors at the beginning, and because of its diversified ownership, those directors would be nearly impossible to dislodge. These political directors would have AGSOC competing with other businesses in the Alaskan economy with the competitive edge of no taxation and no capital requirements. Through a slow process, this politician's boondoggle would begin to control and affect more and more of the Alaskan economy, with government's help.

Since AGSOC would be prohibited from retaining earnings for reinvestment, it couldn't help itself grow even when reinvestment might be economically feasible.

Even if the claimed purpose of AGSOC is to somehow return wealth to the people, there is no question that there are many better ways to do so. The people of Alaska are already in a dangerous situation with a state government holding billions of dollars of surplus funds while individual Alaskans go without. The simplest, most reasonable, and most consistently capitalistic way to solve the problem is to take that dangerous surplus away from the government and give it to each individual to choose for himself whether to consume or invest with it. This can be achieved through the elimination of taxes, among other means. We must assume that each person knows his own happiness better than the government does.

I have laid out my observations about the theories promoted by Mr. Kelso and Senator Gravel. If you have been concerned enough to stay with me to this point, you may ask yourself, "What can I do?"

The thing that must be done is for all of us as individuals or in groups to oppose AGSOC now, before it's too late.

The most effective group to begin this effort is the hard-working, self-sufficient businessmen and businesswomen of Alaska. They are the ones who keep this economy limping along despite government interference, and they are among those who would be affected most adversely by the adoption of the AGSOC foolishness.

If Kelso's scheme is allowed to happen, capital accumulation, the source of our high American standard of living, would soon begin to dry up. Men do not save and invest when they know it will be confiscated from them.

Schemes like AGSOC would set up an economic dictatorship which, through the political application of capital, would select and manage the economy's industries and determine production goals. There is no more devious a plan for a socialist economy.

THE NEW CAPITALISTS

by

Louis O. Kelso and
Mortimer J. Adler

A CRITICAL ANALYSIS

by

Percy L. Greaves, Jr.

This small book contains more economic fallacies than it does pages. The basic assumptions upon which it is built cannot withstand the light of careful scrutiny. Furthermore, the alleged facts are not documented and the logic employed is extremely loose. Its strong effect on the casual reader rests largely upon the repeated assertion of seemingly plausible statements which, upon close analysis, turn out to mean almost the exact opposite of what they first seemed to say.

Any attempt to put the book's proposals into effect would immediately reduce the incentive to produce and result in a rapid paring down of the American standard of living. At the same time, it would set up an economic dictatorship which, through the political allocation of capital, would select the management of the nation's industries and determine all production goals. In short, it is an unwitting blueprint for the establishment of a Soviet America.

A complete analysis of all the book's fallacies would necessitate a theoretical treatise of several large volumes. However, the following brief analysis of seven of the book's basic fallacies should be helpful in indicating why the book is unworthy of serious consideration. These seven basic fallacies are:

- I. Capital produces at least 90 percent of the gross national product. (pp. 5, 6, 38-40, et al.)
- II. A progressive concentration of the ownership of capital exists; the great bulk of capital is owned by 3 or 4 percent of the households (pp. 14-15, 28-37, et al.)
- III. Savings are not required for capital accumulation. (pp. 53, 55, 59, et al.)
- IV. No real shortages of labor and resources exist in Western nations. (pp. 4, 41, 46, 86, 101, 104 et al.)
- V. Government redistribution of income is now necessary. (pp. 6, 31, 32, 41, 45, et al, ad infinitum.)
- VI. Bank credit expansion can create wealth. (pp. 17-18, 55-56, 58-59, 60-63, 100-102, et al.)
- VII. Proposals provide for a free society. (Implicit throughout and stated in conclusion, pp 108-109.)

I. Capital produces at least 90 percent of the gross national product.

The early classical economists and Karl Marx believed that human labor produced all economic values. Today, most labor union leaders, as well as those who write our laws, believe that human labor is responsible for producing almost all economic values and that employees, as employees, are entitled to all increases in production.

The authors of this book believe that capital is responsible for the production of almost all economic values and that the share attributable to capital is ever increasing with each addition to available capital. They assume that this is an apparent fact and make no attempt to document it or defend it logically. They apparently assume that because the increasing use of capital results in higher physical volume of goods, all the increased human satisfaction resulting from such increased quantities must be attributed to capital.

This neo-capital theory of value is just as indefensible as the labor or neo-labor theory of value. They both ignore the essential factors of time and abstinence as well as the factor of profit and loss which results from the uncertainty of future demand at the time businessmen commit their capital to the time-consuming process of producing particular goods. Attributing 90 percent or more of all production to any one essential factor and belittling the contributions of the other factors as insignificant and no longer needed is a little like attributing all football victories to the backs who score the touchdowns and thus implying that the linemen are no longer necessary. Attention is concentrated on the sensational at the expense of other very essential contributions. No football game can be won without linemen. Similarly, no economic production can take place without human foresight and the combination of capital and labor over a period of time. Each of the four factors is both important and essential.

Capital is always the result of human action. To obtain capital, men must first save, i.e., consume less than they produce. Only such savings can give them the time and ability needed to produce capital goods. Human ideas and foresight of future needs must also precede the introduction of every new capitalistic method. Then men must not only produce the capital goods but also direct and manage their use in production of other goods. Without the human factor, there would be no production, capitalistic or otherwise. Capital alone is incapable of producing anything.

Men do not value all labor or all capital. Men only value the specific units of labor or capital which they are considering in connection with a specific situation. Men think in terms of the value to them of one more, or one less, unit, that is the marginal unit. If they are buying, they compare the value to them of one more unit of labor or capital of a specific type and the price they must pay for it. They then buy until one more unit is no longer worth its market price to them. When they consider selling, they compare the value to them of one less specific unit with the value to them of the sum of money they receive in return for it. The market values of all types and units of both labor and capital are traceable to the values consumers are expected to place on their final products.

In the market place all identical units sold at the same time and place are sold at the same price. The market process thus tends to allocate every available unit of capital and labor to the production of those products which are expected to bring the highest prices from consumers. This means that each additional unit of capital tends to be used to produce something considered less valuable than what was produced with previously available capital. Otherwise, the previously available units of capital would have been used to make those products.

So, with any given population, each additional unit of capital is not only worth less than the units of the previously existing supply of capital units, but it also reduces the value of every other existing capital unit with which it competes. Thus, with any given population, every increase in the amount of available capital reduces the importance of every existing unit of capital. Man can then have more of the things he wants but the additional things are not as important to him as the things he desired when less capital was available. So more capital makes capital less important (valuable), rather than more important (valuable) to man.

Let us attack the problem in another way. As man is constituted, his desires are insatiable. As soon as some desires are satisfied, other unsatisfied desires arise to take their place. If they did not, man would stop eating and all his other actions. He would, in fact, lie down and die.

As long as man lives, he has unsatisfied desires. This means there is always a demand for more of what labor can produce with available resources. There are always ores that are not mined, land that is not planted, waters that are not fished, and goods that are not made because there is an insufficiency of labor. Labor, a necessary factor of all economic production, is the limiting factor in almost all areas of production. Every new person born on this earth brings his own unsatisfied demands for more things than can be produced with available supplies of labor. There is no such thing as a sufficiency of all kinds of labor.

Some types of labor are always in short supply. The economic problem is how to use available supplies of labor so as to produce the highest valued possible products, that is, how to prevent the waste of available supplies in idleness or producing less valuable products than such types of labor are capable of producing. All men have a point at which they prefer rest or leisure to the results of more labor, but up to that point men desire more of the goods and services that they can obtain only by more of their own labor or by spending money they are paid for contributing more of their labor.

Millions are unemployed today because political conditions either make them unemployable or create a situation in which they prefer to be unemployed, even though there is a great unsatisfied demand for the things they could help to produce. These political conditions are the laws and customs which hinder or prohibit the employment of persons where they could be most productive in terms of what consumers want more of most. These laws and customs include those that permit unions

to raise wages above free market rates, thus reducing the number employable in unionized industries; minimum wage laws, which prohibit the employment of those for whose products consumers will not pay the equivalent of the minimum wage; unemployment benefits, which encourage men to remain unemployed; and employment taxes, including social security taxes, progressive income tax rates and higher rates for overtime, all of which increase the costs of labor to employers and thus to the ultimate consumers.

It must be remembered that businessmen are merely middlemen between the workers and consumers. They will always hire every possible person they can afford to pay, up to wage rates that raise costs above what they can expect to recover from consumers. If they can make a penny by hiring one man more and selling his product, they will do so. Businessmen constantly strive to hire all who are willing to work at the free market wages which are set at the point which it is expected can be recouped from the ultimate consumer. Laws and customs which interfere with such free market wages also interfere with employment. They either cause unemployment or shift men into poorer paid jobs where they compete with less skilled persons who are driven further down the economic ladder, some of them being pushed below the minimum wage and thus into compulsory unemployment. These interventions have produced mass unemployment but in a free market society there can be no surplus of labor as long as men have unsatisfied desires which the employment of labor could satisfy. As mentioned above, such unsatisfied desires are a fact of human life.

One of the values of owning capital is that it saves men time. If we have the capital, we do not have to take the time and trouble to produce it. The payment for capital is thus a payment for time saved as well as for the labor needed to produce it. The payment for time is called interest. The rate of interest is determined by man's time preference, that is, by how much he prefers to have some things now rather than a year from now. Businessmen devote time and labor to the production of specific types of capital goods when they foresee that the cost of producing such capital goods will be less than their expected market value at the time of their completion. Not even the best businessman can always foresee future market conditions perfectly. This imperfection of human foresight is responsible for the factor of profit and loss. A period of time must elapse between the time businessmen decide what to produce and its later availability for sale. Those who turn out to have been relatively the most proficient in foreseeing correctly future demands make a profit. Those who do not suffer a loss.

In this connection, it should be remembered that profits are the amounts they receive over and above their labor costs, expenses for supplies and raw materials, and interest charges on necessary capital for the necessary period of time. When businessmen recover only their expenses for labor, supplies and raw materials and do not recover sufficient funds to pay the interest rate they could have obtained by lending their capital funds, they have suffered a loss. No one goes into business without the hope of earning more than he could by lending his money out or putting it in a savings account. On the other hand, profit or loss is merely the relative difference in expected market values between the time production is started and when it is completed, that is the time when the producer can transfer its ownership to another who then assumes the responsibility for future changes in its value.

For the fallacy of this book, all this means that the contributions of capital to production must be traced back to the contributions of the four essential factors that are necessary for the creation of capital. These four factors are human foresight, scarce goods consumed (savings) human labor and time. The scarce goods consumed in producing capital are the tools, supplies, and raw materials which, in turn, represent savings produced by human labor over a preceding time period.

The more capital savings there are available, the more apt we are to undertake projects which take a long time to produce to the point of operation and which will last a long time before their value is fully consumed. This means that interest payments are likely to be a larger factor in the costs of such enterprises. Any profits above the basic interest rate will attract competition which will pare down and finally eliminate the profit item. However, with the passage of time and changes in consumer preferences, new opportunities constantly arise for the re-emergence of new profits and losses.

As men are constituted, human foresight in deciding what to produce is imperfect and always will be. Likewise, our time, labor and capital are in short supply and always will be. The competition of a free market will allocate available supplies so that in the long run they will be combined to produce the highest possible values known to mankind. Should any investment temporarily obtain profits over and above labor, material and interest charges, competition, if not politically prevented, will soon tend to eliminate the profits. All profits are at best only fleeting in character and must be re-earned if they are to reappear.

In this connection, it should be pointed out that every increase in capital permits the production of goods and services not previously produced. Each new addition to capital goes to work by bidding up wages and the prices of raw materials before it can obtain the factors needed to go into production. Then, the newly produced goods must compete with existing goods and services and offer consumers a better buy before the contributor of the capital can receive a cent back on his investment. Further, the capital goods and the products they make must continue to compete for their originally estimated life if the capitalist is to get back his full investment with interest and possibly a net profit.

Another popular fallacy, inherent in the logic of the book's authors, is that it is thought that if corporate income taxes are reduced or repealed, the present profits before taxes would continue to be about what they are now and that this would be a windfall for the owners of capital. This is a gross error.

As long as a market economy exists, competition will determine the allocation of the reduced taxes among the various market participants as each specific condition dictates. This means that the repeal of 50 percent corporate income taxes would not double available corporate income as the authors seem to think when they estimate the share of production they attribute to capital. Actually, market competition would rapidly force the sharing of the tax savings in lower prices, increased production and higher wages. No doubt such an event would affect interest rates (time preferences). It would also change the

pattern of goods and services produced and thus those on which the highest profits of the future would be made. However, these changes in the allocation of produced income would be determined by the existing market forces and not by corporations trying to maintain the same wages, prices and production pattern as prevailed before the reduction in corporate income taxes.

Corporate income taxes are indirect taxes levied on market operation. Such taxes tend to hide the real burden of government spending from the general public which in the long run must bear the full burden. Unfortunately, many high and low income people, as well as the authors of this book, tend to think that it is the capital stock holders who now bear the full burden of corporate income taxes. This is just not so. Investors still earn the market rate of interest plus profits or less losses, depending on the foresight of each company's management, under existing conditions, in supplying what consumers want most as shown by how they spend their money.

In the long run, those who accumulate capital by consuming less than they produce must receive interest on their savings. If they did not, they would not invest their savings in capitalistic production. No law short of a complete dictatorship can force a man to save and invest without payment of interest. Nor can any law eliminate the uncertainties of the future. Any attempt to reduce or eliminate profits from business enterprise would only result in reducing the efforts of business to provide more efficiently for the uncertain human wants of an unknowable future.

While laws can and do reduce the return on capital, they cannot do so without at the same time reducing real wages and increasing the costs of the goods and services people want. Every government tax, rule or regulation which is not for the purpose of protecting or defending life, health, property or the activities of the market place must be a burden on all market participants. What is more, it is the market and not the government that allocates that burden and it does not spare those with low incomes. Except for their proposal to remove all corporate income taxes, the proposals of this book would increase the present burdens of every American. Its authors have no real concept of how a capitalistic society functions and how the benefits from the increased use of capital are shared by all market participants.

II. A progressive concentration of the ownership of capital exists; the great bulk of capital is owned by 3 or 4 percent of the households.

There is a slight plausibility to this argument. However, such plausibility is entirely due to political interferences rather than free market operations. One little known result of the political interventions before, during and since the New Deal is that they have tended to protect the positions of those already at the top of the business heap by making it considerably more difficult for new and struggling new competitors to replace them.

This is particularly true of the tax laws. Under present tax laws, it would be impossible for any man or family to duplicate the contributions to society of Henry Ford. He raised wages and benefited millions by making autos available for a few hundred dollars because he was able to

plow back his profits into expansion of his original small plant. This process could not be duplicated on a similar scale today. In this connection, it should be further stressed that the benefits of his increased capital investment did not all go to him or his family. The market compelled him to share his gains with his workers, his suppliers and his customers.

Other laws also help to protect those who have arrived from the competition of newcomers. This is most apparent in the labor area where union members can keep the unemployed from competing for the highest paid jobs. This unfortunately is the underlying cause of the economic distress and unrest among American negroes. However, all interventionary laws have this effect. It is quite evident where permits or licenses are required for the sole purpose of limiting competition. Laws which prevent the use of new materials or more economic methods or protect featherbedding are other instances. So also are the farm laws which curb the most efficient use of land. So also are oil import quotas, export licenses, interstate commerce regulations, certain food and drug regulations and many many more types of government owned and operated activities.

However, it is not such intrenchment of established business that the authors of this book have in mind. Nonetheless, it is the results of such interventions that opened the door to their approach. They build heavily on the results of government directed expansion of bank credit and the progressive income tax. They constantly stress the point that much present day capital accumulation is amassed by corporations plowing back their earnings rather than paying them out in dividends. They even admit that personal income taxes at higher rates than those on capital gains are a major factor.

However, they neglect to mention another contributing factor---that interest payments on corporate bonds entirely escape corporate income taxes. This fact, plus the effects of inflation, encourages the accumulation of capital in the form of corporate debts and capital gains upon the retirement of the bonds. They do not seem to realize that many of the conditions they deplore could be eliminated by simply removing the double taxation now levied on corporate dividends and levying the same tax rate on all personal and corporate income.

Unfortunately, the error in their reasoning is still greater. They assume that because a great part of capital accumulation takes place within existing corporations that almost all of it does and then as they proceed they not only assume that all capital accumulation happens in this manner but also that the owners of capital stock always remain the same persons. Actually, where corporations accumulate capital in order to provide their owners with capital gains rather than dividends, the stockholders must sell some of their holdings in order to realize their capital gains. The authors ought to visit the stock market some day, or at least read the figures on the turnover of stock ownership every business day. It runs into millions of shares.

While the authors with ever increasing emphasis proclaim the ever narrowing number of the nation's stockholders, the actual figures belie them. On June 24, 1965, the New York Times and Wall Street Journal

published figures of the New York Stock Exchange reporting that the number of stockholders of publicly held corporations has increased with every count made since 1952. The total figure now exceeds 20 millions and includes one out of every six adults in the United States. This is a far cry from the claim of the authors and this is only for the publicly owned corporations.

Many of our wealthiest men are owners of closely held privately owned corporations. So are many of our middle class citizens, including millions who place their savings in their own businesses with which they are more familiar than with the affairs and management of publicly owned corporations. The facts indicate that over the years the ownership of capital has become ever wider as has the resulting benefits to workers and consumers who use the many products made possible by the increase in capital. Many more than the Ford family are now benefiting from the existence of the Ford Motor Car Company. And so it is with every large corporation that earns profits.

The authors completely overlook the huge savings of the masses in many areas, including home ownership and other real estate. Take life insurance for example. There are now more than 120 million individual policy-holders insured with legal reserve life insurance companies holding more than \$141 billions in assets. In 1960, 89 percent of all family heads were insured, including 71 percent of those with annual incomes under \$3000. In 1963, American families received from life insurance companies payments amounting to 10 billion dollars. Such payments as well as the assets held by life insurance companies for their policy-holders are increasing with every passing year.

By the end of 1964, insured deposits in mutual savings banks had risen to more than 42 billion dollars, compared with only 10 billions at the end of 1945. This quadrupling was not done by any 3 or 4 percent of the nation's households. In the same period the savings capital of the savings and loan associations had increased from less than 8 billion dollars to almost 102 billion dollars. This is not where a few enormously wealthy capitalists are concentrating their savings. Individuals also now hold more than 49 billion dollars worth of the national government's baby bonds. This figure is up by more than 6 billion dollars since the end of World War II.

There is absolutely no evidence that there is a progressive concentration of capital in the United States. In fact, all the available evidence points in the opposite direction. Unfortunately, too much of the increasing savings have gone into forms that are hard hit by the inflationary policies of our national government.

There are two lesser points that should also be mentioned. First, the authors consider depreciation, amortization and depletion, along with withheld earnings, as "internally generated funds" which contribute "today almost three-fourths of new capital formation." Such funds are merely a replacement of capital consumed in production. While they may represent a demand for new capital goods, they are not an increase in capital, but merely a maintenance of prior capital accumulations.

Second, the book makes no mention of the effects of inflation on corporate earnings as figured by tax authorities, in general, a part of what is considered "taxable profits" is in fact only illusory profits. Under the tax laws, taxpayers are allowed to amortize or depreciate only the original costs and not the eventual replacement costs. Thus, when inflation increases the dollar costs for replacements, the government is actually taxing as a profit what is in fact a loss, or technically a consumption or depletion of previously accumulated capital assets. So the authors actually consider the mere replacement of such consumed capital as further evidence of their imagined concentration of the ownership of capital.

III. Savings are not required for capital accumulation.

This is one of the most idiotic ideas on which the entire book is based. The authors bluntly assume that capital can be created from scratch and without any abstinence by the application of the future earnings from capital created by the mere bookkeeping addition of sums to bank deposits. The only basis furnished for such illogical reasoning is a study that Harold G. Moulton made some thirty years ago. That study indicated that historically capital accumulations have on certain occasions increased most rapidly during periods of "high-level consumption."

Dr. Moulton made this study for Brookings Institution early in the New Deal. It was part of a four volume series in which each succeeding volume pyramided its own fallacies on top of those of the preceding volumes. However, Dr. Moulton and his Brookings associates, including Dr. Edwin G. Nourse, later, 1946-49, Chairman of President Truman's Council of Economic Advisors, are not to blame for the extreme interpretation placed on their findings by the authors of the book under review. In boom times, particularly those induced by expansion of bank credit, there are more dollars for both consumption and investment.

The fact remains: all capital accumulation must be the result of savings on the part of someone. Capital can only be amassed by abstaining from consuming all that is produced and available. Before goods can exist, they must be produced. Those who consume all that they produce have no savings or capital. Those who consume less than they produce have some savings. These savings are their capital. It is as simple as that.

Unfortunately, the authors of this book have been fooled, as have many others, by the illusion that the granting of bank loans by bookkeeping processes is a wealth creating process. This illusion will be dealt with under VI. Here, it is sufficient to state that physical capital goods, the only kind that can be used in production, can not be created by accounting manipulations. Capital accumulation requires abstinence on the part of the owners of wealth. They must first live on less wealth than they, their ancestors or other benefactors have produced.

In the market economy, people are paid in money for their contributions to the market. When they do not spend all their money income for consumption of goods and services, there must remain in the economy a portion of their contribution to society which is available as capital. They can use that capital themselves or transfer title to it by lending or investing that part of their money income. When one lends his savings, he merely transfers title temporarily to existing wealth.

This, of course, assumes no theft or manipulation of the money supply such as the authors of this book endorse when they propose making their proposed capital-creating bank loans redeemable in newly created Federal Reserve Notes. When one borrows or spends artificially created bank credit, one merely exercises a claim on previously existing wealth---wealth which in a free and moral society would be allocated to someone spending funds that were received in return for a contribution to society.

Capital cannot be created out of thin air or by the bookkeeping opening of a bank credit. The authors believe that capital can be so created. All that they ask is that the bank borrower pay an insurance premium to a government agency which will insure the bank against any entrepreneurial error by the user of such accounting-created-capital. They expect that such accounting created capital will earn sufficient profits and interest to pay off the original loan with interest. This is pure nonsense. Yet the entire plan of the book is based on it.

IV. No real shortage of labor and resources exist in Western nations.

If this were so, there would be no economic problem. A prime factor of life here on earth is that the things men want and can produce are in short supply. Where they are not in short supply they are free goods and there is no economic problem.

The top shortage is labor. As mentioned under number I, many resources are not fully developed to the extent of present technological knowledge because there is a shortage of labor. The usual expression is that labor costs would be too high, or that it would be uneconomic or simply that it would not pay. All of which means that there are better uses available for the labor on hand. Unfortunately, governments are not always guided by such economic logic. The present development of atomic power for peaceful uses is still uneconomic. The labor and capital so consumed could produce higher values if there were no government interference with market processes. This is true of almost every government activity except those of defense and the peaceful settlement of disputes. If this were not so, men would find it profitable to undertake such activities in a free market.

Nothing can have value in the market place unless the supply is less than the demand for it as a means for satisfying some human need or want.

It goes without saying that there are many resources around the world that men could and would exploit if governments did not hinder or prohibit such exploitation. However, there is a real shortage of labor and resources in the form that men find them useful and there always will be.

V. Government redistribution of income is now necessary.

The only justification for such a belief is that of Marx and Engels in the Communist Manifesto, where they state that every government intervention makes matters worse and creates a demand for further intervention until the point is reached where the whole capitalistic system is overthrown and replaced by a dictatorship of the proletariat.

A good argument might be made that because government spending, taxing and inflation policies have destroyed considerable private savings and potential private savings the government now has an obligation to those it has impoverished. However, that is not the argument of the book. The authors imply that all present deplorable conditions are the natural result of a free and unhampered capitalistic system which must be reformed by governmental action. They thus offer their plan for the political creation of capital with the promise that Congress will vote to give every person his fair share of the capital created by bank loans. The owners of such capital will then somehow be entitled to receive 90 percent or more of all production.

It is true, of course, that there are people in this country who are in need of financial help. That this number is now large is due primarily to political interferences with the operations of a free market as well as uneconomic fiscal and monetary policies. However, it is still likely that private charity could and would take care of all cases of real need, particularly if political restraints on employment were lifted.

Present day political programs only serve to encourage and sustain poverty and unemployment by dampening the spirit and ability of people to find self supporting jobs where they could contribute to society as they improve their own lot in life. Present programs lead people to believe that they are entitled to a living without any contribution on their part. In fact, they are even encouraged to think they are contributing when they are living on and distributing largesse obtained through taxes collected from the more successful citizens. The illusion that the burden of such taxes fall entirely on the well-to-do is encouraged at every opportunity. It is popularly considered a form of economic justice. Actually, as explained previously, the market allocates the tax burden on every citizen of the land, even those with the least to spend.

This book encourages the popular fallacy that only a few own capital and if the government did not intervene, these few would receive 90 percent of the nation's production. This is pure nonsense. Market processes, if left free from government interferences, allocate all production to those responsible for its production. Everyone is then free to choose the most attractive opportunity open to him. Every worker is assured of the market value of his wages before those advancing his wages can get back a cent. The market processes thus see to it that the capitalists are the last to receive any of the gains from their contribution. This book encourages its readers to think otherwise. They declare that every person is entitled to become owners of capital without any contribution or sacrifice on their part, except for the

payment of a small insurance fee to a government agency. Their plan is a plan for the redistribution of 90 percent of total production. It would rapidly reduce total wealth to the point where many would starve. They simply do not understand that every honest and moral person would attain his maximum possible income in a free and unhampered market economy.

VI. Bank credit can create wealth.

It would take a volume to present fully the monetary explanation of the trade cycle as expounded by Ludwig von Mises. However, Mises has clearly demonstrated that modern recession and depression problems are basically the result of political attempts to stimulate economic activity by the expansion of the money supply through the creation of circulating bank credit. Should the holders of such bank credit desire to convert their artificially created bank accounts into cash, the central banks, in our case the Federal Reserve Banks, are empowered to print legal tender paper money against evidences of debt owed to banks. In the United States, such printed money is in the form of Federal Reserve Notes.

The authors of this book would extend this disastrous principle still further. They propose the printing and issuance of Federal Reserve Notes against bank loans with no security except government insurance and the hope that the sum created will be put to work as capital in such a way that it will before too long repay the loan with interest. They blithely assume that such government insurance can be sold for a mere trifle just as the National Government now insures mortgages on real property.

Actually, banks perform a useful social function when they operate as middlemen between savers who want to lend money and borrowers who need and want funds they expect to be able to repay with interest at the maturity of the loan. Such loans are merely temporary transfers of monetary savings (purchasing power) from one person to another. They do not increase the available amount of spendable money in the economy. What the borrower can now spend, the lender can no longer spend. Such voluntary loans help all parties concerned, whether made through a bank or not.

However, when a bank makes a loan merely by adding the sum to the checking account of the borrower, it is not transferring to the borrower the title to someone's actual monetary savings (purchasing power). The bank is merely adding this sum to the available amount of spendable money in the economy. This addition to the money supply empowers the borrower to go out and buy something, leaving less available for all previous owners of money. Thus, those who have obtained their money in payment for their contributions to society find that they cannot buy as much as they could have bought if the bank had not issued an artificially created claim to its borrower. Such bank loans merely transfer a part of the existing wealth from those who helped create it to the borrower from the bank. Such bank loans add no wealth to that previously existing. They merely transfer titles to existing wealth at the expense of all those who have earned or saved their dollars which will now buy less.