

*For information on the policy conference discussing this paper, October 7, 2005 in Washington, D.C. see <http://cog.kent.edu/FairExchangeBrochure.pdf>.*

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## **Fair Exchange: providing citizens with equity managed by a community trust, in return for government subsidies or tax breaks to businesses.**

by  
Deborah Groban Olson<sup>1</sup>

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<sup>1</sup> Deborah Groban Olson, Attorney at Law, has specialized for 24 years in creating and advising employee owned companies, equity compensation plans, including ESOPs, stock options, and cooperatives, representing companies, unions, families who own companies, trusts, and employees. She is Executive Director of the Capital Ownership Group (COG), an on-line think tank, developing policy to broaden capital ownership globally that operates from the Ohio Employee Ownership Center at Kent State University. She is a board member and past chair of the National Center for Employee Ownership (NCEO) and a board member of the European Federation of Employed Shareholders (EFES). Her publications are available at [www.esoplaw.com](http://www.esoplaw.com). BA, 1971 University of Wisconsin; JD (Order of the Coif) 1976, University of Wisconsin.

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## I. INTRODUCTION

### A. What is Fair Exchange?

“When communities invest in businesses by giving them tax abatements, tax breaks or assets at below market rates, the citizens should get equity to be managed by a community trust.”<sup>2</sup>

That is the definition of “Fair Exchange” (hereinafter “FE”) used here.

The resounding response to this concept has been “Yes, of course!” from business people, federal, state, and local legislators, union leaders, community organizers, foundation staff, law professors, and journalists.<sup>3</sup> Simply treating government investors the same as business investors is a commonsense idea that holds increasing sway as businesses become more mobile and their attachment to any particular community becomes more tenuous and subject to change based on market factors.

The devil in the Fair Exchange concept is in the details. This article explores legal and economic precedents; proposes Fair Exchange models; discusses practical and legal issues involved in designing the models; considers potential applications across a wide range of issues, venues and jurisdictions; and discusses strategies for implementing workable FE proposals. This article aims to generate substantial and detailed discussion on how to actualize FE at the local, state, federal, and/or global level.

At present there are no existing FE models to describe, though there are substantial and successful precedents for many of its parts. So, here is a hypothetical to clarify the concept. Please note this is only one of many possible ways to organize an FE model.

Suppose Multinational Manufacturing & Marketing, Inc. (MMM) seeks \$18 million in tax abatements, low interest loans and loan guarantees to build a new corporate headquarters and manufacturing facility in Detroit. Suppose the City of Detroit, State of Michigan and U.S. government provide a joint package of \$18 million in abatements, loans and loan guarantees (\$6 million from each). MMM agrees to provide jobs and infrastructure improvements worth at least \$18 million over the next six years. The company’s investment may provide jobs for some citizens, but all citizens are paying for them. The total citizenry deserves a return on its investment. Thus, as part of the loan and loan guarantee package, the community investors each receive MMM shares worth 10%

<sup>2</sup> This definition was created by the author, Deborah Groban Olson.

<sup>3</sup> When the author has presented this concept to them.

(in this case \$600,000 each) of their investment at the deal closing simply for risking their money.

Suppose MMM decides to close its facilities and move its operation to Sri Lanka after three years, having provided only \$3 million in jobs and improvements? What can be done to enforce the agreement and compensate the taxpayers for their loss? Currently some communities have clawback laws<sup>4</sup> that allow the governments to seek compensation from MMM. But most do not. Furthermore, clawback compensation is viewed entirely as a disincentive for MMM to move its facilities.

By contrast, under an FE law or FE Community Benefit Agreement (CBA), taxpayers would be treated more like other business investors, securing their return with reasonable collateral or equity. MMM, the governments and three community trusts (the Detroit Community Trust, the Michigan Community Trust and the U.S. Community Trust) would sign an agreement wherein MMM gives \$6 million worth of stock warrants (in addition to the initial \$600,000 each received as a closing requirement) for its publicly traded common stock, as collateral for the government benefits it receives, to each of three community trusts. These warrants only mature if MMM does not fulfill its \$18 million worth of promises in the agreed upon time, using metrics agreed upon in the initial contract. The warrants mature to the extent the promises are not met. In the current example MMM received \$18 million in benefits and returned \$3 million in value. A total of \$15 million in MMM stock warrants mature, providing \$5 million worth of publicly traded common stock to each of the three community trusts in addition to its initial \$600,000 each.

Each community trust has stock that it can hold, to get dividends; or sell for cash or other securities. The assets and income in the community trusts can be allocated to individual accounts for each citizen of the jurisdiction, reinvested in local companies, used to augment public services currently paid for with taxes or fees, or some combination of these options. Although each community would prefer that the jobs not leave for Sri Lanka, at least the communities' investments in MMM are bringing these community trusts the same benefit all other MMM shareholders are getting from the cost savings due to production in Sri Lanka.

Local citizens control decisions about how the community trust income is best invested to protect local citizens. The community trusts (particularly in conjunction with thousands of other community trusts, public pension and social investors) vote their stock to make MMM a more socially responsible company.

Federal legislation requiring creation and enforcement of local FE laws, as a prerequisite for receipt of certain federal funds, would enable communities to enforce FE laws without losing companies to other U.S. communities. If global trade rules included FE

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<sup>4</sup> Greg LeRoy, *No More Candy Store: State and Cities Making Job Subsidies Accountable*, Institute on Taxation and Economic Policy (1997); and Kenneth P. Thomas, The Sources and Processes of Tax and Subsidy Competition, presented at "Reining in the Competition for Investment" conference at University of Minnesota (February 2004) found at [www.hhh.umn.edu/img/assets/6158/thomas\\_paper.pdf](http://www.hhh.umn.edu/img/assets/6158/thomas_paper.pdf) (4/3/2005)  
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requirements it could level the playing field for communities worldwide to enact FE laws, thus increasing the power of governments in their business dealings with companies. If FE were used broadly, community trusts could pool their stock assets so that each held a diversified portfolio of assets; yet create voting trusts so that each community could vote the original bloc of stock it added to the pool.

Many of the questions this example undoubtedly raises in the readers' minds are addressed herein, and others are raised. The article's purpose is to inaugurate and focus a policy discussion on the concept that **any government investment in any private business should be handled as a business investment by a location-bound investor in a non-location-bound business**. Government investors need more sophisticated tools to make these transactions an exchange of fair value. This article opens the discussion, marshals precedents, draws lessons from them and intends to provide a platform from which communities can begin to experiment with the policy to develop best practices.

There is a long history of government investment in private companies through land grants, abatements, natural resource leases, loans, loan guarantees and bailouts<sup>5</sup>. The quality of these deals as business propositions, for governments and citizens, range from profitable business ventures to scandalous scams.

This article will show both kinds of examples and the lessons they provide for creating Fair Exchange legislation.

During its first 100 years, the U.S. government used land grants to railroads, homesteaders and state governments to develop the west, after removing the Native Americans. It had little else it could invest. The government succeeded in its goal. The homesteaders helped to populate the west and create towns and states. Many poor European and American peasants became the yeoman farmers Thomas Jefferson's extolled as the bedrock of democracy. The state land grant colleges are now some of our largest and most prestigious universities.<sup>6</sup> And according to at least one congressional committee, the government received in discounted transportation costs an amount equivalent with what it gave the railroads (at least according to one congressional document).<sup>7</sup>

The Tennessee Valley Authority (TVA) was a very good deal for the government. It has provided a wide range of much needed public services for over 70 years, including flood

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<sup>5</sup> Act of May 20, 1862 (Homestead Act), Public Law 37-64, 392 (repealed FLPMA 1976); <sup>5</sup> Act of July 2, 1862 (Morrill Land Grant Act), ch. 130, 12 Stat. 503, (current version at 7 U.S.C. 301 et seq.); <sup>5</sup> Act of July 1, 1862 (Pacific Railway Act), 12 Stat. 489; Tennessee Valley Authority Act of 1933, 48 Stat. 58-59, 16 U.S.C. § 831; Emergency Loan Guarantee Act of 1971 Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974; Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974; Chrysler Loan Guarantee Act of 1979, Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat. 1324, 15 U.S.C. 1861 et. seq; [Financial Institutions Reform Recovery and Enforcement Act \(FIRREA\)](#), 12 U.S.C. 1181, PL 101-73, 108 Stat. 183 (8/9/1989); Air Transportation Safety and System Stabilization Act, 49 U.S.C. 40101 et seq, P.L. 107-42, September 22, 2001.

<sup>6</sup> Such as the Universities of Michigan and Wisconsin.

<sup>7</sup> LM – We need this citation or to remove this sentence.

control, generating cheap power, bringing businesses, jobs and electricity to a large and extremely poor portion of the country. Beginning in the darkest hours of the Great Depression, it continues to provide power and development benefits today. It has also repaid the government's financial investment many times over.

In the 1979 Chrysler Loan Guarantee Act<sup>8</sup> and the 2001 federal airline bailout<sup>9</sup>, the government required the corporate loan recipients to provide stock warrants in addition to repaying their loans. In the Chrysler case, Chrysler was saved, including all the related jobs and economic activity, the employees got 15% of the company's stock, the loan was repaid in full to the government ahead of schedule and the U.S. government made over \$300 million when it sold its stock warrants. It is too early to know whether the government will make money on the airline stock warrants. However, when the government began to require 10 – 30% in stock warrants for airlines to qualify for loans and loan guarantees, Northwest Airlines concluded that it did not need the funds enough to give up equity, and decided not to submit its application. Both of these were businesslike deals in which the government got an upside for risking its funds. These provide the basis for the income end of the Fair Exchange models proposed below in this article.

By contrast, the savings and loan bailout was a disaster for the U.S. government and citizens. The \$157 billion bailout was financed by floating 30-year bonds that, with interest, may ultimately cost the taxpayers as much as \$500 billion or more. There is considerable evidence that most of the savings and loans failed due to misconduct by senior insiders or outsiders. Politically well-connected insiders received remarkable benefits at the taxpayers' expense. High-ranking government officials dismantled the federal strike forces seeking criminal prosecution in these cases. Although it was necessary to protect the small savers from loss in the failed savings and loans, most of the bailout benefit went to a wealthy few. This bailout is an example of many of the things governments should not do when investing in private businesses.

The Conrail deal shows the shortsightedness that comes from legislators taking dogmatic positions about public-private partnerships or allegiance to special interests at the public's expense. When the government created Conrail out of the bankruptcy of seven other railroad companies, the legislation required that by a stated deadline, Conrail had to become profitable and be sold to the private sector as a unit, or be sold off in pieces. It did not provide for the possibility of the government holding Conrail stock after the company became profitable, in order to reap rewards from its risk. The government invested over \$10 billion in Conrail. Due to this arbitrary deadline, it sold its Conrail stock in 1987 for \$1.9 billion. Ten years later, CSX bought Conrail for \$10 billion. Had the government held onto its Conrail stock for 10 years it would at least have broken even on its investment, instead of losing \$8.3 billion on the deal.

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<sup>8</sup> Chrysler Loan Guarantee Act of 1979, Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et. seq

<sup>9</sup> Air Transportation Safety and System Stabilization Act, 49 U.S.C. 40101 et seq, P.L. 107-42, September 22, 2001

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The Alaska Permanent Fund (APF), Alberta Heritage Savings and Trust Fund (Heritage Fund) and the Canadian Labor Sponsored Investment Funds (LSIFs) provide very useful examples of structures and the complex issues involved in developing the distribution end of Fair Exchange legislation.

APF provides an example of natural resource royalty money being used by a state to provide dividends to all of its citizens, and a source of income for government services, while investing the fund principal with no other social investment objectives. The fund grows nicely, but the citizens become addicted to the dividend income in ways that may undermine their capacity to act for the general good as citizens. The APF provides the author's model for how a Fair Exchange trust might provide individual citizens with dividends from government investments in companies.

Heritage Fund provides an example of natural resource royalty money being used by a province to lower taxes, make investments in economic development projects, government owned businesses in Alberta and loans to other Canadian provinces at below market rates. This fund, although initially larger than the one in Alaska has not grown. Because it has been controlled directly by the government, unlike the Alaska fund (which is managed as a trust fund independent of the government) the Alberta Fund's direction has shifted with political winds, and its focus is muddled. Alberta is making some changes to operate its fund more like an endowment.

The Canadian Labor Sponsored Investment Funds (LSIFs) provide a model of citizen investment directed by government chartered, labor controlled investment funds. They have produced a significant increase in the venture capital available in Canada, and have enabled substantial economic development in provinces such as Quebec and Ontario that previously had little access to venture capital. In addition to financial factors, they use social and environmental audits to screen the companies in which they invest. The LSIFs were the author's initial model for the Fair Exchange community trusts.

Some combination of the Airline bailout investment requirements, the Alaskan quasi-independent trust providing individual dividends and the well-focused local investment strategies of the LSIFs would make an excellent Fair Exchange law. The TVA also provides an excellent model. All the precedents herein offer useful experiences and cautionary tales as guides in realizing this new policy.

This article does **not** intend to describe the definitive model for FE. The examples herein are preliminary. Based on the experience in creating them, FE cannot be a one-size-fits-all piece of legislation. Each local FE law will need to be crafted to fit the circumstances, resources and competitive situation of the community. This article is the culmination of the Capital Ownership Group (COG)<sup>10</sup> Fair Exchange Project's initial research phase. Based on the underlying research and reactions to the concept, COG aims to launch a

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<sup>10</sup> The Capital Ownership Group (COG) is a non-profit network of professionals, academics and activists on six continents, using broad ownership to abate the negative effects of globalization. COG operates an online conference center, think tank and library based at Kent State University including 20 working groups and participants from six continents. See [www.capitalownership.org](http://www.capitalownership.org).

project implementation phase. It would include creating pilot project models for several communities, publicizing the outcome of the pilots, gathering and disseminating best practices information, educating interested parties, creating a technical assistance capacity, developing collaborative networks of FE trusts, and possibly developing a federal or global trade policy to raise the floor on all government investments in private companies. As a journey of a thousand miles begins with a single step, this article is the first step.

Recent events show the urgent necessity for action in this area. As global competition heats up, developed country economies are squeezed by growing energy costs and lower wages in the developing world, and governments need new economic strategies and tools.

In the past few years, the federally guaranteed pension system has been overrun with bankruptcies of steel companies, airlines and manufacturing firms with under funded defined benefit pension plans.<sup>11</sup> Since few new companies provide defined benefit pension plans, the Pension Benefit Guarantee Corporation (PBGC) is sorely stressed when these firms file for bankruptcy because PBGC only gets a fraction of the pension funds it is obligated to pay retirees<sup>12</sup>. However, the PBGC has started seeking equity for the liabilities it accepts.

A Fair Exchange settlement providing corporate equity in exchange for PBGC taking on company pension liabilities was approved by the U.S. Bankruptcy Court for the Eastern District of Virginia in the Chapter 11 reorganization case of U.S. Airways Inc. The airline owed the PBGC nearly \$2.5 billion dollars for terminating its pension plans, and over \$200 million in minimum contribution liability. Rather than engage in costly litigation about the bankruptcy priority of these claims, the PBGC settled with the airline by accepting \$13.5 million in cash, a seven-year note for \$10 million dollars and 70% of the Unsecured Creditors' Stock in the airline.<sup>13</sup>

Recently, the U.S. government allocated \$51.8 billion as a down payment for rebuilding large portions of Mississippi and Louisiana after the September 2005 Hurricane Katrina disaster.<sup>14</sup> The total government investment is likely to exceed \$200 billion.<sup>15</sup> It is likely that much of those funds will go to rebuild businesses. The day after its passage, the *Wall Street Journal* reported that:

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<sup>11</sup> Business Week, editorial, February 14, 2005 "Entrepreneurs reap benefits while PBGC gets saddled with the costs".

<sup>12</sup>Business Week, editorial, February 14, 2005 "Entrepreneurs reap benefits while PBGC gets saddled with the costs".

<sup>13</sup> *In re U.S. Airways, et al*, US Bankruptcy Court E.D. Va., Alexandria Division, Case No.94-13819, Consent Order Approving Settlement of Claims of PBGC, Docket Entry No. 2917, August 26, 2005, Consent Motion p. 7 and Exhibit A, See also Reuters web site found on 9/7/05 at

<http://today.reuters.com/PrinterFriendlyPopup.aspx?type=mergersNews&storyID=uri:2005-09-05>,

<sup>14</sup> Brody Mullins, "Lobbyists seek leverage from Storm", *Wall Street Journal*, p. A 4, September 9, 2005

<sup>15</sup> CNN Nightly News, September 10, 2005.

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Bolstered by the shift in political winds from Hurricane Katrina, U.S. corporations are pressing lawmakers to approve a range of issues that have languished on Capitol Hill, some of which have little to do with hurricane relief.<sup>16</sup>

Lobbyists were seeking removal of environmental regulatory barriers to drilling for oil and gas in the Arctic National Wildlife Reserve, removal of fuel taxes on airlines and aid to rebuild chicken and oyster farms among many other things<sup>17</sup>.

The government's Hurricane Katrina cash allocation begins in the final year of the \$15 billion federal airline bailout caused by the terrorist attacks on September 11, 2001. Based on this evidence, and the many examples in this paper, it is clear that governments are called upon to invest in businesses on a regular basis. Therefore, it is wise to have an ongoing policy for these situations rather than approaching each one ad hoc.

### **B. There is no longer a good reason for communities to be second-class investors**

Wal-Mart, with annual revenues of \$256 billion is the world's largest retailer and one of its largest companies.<sup>18</sup> Yet it has used more than \$1 billion worth of economic development subsidies for development of its distribution centers and stores in the U.S. Subsidies for individual distribution centers have been as much as \$48 million (with an average of \$7.4 million), while for retail stores the largest subsidy was \$12 million (with an average of \$2.8 million).<sup>19</sup> Although Wal-Mart presents itself as an entrepreneurial success story, it has made extensive use of tax breaks, free land, cash grants and other forms of public subsidies.<sup>20</sup> In addition to tax breaks it gets access to these local markets with the frequent consequence of displacing local businesses and the jobs they provide. "It is quite possible that a new Wal-Mart store will destroy as many (or more) jobs than it creates – and the Wal-Mart jobs may pay less, meaning they do less to stimulate the local economy."<sup>21</sup> These facts exemplify the central contradiction in the current relationships between corporations, governments and citizens.

People live and raise their children in specific communities. The web of human relationships that are a neighborhood or community are essential to us as people. When we have the financial ability, we seek to live in places where the quality of life will be safe and secure; where we will know our neighbors and help raise and educate each other's children. We want clean water, air, food and medicine. We choose to live in places where we, and likely generations before us, have invested in both physical and social infrastructure such as libraries, schools, parks, community organizations, churches

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<sup>16</sup> Brody Mullins, "Lobbyists seek leverage from Storm", *Wall Street Journal*, p. A 4, September 9, 2005

<sup>17</sup> Brody Mullins, "Lobbyists seek leverage from Storm", *Wall Street Journal*, p. A 4, September 9, 2005

<sup>18</sup> Press Release and Executive Summary, Phillip Mattera & Anna Purinton, Good Jobs First, *Shopping for Subsidies: How Wal-Mart Uses Taxpayer Money to Finance its Never-Ending Growth* (Good Jobs First May 2004)

<sup>19</sup> Id. Mattera and Purinton p.7

<sup>20</sup> Id. Mattera and Purinton p.7

<sup>21</sup> Id. Mattera and Purinton p.10

etc. We need stable employment near these communities to enable stability in the neighborhood. These human needs have not changed significantly over the centuries.

By contrast, business entities in this age of computers and global markets have none or few of those constraints of place. Before technology made global markets possible, businesses often had a closer connection to specific communities because they needed to be close to natural resources, skilled labor, markets or transportation hubs. Our laws and forms of government have not caught up with this seismic social shift. Yet, to function successfully, businesses still need government to enforce contracts, keep order, protect property, provide infrastructure and allocate or protect claims to use of natural resources.

### **C. What has the role of government been in balancing the needs of human communities and business, and how has globalization changed it?**

Because we need to earn a living, humans have always adapted their means of living to the demands of the economic engines. Often at great human expense, such as sweatshops, child labor, overcrowded, diseased and crime infested slums. In democratic societies, when these conditions threaten the general community welfare, social movements arise such as unions, progressive political movements, etc. to demand change through government intervention.

In order to provide jobs for communities, governments at all levels have created programs to entice businesses to locate to protect the economic well being of the community. Businesses quickly learn to use, manipulate or lobby to create these programs to meet their own competitive ends.<sup>22</sup> Now that election campaigns in the U.S., at least, are so costly, businesses have achieved unprecedented control over legislative bodies.<sup>23</sup>

A key function of government has been to develop, allocate and regulate the use and restoration of natural resources.

Our current policies on government subsidy to businesses have brought us to the point where Wal-Mart, a global corporation that causes companies in China to compete with

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<sup>22</sup> Greg LeRoy, *No More Candy Store: State and Cities Making Job Subsidies Accountable*, Institute on Taxation and Economic Policy (1997); and Kenneth P. Thomas, The Sources and Processes of Tax and Subsidy Competition, presented at “Reining in the Competition for Investment” conference at University of Minnesota (February 2004) found at [www.hhh.umn.edu/img/assets/6158/thomas\\_paper.pdf](http://www.hhh.umn.edu/img/assets/6158/thomas_paper.pdf) (4/3/2005)

<sup>23</sup> According to Common Cause, a U.S. public interest group that lobbies for accountable government and clean elections: “The way congressional campaigns are currently financed is corrupt. It is a system where individuals and groups can contribute significant sums of money to elected officials who have the power to make decisions affecting the interests of those donors. It is also a system where incumbents’ financial advantage often results in noncompetitive elections, making them less responsive to the voters and more responsive to special-interest contributors.” Common Cause web site (found at:

[\(4/14/05\)](http://www.commoncause.org/site/pp.asp?c=dkLNK1MQIwG&b=191979)

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each other to lower wages<sup>24</sup> has received \$1 billion in subsidies intended to protect communities and jobs, even though the opening of Wal-Mart stores in many communities leads to the closing of local businesses run by local people.<sup>25</sup>

Clearly, major change is needed. The balance between communities, business and government has swung much too far in favor of businesses. Since we do not have global government, it is increasingly difficult for nations, states and local governments to regulate businesses. Now that businesses are multi-national, they are no longer subject to the laws of a single jurisdiction. However, tax breaks, tax abatements and subsidies of all types are granted by specific jurisdictions. Upon granting such benefits, local governments are in a position to require the same treatment as other business investors.

## **II. HISTORICAL PRECEDENTS OF GOVERNMENT INVESTMENT IN PRIVATE BUSINESSES - FOR THE REVENUE END OF FAIR EXCHANGE**

### **A. Questions Considered**

Any Fair Exchange law will, of necessity, be a complex legal and economic structure. There are legal precedents for most of the proposed Fair Exchange features, although to date they have not all been combined in a single program. This article is based on a literature survey seeking precedents and guidance on the feasibility of Fair Exchange. It is a conceptual and historical overview, not an exhaustive study of each precedent.

This article does not report at length on each of the precedents reviewed, but instead focuses on those where the government or government-created citizen board of directors entered into contracts with private companies that involved an equity component with a structure similar to those of a private investment.

For each precedent, we investigated: 1) what their intended goals were; 2) whether their goals had been to broaden asset ownership; 3) how well did they succeed at their announced goals; 4) whether and how their structure or policies might inform future Fair Exchange policies; 5) whether the community got fair value for its investment in financial terms; 6) other social or economic return on investment obtained by the government or quasi-government body; and 7) available information on other impacts of the program. We also investigated the problem of quantifying non-monetary returns to communities, and suggested a preliminary basis for measuring community benefits.

### **B. Homestead Act of 1862**

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<sup>24</sup> William Greider, One World Ready or Not, The Manic Logic of Global Capitalism, Simon & Schuster (1997) pp. 341-345.

<sup>25</sup> Phillip Mattera and Anna Purinton, Shopping for Subsidies: How Wal-Mart Uses Taxpayer Money to Finance its Never-Ending Growth (Good Jobs First May 2004) p. 10

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U.S. government policy on the relationship between government, business and citizens in the 18<sup>th</sup>, 19<sup>th</sup> and early 20<sup>th</sup> centuries is a good starting point for comparison to and consideration of our policy options in the 21<sup>st</sup> century.

### **1. What was the context of the Homestead Act of 1862?**

Although it provided land to the landless, the central purpose of the Homestead Act was to settle the frontier, build communities and develop the U.S. economy. Other laws passed at the same time used government land to create agricultural colleges and induce railroad companies to build railroads in the frontier. Some well-respected scholars believe that large railroad companies, timber interests and land speculators got the best land and the most benefit from these laws.<sup>26</sup>

It is possible to discern other motives from the congressional debates at the time, including: 1) social justice (particularly racial and gender equality) - in many states, only white men with property could vote; 2) discovery of gold in California in 1848, and 10 years later, in Colorado and Nevada precipitated a rush of settlers and raw communities; 3) the secession of the Southern states from the Union shortly preceded passage of the Homestead Act in 1862; 4) growth of industry and economy in the U.S. by attracting workers to the West and to the country, particularly to work for railroad companies farm-market transportation industry.

The motivation to grow industry and economy by attracting settlers to the West can also be observed in related laws that preceded and accompanied the Homestead Act. The salient examples include the following. The Preemption Act of 1841<sup>27</sup>, which allowed squatters with an established claim, guaranteed permission to purchase their land at the minimum price of \$1.25 per acre, once the area opened for survey and settlement; the Graduation Act of 1854<sup>28</sup>, which reduced the price of public lands to settlers depending on the length of time it had been on the market<sup>29</sup>. The Morrill Land Grant Act 1862<sup>30</sup> provided for college land grants. The Pacific Railroad Act 1862<sup>31</sup> provided participating railroad companies with gratis 5 square miles of public land for every mile of rail laid. This was increased to 10 square miles when the Act was amended in 1864<sup>32</sup>. They also received a 400-foot right of way surrounding the whole railway (200 ft either side). Accordingly, 170 million acres were placed in hands of businessmen who became land speculators.

<sup>26</sup> Paul Wallace Gates, *The Homestead Law in an Incongruous Land System*, in AMERICAN HISTORICAL REVIEW 41, 4, 652-681 (July 1936)

<sup>27</sup> Citation

<sup>28</sup> 33rd Congress, Session I, Chap. 244, p. 574, August 4, 1854

<sup>29</sup> Lands that had been in the market for: ten years could be sold at \$1 per acre; for fifteen years, 75¢ per acre; twenty years, 50¢ per acre; twenty-five years, 25¢ per acre; thirty years, 12½¢ per acre.

<sup>30</sup> Act of July 2, 1862 (Morrill Land Grant Act), ch. 130, 12 Stat. 503, (current version at 7 U.S.C. 301 et seq.)

<sup>31</sup> Act of July 1, 1862 (Pacific Railway Act), 12 Stat. 489

<sup>32</sup> Senate Committee on Energy and Natural Resources report on H.R. 1658, 108<sup>th</sup> Congress, "Background" for the Railroad Right of Way Conveyance Validation Act of 2003, describing the land grant features of the Pacific Railroad Act of 1862, 12 Stat. 489 and its 1864 amendment 13 Stat. 356, c.216 (1864).

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Other data shows that the land grant acts that were enacted following the Homestead Act gave or sold larger plots to private corporations (303,500,000 acres), to schools, public works and other institutions (328,480,000 acres), and to the railroad corporations, veterans or sold under special timber or desert laws (224, 900,000 acres).<sup>33</sup> This government-business alliance gave rise to business tycoons such as Cornelius Vanderbilt, while it blunted the impact of homesteading for individuals. The post Civil War government favored business over farmers, and tariffs protected eastern industry. The Kansas-Nebraska Act 1854<sup>34</sup> opened up more land to offer to settlers as the government had ‘legal’ acquisition of land from Native Americans. Finally, the Taylor Grazing Act 1934<sup>35</sup> substantially decreased land available to homesteaders in the West by creating grazing districts on unappropriated and unreserved lands of the public domain.

The Homestead Act provided that any citizen (or applicant for citizenship) head of household, veteran or person over age 21 who had not fought against the U.S. could make a claim for 160 acres of certain public land and obtain title after building a home on it and farming it for 5 years.<sup>36</sup> However, the Homestead Act<sup>37</sup>, the Morrill Act<sup>38</sup> and the Pacific Railroad Act<sup>39</sup> were passed quickly after the South seceded. Until then, the Southern states had blocked the passage of the Act because of its possible impact on slavery in the south. If migrants came from northern territories, the new states would be free states, thus limiting the clout of slave states within the U.S. and increasing the clout of non-slave states. The enactment of the Kansas-Nebraska Act of 1854<sup>40</sup> was also a notable precursor to the passage of the land acts. The Kansas-Nebraska Act established the territories of Kansas and Nebraska while attempting to settle the controversy regarding slavery and the location of the transcontinental railroad. The Act provided that each state would have sovereignty over the slavery issue.<sup>41</sup> Thus, after the Southern states left the Union, the northern states seized the opportunity to get new states in the West developed as free (not slaveholding) states, and get the trans-continental railroad built in the North.<sup>42</sup>

Williams describes these acts as some of the first and most enduring pieces of major domestic policy.<sup>43</sup>

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<sup>33</sup> Data from the U.S. Dept of Interior Public Land Statistics, 1998 in Trina Williams, 2000, p.6

<sup>34</sup> Kansas Nebraska Act of 1854, U.S. Stats. At Large, Vol. 10, p. 277

<sup>35</sup> Taylor Grazing Act, 43 U.S.C. 315, June 28, 1936

<sup>36</sup> Act of May 20, 1862 (Homestead Act), Public Law 37-64, 392 (repealed FLPMA 1976)

<sup>37</sup> Act of May 20, 1862 (Homestead Act), Public Law 37-64, 392 (repealed FLPMA 1976)

<sup>38</sup> Act of July 2, 1862 (Morrill Land Grant Act), ch. 130, 12 Stat. 503, (current version at 7 U.S.C. 301 et seq.)

<sup>39</sup> Act of July 1, 1862 (Pacific Railway Act), 12 Stat. 489

<sup>40</sup> Kansas Nebraska Act of 1854, U.S. Stats. At Large, Vol. 10, p. 277

<sup>41</sup> <http://www.infoplease.com/ce6/history/A0827030.html> (accessed 9/22/05)

<sup>42</sup> D. Olson interview with Todd Arrington, historian, Homestead National Monument, U.S. Park Service May 20, 2004.

<sup>43</sup> Trina Williams, *The Homestead Act: A Major Asset-building Policy in American History – Working Paper 00-9*(p. 1), in INCLUSION IN ASSET BUILDING: RESEARCH AND POLICY SYMPOSIUM, St. Louis Washington University/Center for Social Development, at <http://gwbweb.wustl.edu/csd/Publications/2000/wp00-9.pdf>, accessed on July 8, 2004

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## ***2. What were the Homestead Act's specified objectives?***

The subtitle of the Homestead Act 1862<sup>44</sup> was, “An act to secure homesteads to actual settlers on the public domain,” which aptly describes its objective to ensure that those public lands were made available for use by families who would actually work them and not sold to wealthy individuals or speculators.

The intended purpose and benefits of Homestead Act of 1862<sup>45</sup> were summarized in an 1884 report to the Public Land Commission as

... the outgrowth of a system extending through nearly eighty years of history...the Homestead Act stands as the concentrated wisdom of legislation for the settlement of public lands. It protects the Government, it fills the States with homes, it builds up communities, and lessens the chances of social and civil disorder by giving ownership of the soil, in small tracts, to the occupants thereof.<sup>46</sup>

During the first century of U.S. history, the government had little cash and viewed land sales as a primary source of finance for the federal government.<sup>47</sup> During that century, the domestic economy developed and the land mass grew enormously through events such as the Louisiana Purchase, cession from Mexico, cession of land from states, and treaties with Great Britain, Spain and purchase from Texas.<sup>48</sup> In order to create a governable country spanning the continent, U.S. government policy included removal of the Native Americans and opening of these new lands to development by railroads, mining and timber companies, and homestead ownership by primarily European-Americans. Land was the major source of capital available to the U.S. government to induce developers and settlers to take considerable risks to build in the raw frontier.

It is clear that the primary objective of the government was to settle the West and to create new ‘free’ states. Since the prospects were formidable in those times, they had to give away land as incentive for anyone to go. Giving land to landless was not the primary objective, but a vehicle to achieving the primary objective.

## ***3. What is known of the benefits of the Homestead Act?***

The reported benefits of the Homestead Act include the following.

The following statistics show the number of homestead claims submitted, and the number of patents issued after 5 years. The largest number of applications was submitted between 1900 and 1909 (794,513 entries). The largest number of final titles granted was between 1910 and 1919 (384,954 homesteads). Between 1862 and 1938, 3 million

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<sup>44</sup> Act of May 20, 1862 (Homestead Act), Public Law 37-64, 392 (repealed FLPMA 1976)

<sup>45</sup> Act of May 20, 1862 (Homestead Act), Public Law 37-64, 392 (repealed FLPMA 1976)

<sup>46</sup> T. Donaldson, *The public domain: its history, with statistics*, (p. 350), New York: Johnson Reprint Corp. (1884/1970) in *supra*, Trina Williams, 2000

<sup>47</sup> Supra, Trina William pp. 1-2.

<sup>48</sup> Supra, Trina Williams pp. 1, 2 and 22.

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people applied and almost 1.5 million households were given title to 246 million acres of land. This acreage compares closely to the land area of Texas and California combined<sup>49</sup>. The U.S. Department of Interior (1998) lists that 287.5 million acres of the public domain were granted or sold to homesteaders. This is approximately 20% of public land.<sup>50</sup>

Billington describes the Homestead Act as a failure in terms of its reformist origins, because the laborers it was intended to help did not have the money to move west, or to buy equipment. The law didn't provide enough land to successfully farm on the Great Plains.<sup>51</sup> Similarly, according to Fred Shannon<sup>52</sup>, most of choice land was picked over before the Act passed and, in any case, the government didn't implement any help for those who wanted to take advantage of it. Without some support, the act could only benefit monopolists or those with ample means.<sup>53</sup> Since the federal government had acquired the Western territories as legal property to give away, few Native American tribes remained free, and the majority had been restricted to small reservations on land that, according to data in Schwartz' article, was 55% untillable<sup>54</sup>.

Table 8 in Schwartz<sup>55</sup> article has an approximate comparison of those who filed original and final entries between 1900 and 1910. It doesn't include homesteads commuted before 5 years and doesn't provide any evidence of economic success of the occupant. However, the table shows that 3 out of 5 homesteaders failed to last the five years. According to Schwartz calculation, if it is assumed that each homesteader was the head of a household of five, and no-one filed for more than one homestead, then all of those involved in homestead filings between 1900-1910 accounts for less than 6% of population at the time.<sup>56</sup>

Although the Homestead Law did not explicitly exclude blacks from homesteading, often the laws were administered to exclude them.

"Blacks were ineligible for any public land prior to the Civil War because they were not considered citizens. After the Emancipation Proclamation and the end of the Civil War, the situation of Black freedmen and women often depended upon local leadership and conditions. As early as 1865, certain white Southerners

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<sup>49</sup> Trina Williams, pp. 5-6

<sup>50</sup> Trina Williams, p. 6

<sup>51</sup> Ray Allen Billington, *Westward Expansion: A History of the American Frontier*, fourth edition (New York Macmillan Publishing Co 1974) pp. 607-09; in E. A. Schwartz, Comparing Allotment and Homesteading, 1900-1915, in Native American Documents Project (2004: 1)

<http://csusm.edu/nadp/acompare.htm>, accessed on 4/29/05

<sup>52</sup> Fred A. Shannon, 1968 "Comparing Allotment and Homesteading, 1900-1915", *Native American Document Project*. p 303 <http://www.csusm.edu/nadp/acompare.htm> accessed on February 24, 2005.

<sup>53</sup> Fred A. Shannon, 1968: 303 ibid.

<sup>54</sup> E. A. Schwartz, Comparing Allotment and Homesteading, 1900-1915, in Native American Documents Project (2004: 1) <http://csusm.edu/nadp/acompare.htm>, accessed on 4/29/05

<sup>55</sup> E. A. Schwartz, 2004, p. 3

<sup>56</sup> E. A. Schwartz, 2004, p. 1-2

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put legal obstacles in place to prevent ex-slaves from acquiring property<sup>57</sup>.

Magdol (1977) explains,

“In the provisional state governments under President Johnson’s protective leniency, planters not only prohibited black landownership but enacted extreme measures of social control that virtually restored slavery. The black codes struck directly at freedmen striving to escape the subordination and to obtain their communities. It was class and race legislation.”<sup>58</sup>.

The Freedmen’s Bureau invalidated such measures but there was no enforcement. In some cases Black Buffalo Soldiers were denied the right to make claims for land they fought to defend by the people they defended.<sup>59</sup>

“On June 21, 1866, Congress passed the Southern Homestead Act. Forty-six million acres of unsold public land in Alabama, Arkansas Florida, Louisiana, and Mississippi were set aside for purchase in 80-acre plots, then later 160-acre plots. The primary beneficiaries, at least in the first six months, were to be landless freedmen . . . . The desire for land among the former slaves was strong and they deluged local land officers with requests for homesteads.<sup>60</sup>

However, much of the land was poor and, before it had been distributed, the Act was repealed (June 1876). Subsequently, the homestead only clause was removed and the land was opened up for sale<sup>61</sup>.

“Of the 67,600 homestead applications made under the Southern Homestead Act, only 27,800 at most received final patent, which equates to the transfer of 2.9 million acres, about 6% of the land originally offered. Estimates from a sample of homestead claims in Mississippi reveal that about 23% of claimants, under the Southern Homestead Act were judged to be Black. In that sample, 35% of Black claims were successful compared to 25% of white claims.<sup>62</sup> Using these percentages, 5,440 of the 27,800 final patents may have been awarded to Black homesteaders. Citing Magdol (1977), only 4,000 Blacks even made homestead entries under the Act<sup>63</sup>.

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<sup>57</sup> Williams, 2000: 9

<sup>58</sup> E. Magdol, *A Right to the Land: Essays on the freedmen’s community*, Westport, CT: Greenwood Press (1977) in Trina Williams, 2000, pp. 8-9

<sup>59</sup> Trina Williams p.9 citing C. Cox (1993), “The forgotten heroes: The story of buffalo soldiers”. New York: Scholastic Inc.

<sup>60</sup> M. L. Lanza, *Agrarianism and reconstruction politics: The Southern Homestead Act*, Baton Rouge: Louisiana State University (1990) in Trina Williams, p.10

<sup>61</sup> M. L. Lanza, *Agrarianism and reconstruction politics: The Southern Homestead Act*, Baton Rouge: Louisiana State University (1990) in Trina Williams, p.10

<sup>62</sup> M. L. Lanza, *Agrarianism and reconstruction politics: The Southern Homestead Act*, Baton Rouge: Louisiana State University (1990) in Trina Williams, p.10

<sup>63</sup> E. Magdol, *A Right to the Land: Essays on the freedmen’s community*, Westport, CT: Greenwood Press (1977, p. 160) in Trina Williams, 2000, pp. 8-9

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Thus, Blacks who wanted to be small farm owners were given much less opportunity than comparable whites when the government was giving away free land<sup>64</sup>.

#### ***4. Did the Homestead Act have a lasting impact on the U.S. economy?***

Williams poses the question: how many people living today had ancestors who acquired property through the Homestead Act?<sup>65</sup> As a means of gauging the Act's long-term impact, Williams<sup>66</sup> calculates the living descendants of each family that acquired property under the Homestead Act based on three different sets of assumptions. The most aggressive showing that in the year 2000 there were 93 million living descendants of the Homesteaders, which (based on 2003 population of 293 million<sup>67</sup>) would make those descendants approximately 32% of the current U.S. population. Her medium estimate was 46 million descendants, or 25% of the current adult population. Her most conservative estimate in which the homestead property passed to only one descendent per generation was 20 million. "Taking the medium estimate of 46 million...would mean that a quarter of the adult population potentially has a legacy of property ownership and assets in their background that can be directly linked to...the homestead policy".<sup>68</sup>

Land ownership changed the lives of landless families in numerous ways, providing upward mobility and a more secure future for the homesteader and his descendants.<sup>69</sup>

"Just as gaining an education is the surest way to rise in society today, in colonial days the acquisition of property was the key to moving upward from a low to a higher stratum. The property holder could vote and hold office, but the man with no property was practically on the same level as the indentured servant or slave".<sup>70</sup>

Todd Arrington, historian at the Homestead National Monument of America calculates that the "the Homestead Act is still responsible for the generation of \$46.3 billion every year".<sup>71</sup> Although some drawbacks have been identified regarding the Homestead Act (poor land, lack of implementation help, selective administration regarding racial eligibility, etc.), it provided a voice and an opportunity for some small landholders.

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<sup>64</sup> Williams, 2000, p. 10

<sup>65</sup> Trina Williams pp. 6 - 7

<sup>66</sup> Trina Williams (pp.7-8 and Chart I)

<sup>67</sup> U. S. Census press release dated 12/22/2004 estimating the U.S. population as of July 1, 2004.

<sup>68</sup> Trina Williams, p. 8.

<sup>69</sup> Trina Williams, p. 3.

<sup>70</sup> Dick Everett, 1970 1-2, as cited on p. 3 of Williams.

<sup>71</sup> Todd Arrington, Historian at the Homestead National Monument of America, "Economics and the Homestead Act" (2005) "bases his calculation as follows: "All the states that had homesteading at some point in American history have a modern combined gross state product of \$4.63 trillion. If we assume that just one percent of that modern total can be related to homesteading (via agriculture, manufacturing, retail sales, real estate, etc.), that means that the Homestead Act is still responsible for the generation of \$46.3 billion every year... Dollar figures taken from the website of the United States Census Bureau. 1998 figures are the most recent available."

Williams argues that the Act was progressive, insofar as it broadened the base of asset ownership beyond the wealthy.<sup>72</sup>

### ***5. Relationship between the Homestead Act and Fair Exchange***

The Homestead Act was one of the country's first and most enduring economic policies. It embodied the Jeffersonian concept that American democracy is best protected when the majority of common people have a material stake in society, and that it is in the best interest of the country as a whole to enable broad stake holding. It was a major force in the settlement of the Western territories. It may have provided a portion of the asset basis for 25-32% of the adults currently living in the U.S.

It does not provide Fair Exchange any models for administration or technique.

It does support the proposition that building assets amongst the common folks helps promote healthy growth. The Homestead Act succeeded at its goal of populating and taming the frontier. Since broad asset distribution was not the primary purpose of the Act, we have thus far found no research directly on that point. The Association of Government Historians is currently working on a study looking at GDP before and after Homesteading.<sup>73</sup>

It also exemplifies the ways in which our government programs aimed at promoting general prosperity have often excluded those with the greatest need, such as recently freed black slaves and dispossessed Native Americans. One cannot help but wonder if the inner cities of our big cities might not have many of their current problems if we had made the Homestead Act readily available to freed slaves, or actually provided the often discussed, but never enacted, 40 acres and a mule.

Similar mistakes were repeated during the post-World War II housing boom, when GI bill and Federal Housing Administration (FHA) low interest loans were readily available to veterans and working class people. But, people of color were generally unable to take advantage of these programs due to housing discrimination and redlining. Most Blacks could only purchase homes in traditionally black communities. Most commercial lenders would not make home loans in those communities. So, although the loan guarantees were theoretically available, Black people were not able to take advantage of those benefits in the same proportion as whites. Thus, they missed out on the huge increase in asset value and assets that a wide swath of middle class Americans received between the end of World War II and 1980.<sup>74</sup>

During the 19<sup>th</sup> century in addition to the Homestead Act, the U.S. government gave vast amounts of land to private businesses to build railroads. These government grants helped

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<sup>72</sup> Williams, 2000, p. 10

<sup>73</sup> D. Olson interview with Todd Arrington, historian, Homestead National Monument, U.S. Park Service May 20, 2004.

<sup>74</sup> Thomas Sugrue, *The Origins of the Urban Crisis: Race and Inequality in Postwar Detroit*, Princeton University Press (1996) pp.67, 71-72.

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build the vast fortunes for a few families such as the Vanderbilts, Goulds, Harrimans and others referred to historically as robber barons.<sup>75</sup> The concentrated wealth in the hands of a few robber barons ultimately led to the creation of anti-trust laws to break up that wealth for the benefit of society. Today we face a similar concentration of wealth in the hands of a few. But they are global, not national corporations. There is no global government to break up the wealth concentration. Fair Exchange is a means to begin broadening the ownership of concentrated corporate wealth and chip away at the problem, prior to the creation of global government.

Important lesson of the Homestead Act are that it provided ownership enabling family farms, population of the West and consolidation of the country. The policy was in effect from 1862-1998 and may have helped asset accumulation of 25% -32% of the current U.S. population. Even though we may not be able to use any specifics of the Homestead Act in a Fair Exchange legislative model, the lesson for Fair Exchange is that a policy that broadens ownership can profoundly impact the future of a community.

### C. Tennessee Valley Authority (TVA)<sup>76</sup> – A Very Fair Exchange

The TVA is a striking example of a successful public/ private partnership, in which the public got a very fair exchange for its investment. The federal government's initial investment of \$50 million<sup>77</sup> and subsequent appropriations totaling approximately \$1 billion (inclusive of the initial \$50 million) through the 1950's paid off handsomely, and has fulfilled its objectives well.

The TVA began repaying the U.S. Government for its appropriation investment in 1948 on a sliding scale. "A return on the U.S. Government's initial appropriation investment in TVA power facilities, plus a repayment of the initial investment, is specified by law. The payment for 2000 was \$54 million, and total cumulative repayments and return on investment by TVA to the U.S. Treasury exceed \$3 billion." *TVA 2000 Annual Report*<sup>78</sup>

TVA is now entirely self-supporting on its power generation revenue, which as of 2004, was over \$7 billion per year serving a 41,000 square mile watershed.<sup>79</sup> It annually pays local governments \$338 million in payments in lieu of taxes.<sup>80</sup> TVA provides wholesale electricity, serving 8.5 million people through 158 local power distributors, including municipalities, cooperatives, industries and eight federal government agencies.<sup>81</sup> TVA

<sup>75</sup> Long, J. Bradford (Prof. University of California Berkley and NBER), *Robber Barons* (Draft 2, 1/1/1998) found on Prof. Long's web site: <http://www.j-bradford-delong.net/> (accessed on 3/23/05).

<sup>76</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831.

<sup>77</sup> C. Herman Pritchett, "The Tennessee Valley Authority as a Government Corporation", Social Forces, Vol.16 No. 1, October 1937, 120 at 122.

<sup>78</sup> *TVA 2000 Annual Report*, Management's Discussion and Analysis

<sup>79</sup> Tennessee Valley Authority Official web site, FAQ, [www.tva.gov/abouttva/keyfacts.htm](http://www.tva.gov/abouttva/keyfacts.htm) " How is TVW Funded?" 03/11/05

<sup>80</sup> Tennessee Valley Authority Official web site, FAQ, [www.tva.gov/abouttva/keyfacts.htm](http://www.tva.gov/abouttva/keyfacts.htm) " Does TVA Pay Taxes?" 03/11/05

<sup>81</sup> Tennessee Valley Authority Official web site, FAQ, [www.tva.gov/abouttva/keyfacts.htm](http://www.tva.gov/abouttva/keyfacts.htm) "How is TVA Electricity distributed?" 03/11/05

electricity costs less than most electricity produced around the nation.<sup>82</sup> Its waterways reduce transportation costs for Valley businesses by \$400 million each year compared to other modes of shipping.

TVA does all of the above while also providing flood control, improving river navigation, serving as a regional economic development agency and lender, developing and teaching modern agricultural and environmental stewardship methods, providing recreational spaces and opportunities, creating small business incubators, bringing local communities into the information age, and improving business and workforce productivity.<sup>83</sup> During its heavy dam construction phase in the 1940's it had over 28,000 employees<sup>84</sup>. It reported in its 2004 Annual Report that over the past three years it helped its development partners attract or retain 145,000 jobs, provided \$57.4 million in loan commitments, which leveraged \$832 million in additional investments. In FY 2004 in combination with its partners it leveraged investments of \$2.1 billion.<sup>85</sup>

### ***1. What was the stated objective of the Tennessee Valley Authority?***

The TVA was one of the most visionary of President Franklin Roosevelt's New Deal innovations developed to lift the nation out of the Great Depression. The Depression's devastating impact on the South, and the ongoing dispute (described below) about how to deal with the government owned dam project and nitrate plants at Muscle Shoals, Alabama, enabled Roosevelt to embark on a grand plan to create a regional planning agency on a scale never before attempted. After his 1932 election Roosevelt said "It is clear that the Muscle Shoals development is but a small part of the potential public usefulness of the entire Tennessee River ...transcends mere power development ...and leads logically to national planning for a complete river watershed involving many States and the future lives and welfare of millions."<sup>86</sup> He asked Congress to create "a corporation clothed with the power of government but possessed of the flexibility and initiative of a private enterprise". May 18, 1933, the TV Act was passed. Its stated purpose was:

An Act to improve the navigability and to provide for the flood control of the Tennessee River; to provide reforestation and the proper use of marginal lands in the Tennessee Valley; to provide for the agricultural and industrial development of said valley; to provide for the national defense by the creation of a corporation for the operation of

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<sup>82</sup> The cost of one kilowatt-hour for TVA customers is 6.4 cents versus the national average of 8.5 cents. Tennessee Valley Authority Official web site, FAQ, [www.tva.gov/abouttva/keyfacts.htm](http://www.tva.gov/abouttva/keyfacts.htm) 03/11/05

"How do TVA rates compare with those of other power companies?"

<sup>83</sup> Tennessee Valley Authority Official web site, FAQ, [www.tva.gov/abouttva/keyfacts.htm](http://www.tva.gov/abouttva/keyfacts.htm) "What contribution does the TVA make to the Valley economy?" 03/11/05

<sup>84</sup> Tennessee Valley Authority Official web site, "A Short History of the TVA"  
[www.tva.gov/abouttva/history.htm](http://www.tva.gov/abouttva/history.htm) 03/11/05

<sup>85</sup> TVA Annual Report 2004 p.12

<sup>86</sup> Thayer Watkins, "Regional Development Policies and Programs of the U.S." Economics Department, San Jose State University, [www2.sjsu.edu/faculty/Watkins/usreg.htm](http://www2.sjsu.edu/faculty/Watkins/usreg.htm) 3/12/05

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Government properties at and near Muscle Shoals in the State of Alabama, and for other purposes.<sup>87</sup>

## 2. TVA History

In 1926 Senator George Norris (R. Nebraska) introduced a bill directing the federal government to take over and expand the Wilson Dam project at Muscle Shoals, Alabama and to build more federal dams along the Tennessee River. Norris' concern for farmers caused him to vehemently oppose President Warren G. Harding's attempt to privatize the federal project to build the Wilson Dam at Muscle Shoals<sup>88</sup>. In 1921 Henry Ford offered to lease the dam and two nitrate plants for \$5 million through the next century. Norris believed this was not a good deal for the government or for the local farmers and workers. He described it as the worst real estate deal "since Adam and Eve lost title to the Garden of Eden".<sup>89</sup> Although the project made no progress in the Coolidge administration and was later vetoed by Herbert Hoover, it was ready and waiting for Roosevelt, who got it enacted in 1933.

During its early days, owners and managers of power companies that served the Tennessee Valley, criticized the TVA as being both unnecessary and creating unfair subsidized competition. Its best-known critic was Wendell Willkie<sup>90</sup>. Wilke helped create Commonwealth and Southern utility company ("C&S"). Along with the Tennessee Electric Power Company ("TEPCO")<sup>91</sup>, Willkie and C&S waged a 5-year battle against the TVA, challenging TVA's constitutionality. In January of 1939<sup>92</sup> the U.S. Supreme Court ruled that the TVA had the right to build power plants in competition with private companies. Shortly thereafter, TVA bought C & S's facilities.

In its early years when it was supported by Congressional appropriations, the TVA was able to develop fertilizers for growing crops and trees, teach farmers how to improve crop yields, help to replant forests, control forest fires, improve habitat for wildlife and fish. The most dramatic change came from the electricity generated by TVA dams. Electric lights and appliances made life easier and farms more productive. Electricity also drew industries into the region – and therefore jobs.<sup>93</sup> During the 1940s, the TVA engaged in one of the largest hydropower construction programs in order to produce aluminum for bombs and planes.

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<sup>87</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831.

<sup>88</sup> Insert bill number.

<sup>89</sup> Jack Neely, Tennessee Valley Authority Official web site, "Clash of the Titans", [www.tva.gov/heritage/titans/index.htm](http://www.tva.gov/heritage/titans/index.htm) 03/11/05

<sup>90</sup> Tennessee Valley Authority Official web site, "The Indiana Farmer" TVA Heritage, [www.tva.gov/heritage/wilke/index.htm](http://www.tva.gov/heritage/wilke/index.htm) 03/12/05

<sup>91</sup> Timothy P. Ezzell, "Jo Conn Guild" *The Tennessee Encyclopedia of History and Culture*, Tennessee Historical Society 1998, Online edition 2002 University of Tennessee Press, <http://160.36.208.47/FMPro?-db=tneencyc&-format=tdeatil.htm&-lay=web&entryid=G050> 3/12/05

<sup>92</sup> Tennessee Electric Power Co. et al v. Tennessee Valley Authority, et al, 306 U.S. 118; 59 S. Ct. 366; 83 L. Ed. 543; 1939 U.S. LEXIS 973 (1939)

<sup>93</sup> Tennessee Valley Authority Official web site, "A Short History of the TVA" 03/11/05

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By the 1950s, TVA had become the nation's largest supplier of electricity and had completed a 650-mile navigation channel the length of the Tennessee River. Still demand exceeded supply but the TVA couldn't get further federal appropriations to build coal-fired plants so it asked for the authority to issue bonds.

President John F. Kennedy enjoyed playing off President Dwight Eisenhower's remark that the TVA represented "creeping socialism". In a 1963 speech at the TVA Kennedy said "The tremendous economic growth of this region, its private industry and its private income ...make it clear to all that the TVA is a fitting answer to socialism – and it certainly isn't creeping."<sup>94</sup>

Legislation was enacted in 1959 for the TVA power system to become self-financing.

The 1960s were years of unprecedeted economic growth in the Tennessee Valley. TVA began to build nuclear plants as a new source of economical power. During the 1970's and 1980's the TVA had difficulty keeping its power costs competitive. It had overbuilt nuclear power facilities, and the oil embargo and increased fuel costs required it to cancel several planned nuclear facilities. In the 1990's it cut its staff in half, reduced expenses and began to stabilize and then reduce its power rates again.<sup>95</sup> Since the late 1990's it has developed a strong pollution control system and begun to invest in solar and wind energy.<sup>96</sup>

### ***3. TVA Structure and Organization***

The Board of Directors is composed of three members who are U.S. citizens appointed by the President of the United States, with the advice and consent of the Senate. Each member is appointed for nine years. The U.S. President appoints the Chair. Board membership is a full-time job compensated by the TVA at a rate comparable to a Level IV Executive Schedule civil servant (the chair is Level III). Directors may live in homes provided by the Government (may now be the TVA), and they must not have any financial or business interests in the power industry or adverse to the TVA.<sup>97</sup> Any board member can be removed at any time by a concurrent resolution of the House of Representatives and the Senate.<sup>98</sup>

The Board directs the corporation, including hiring, firing, contracting, buying and selling assets, etc. However, they are required to pay "prevailing wages" and must give "due regard...to those rates which have been secured through collective agreement by representatives of employers and employees."<sup>99</sup>

<sup>94</sup> Tennessee Valley Authority Official web site, "TVA on the New Frontier", [www.tva.gov/heritage/jfk/index.htm](http://www.tva.gov/heritage/jfk/index.htm) 03/11/05

<sup>95</sup> Tennessee Valley Authority Official web site, "A Short History of the TVA" 03/11/05

<sup>96</sup> TVA Annual Report 2004 "Highlights".

<sup>97</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 2.

<sup>98</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 4

<sup>99</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 3

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The TVA can sue and be sued in its own name, controls its corporate name, can adopt, amend or repeal its bylaws. However, it also has the power to exercise the right of eminent domain in the name of the U.S. Government. It has the power to acquire real estate for the construction of dams, reservoirs, transmission lines, power houses, navigation projects and other structures along the Tennessee River or its tributaries and may use eminent domain to condemn property that private owners refuse to sell it at a fair price. It may also convey or lease land in the name of the U.S. to any corporation or person for use as summer residences, pleasure resorts, or for any purposes to assist shipping or manufacturing with approval from Congress. Numerous specific dams, plants and other facilities are named as either prohibited from being sold by the TVA or permitted to be sold.<sup>100</sup> TVA has authority to help in adjustment of population displaced by its projects, to provide rights of way and easements to local governments, and to create its own law enforcement agents to maintain order on its properties.<sup>101</sup> TVA has the authority not only to produce fertilizer, but to create major programs to experiment with new fertilizer projects and methods through agreements with farmer, farm organizations, agricultural colleges, demonstration farms (except when the nitrogen facilities are needed for military purposes) and to create labs and plants to develop nitrogen products for the military.

TVA has the right to seek assistance from any other federal agency, and the President shall direct that such assistance be rendered, if in his opinion it suits the public interest. Yet the patents on inventions and discoveries created, even by Government employees working on TVA projects, belong to the TVA.<sup>102</sup>

Competitive bidding is required for contracts over \$25,000 except in emergencies or repair situations. The Comptroller General of the U.S. audits the TVA at least annually.<sup>103</sup> TVA has an independent Inspector General's Office appointed by Congress that continuously examines the programs, contracts, and financial reports of TVA to identify areas of needed improvement to insure a more successful TVA, prevent and correct fraud.<sup>104</sup>

#### ***4. TVA public/private business model***

TVA is authorized to sell its power in excess of its own needs on the open market; however, it must give preference to States, counties, municipalities, cooperatives, and non-profit farmers or citizens organizations supplying their own members. It has the authority to build electrical transmission lines to rural communities not served at reasonable rates and make all necessary reasonable rules and regulations for equitable distribution of electric power, and to do experiments to promote wider and better use of electricity.<sup>105</sup> TVA projects are considered to be primarily for the benefit of the people of

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<sup>100</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 4

<sup>101</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 4A

<sup>102</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 5

<sup>103</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 8

<sup>104</sup> Web site of the Office of the Inspector General of the TVA, <http://oig.tva.gov/>. 3/13/05

<sup>105</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 10

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the area, and particularly for the domestic and rural consumers. Industrial uses get secondary priority and are undertaken to make the production of energy affordable for domestic and rural consumers. Entities to which TVA sells wholesale power must distribute it on a fair basis to retail customers not to exceed scheduled rates set by the TVA board.<sup>106</sup> TVA is authorized to make payments-in-lieu-of-taxes to States and municipalities in which its facilities are located and is otherwise exempt from local taxes. These payments are apportioned as half based on business income in the State, county or municipality and half based on property asset value.<sup>107</sup>

From its inception until 1959, Congress provided the TVA authority to issue bonds for specific projects fully backed by the U.S. Treasury.<sup>108</sup> In 1959 Congress expanded TVA's bonding authority to permit it to issue bonds on TVA's credit as needed to support itself as a business independent of government subsidy.<sup>109</sup> These new TVA bonds were not guaranteed by the U.S. Government, but are exempt from State or local taxes other than inheritance, estate or gift taxes.<sup>110</sup> However, TVA still has to provide the Treasury Secretary notice of bond issuance seeking approval as to timing and rate. If the Secretary does not approve these bonds, the TVA may issue them as interim bonds to the Secretary, which the Secretary is directed to purchase up to a limit of \$150,000,000 outstanding at one time. If the TVA and Secretary do not reach agreement on purchase of interim bonds within 8 months after their issue, the TVA may proceed to sell them on the open market.<sup>111</sup>

Beginning in 1961, the U.S. Government required the TVA to start repaying (from proceeds in excess of those needed to meet the TVA's ongoing obligations) the investment the Government made to create and underwrite the TVA's development, at the rate of not less than \$10 million for each of the first 5 fiscal years, \$15 million for each of the next 5 years and \$20 million for each year thereafter until a total of one billion dollars of the appropriation investment shall have been repaid. The repayment plan also provided for the TVA board to defer payments for up to 2 years due to inadequacy of funds occasioned by drought, emergency, poor business conditions or other matters outside the TVA's control.<sup>112</sup>

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<sup>106</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 11 -12

<sup>107</sup> Tennessee Valley Authority Act of 1933, 48 Stat.58-59, 16 U.S.C. § 831, Section 13

<sup>108</sup> Tennessee Valley Authority Act of 1933, 48 Stat.66-67, 16 U.S.C. § 831n(1933), 49 Stat 1078, 16 U.S.C. Sec. 831n-1(1935), 53 Stat 1083, 16 U.S.C. Sec. 831n-2 (1939), Section 15

<sup>109</sup> Tennessee Valley Authority Act of 1933 Section 15d, 48 Stat.66-67 as amended by 73 Stat.280 (1959), 73 Stat.338 (1959), 80 Stat.364 (1966), 84 Stat. 915 (1970), 89 Stat.750 (1975), 90 Stat.376 (1976) and P.L. No 96-97 (Oct.31, 1979), 16 U.S.C. Sec. 831n-4.

<sup>110</sup> Tennessee Valley Authority Act of 1933 Section 15d (b) and (d), 48 Stat.66-67 as amended by 73 Stat.280 (1959), 73 Stat.338 (1959), 80 Stat.364 (1966), 84 Stat. 915 (1970), 89 Stat.750 (1975), 90 Stat.376 (1976) and P.L. No 96-97 (Oct.31, 1979), 16 U.S.C. Sec. 831n-4.

<sup>111</sup> Tennessee Valley Authority Act of 1933 Section 15d(c), 48 Stat.66-67 as amended by 73 Stat.280 (1959), 73 Stat.338 (1959), 80 Stat.364 (1966), 84 Stat. 915 (1970), 89 Stat.750 (1975), 90 Stat.376 (1976) and P.L. No 96-97 (Oct.31, 1979), 16 U.S.C. Sec. 831n-4.

<sup>112</sup> Tennessee Valley Authority Act of 1933 Section 15d (e), 48 Stat.66-67 as amended by 73 Stat.280 (1959), 73 Stat.338 (1959), 80 Stat.364 (1966), 84 Stat. 915 (1970), 89 Stat.750 (1975), 90 Stat.376 (1976) and P.L. No 96-97 (Oct.31, 1979), 16 U.S.C. Sec. 831n-4.

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During the first 25 years of TVA's existence, the U.S. Government made appropriation investments in TVA power facilities. In 1959 TVA received congressional approval to issue bonds to finance its growing power program. For the past four decades, TVA's power program has been required to be self-supporting. As a result, TVA funds its capital requirements through internal cash generation or through borrowings (subject to a congressionally mandated \$30 billion limit).<sup>113</sup>

Theft of its property or fraud against TVA is treated as theft or fraud from the U.S. Government<sup>114</sup> and the Government has the authority to take over any or all of TVA's facilities in case of war or national emergency.<sup>115</sup>

### **5. Is the TVA relevant today?**

The TVA by operating as a quasi-private company, with government investment and oversight, has provided a wide range of much-needed public services for over 70 years, and has repaid the public investment many times over. It is difficult to imagine using the TVA model in the current political atmosphere, which focuses on privatization of much more standard public services and New Deal programs, such as Social Security. Yet, if there is a global economic crisis caused by the rising economic hegemony of China<sup>116</sup>, or decreasing access to petroleum, a TVA type of solution in some field, such as biomass fuel generation is possible. The devastation of large parts of Mississippi, Louisiana and Texas by the 2005 hurricanes may be the sort of crisis that makes TVA type solutions relevant. Sen. Edward M. Kennedy, D-Mass., proposed that Congress create a Gulf Coast Redevelopment Authority, modeled after the Tennessee Valley Authority, to oversee the reconstruction.<sup>117</sup>

It is crucial to understand and consider utilizing features of this well-crafted public/private venture. The TVA got traction as a bold idea out of grave necessity. The Great Depression was a crisis in capitalism caused by, among other things, major changes in methods and locations of production (the rapid urban industrialization of the early 1900's and a major agricultural crisis) and an insufficiently regulated Wall Street investment community. The early 21<sup>st</sup> century is a similar period of global economic change and dislocation. The role of the U.S. as a global economic player is changing, particularly with regard to China and other Asian countries. The U.S. continues to lose increasingly higher skilled jobs to lower wage countries and is increasingly indebted to

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<sup>113</sup> *TVA 2000 Annual Report*, Management's Discussion and Analysis

<sup>114</sup> Tennessee Valley Authority Act of 1933 Section 21, 48 Stat.68-69, 16 U.S.C. Sec. 831t

<sup>115</sup> Tennessee Valley Authority Act of 1933 Section 20, 48 Stat.68 as amended by 96 Stat.49, 16 U.S.C. Sec. 831s

<sup>116</sup> Oded Shenkar, *The Chinese Century, the Rising Chinese Economy and its Impact on the World Economy, the Balance of Power, and Your Job*, Wharton School Publishing (2005) pp. 170 – 176.

<sup>117</sup> WSVN-TV and Associated Press, "Rebuilding Gulf Coast after Katrina most expensive U.S. reconstruction project to date", 9/23/05, found at <http://www1.wsxn.com/news/articles/national/MIA7332>  
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these countries as well.<sup>118</sup> At some point in the near future it is not unreasonable to anticipate that there will be a sufficient crisis in the U.S. economy that may change the political atmosphere away from its current laissez faire direction, providing openings for strategies that utilize government investment as pro-actively as did the TVA.

#### ***6. The Importance of Integrity in the New Deal Programs***

Integrity in the use of public funds in the private sector was a key feature of the New Deal programs.

It's possible to spend large sums honestly, as Franklin D. Roosevelt demonstrated in the 1930's. F.D.R. presided over a huge expansion of federal spending , including a lot of discretionary spending by the Works Progress Administration. Yet the image of public relief, widely regarded as corrupt before the New Deal, actually improved markedly. ... [T]he New Deal made almost a fetish out of policing its own programs against potential corruption....F.D.R. created a powerful "division of progress investigation" to look into complaints of malfeasance in the WPA. The division proved so effective that a later Congressional investigation couldn't find a single serious irregularity it had missed.<sup>119</sup>

The political climate in the U.S. may be changing as the consequences of privatization and tax cuts begin to take their toll on public well-being. The combined social costs of tax cuts, the Iraq war and reconstruction of the massive hurricane damage may change the political climate regarding government spending that will make the New Deal programs more appealing. Particularly when their New Dealers judicious use of public funds is compared with the corruption of the current proponents of less government and privatization, such as the S&L bailout and the Enron scandal, there may be a resurgence of interest in and relevance of the New Deal programs such as the TVA and the Works Progress Administration.

#### **D. 1971 Lockheed Loan Guarantee**

The 1971 Federal Government loan assistance to Lockheed Corporations set an important precedent, showing the willingness of the government to provide financial assistance to a failing non-government corporation.<sup>120</sup> The Emergency Loan Guarantee Act of 1971 passed by a very slim margin in the House and Senate. The justification was the

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<sup>118</sup> Niall Ferguson, "Our Currency, Your Problem: Why Asian banks finance the U.S. way of life?" *New York Times Magazine* p. 19 –22 (3/13/05). "...between 70 and 80 percent of the American economy's vast and continuing borrowing requirement is being met by foreign (mainly Asian) central banks. ... The Bush Administration's tax cuts for the Republican base and a Global War on Terrorism is being financed with a multibillion dollar overdraft facility at the People's Bank of China." (p. 19) "...according to a growing number of eminent economists, this arrangement cannot last. ...Sooner or later they (the Asian banks) have to get out – at which point the dollar could plunge relative to Asian currencies by as much as 1/3 to 2/5ths and U.S. interest rates would leap upward." (P.20)

<sup>119</sup> Paul Krugman, "Not the New Deal", *New York Times* p.A27, September 16, 2005.

<sup>120</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 10.

protection of 60,000 jobs, a potential GNP loss of \$120 to 475 million, mostly in California, just as the economy was recovering from the 1969-70 recession.<sup>121</sup> Other arguments for the loan guarantee were that Lockheed was a major defense contractor, and that its passing from the scene would leave only two major companies in the aerospace industry, causing potential anti-trust issues, and a lack of price competition on military contracts.<sup>122</sup>

The government protected its investment in Lockheed in many ways. It appointed a board consisting of the Secretary of Treasury, Chair of the Federal Reserve System and the Securities and Exchange Commission Chair. The Board was charged with obtaining sufficient collateral. The Act restricted payment of dividends on common stock and payment of other loans to a lender receiving a loan guarantee. The board had power to change management, approve asset sales, inspect the books and have a GAO audit.<sup>123</sup>

The government's loan guarantee of \$250 million enabled Lockheed to obtain a new aid package of \$750 million. Lockheed retired the government loan guarantee early, as it was able to replace it with a revolving credit agreement for \$100 million.<sup>124</sup>

The Act was worded to allow emergency loan guarantees to any major business<sup>125</sup> enterprise, although it was clearly intended to provide a \$250 million loan guarantee to Lockheed.<sup>126</sup>

Thus, at its birth, the Congress understood that such a policy should cover a broad range of possible investment transactions between government and business. This article contends that such a policy is increasingly necessary in a global economy. The government's subsequent case-by-case actions (such as those naming Chrysler or the airline industry) have mistakenly avoided implementation of a clear general policy. A well-constructed federal policy on government investment in private businesses would create a model and a platform for similar policies at the state and local level. This article aims to illuminate examples and help create such policy models.

#### **E. Conrail and Government Investment in Railroads<sup>127</sup>**

<sup>121</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 11.

<sup>122</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, pp. 11-12.

<sup>123</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 12.

<sup>124</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 12.

<sup>125</sup> Emergency Loan Guarantee Act, P.L. 92-70, § 2, 85 Stat. 178 (Aug. 9, 1971)

<sup>126</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 11.

<sup>127</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974

Has the complex relationship between the U.S. government and the railroads been a fair exchange? Was it a fair exchange for the U.S. government to buy, fix and then sell Conrail to the private sector?

### ***1. Railroads and the U.S. Government before 1970***

The U.S. government has been deeply involved in the development, protection, regulation and deregulation of the railroad industry since its earliest days. Development of the railroads was crucial to the development of the American West and a necessity to bind together as a country a huge geographical expanse. The government's first large investment in the railroads was the 131 million acres of land given<sup>128</sup> to private businesses in exchange for building the railroad connecting the two coasts under the Pacific Railroad Act of 1862.<sup>129</sup> Although this land grant is often seen as a gigantic rip-off, the government required the land grant railroads to provide transport for government troops and property for half the normal rate. A Congressional Committee in 1945 reported that the government received \$900 million in transportation for lands that would have cost no more than \$126 million to purchase, because at the time it required a railroad to make it valuable.<sup>130</sup>

National railroads were the first national corporations and pioneered corporate business practices regarding treatment of customers, employees, state, local and federal government. The rise of the railroad companies and their impact on America is a good analogy for the rise of multi-national corporations and their impact on the global culture and economy. Railroad owners became fabulously rich. The size of railroad companies and their resources dwarfed the resources of those, such as farmers, workers and injured parties who dealt with them.

Because of the potential profits it could generate, the potential monopoly it could exert over an area, and the wide variety of manipulation that could be employed, the railroads were at the center of most of the corruption of the late 19<sup>th</sup> and early 20<sup>th</sup> centuries. Names like Jay Gould, James Fisk, Cornelius ‘Commodore’ Vanderbilt, and Daniel Drew were synonymous with corruption and scandal”.<sup>131</sup> “As business grew rapidly during the last half of the 19<sup>th</sup> century, government control fell hopelessly behind.<sup>132</sup>

In 1887 the Interstate Commerce Commission (ICC) was created to regulate the railroads, shifting that responsibility from the states, which were not well equipped to regulate these national companies. Yet it took 30 years, numerous additional regulations and Supreme

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<sup>128</sup> National Railroad Museum web site [www.nationalrrmuseum.org/collections-018-historical-outline.html](http://www.nationalrrmuseum.org/collections-018-historical-outline.html) “Nation Building 1860-1900”

<sup>129</sup> Pacific Railway Act of 1862, U.S. Statutes at Large, Vol. XII, p.489 ff.

<sup>130</sup> National Railroad Museum web site [www.nationalrrmuseum.org/collections-018-historical-outline.html](http://www.nationalrrmuseum.org/collections-018-historical-outline.html) “Nation Building 1860-1900”

<sup>131</sup> National Railroad Museum web site [www.nationalrrmuseum.org/collections-018-historical-outline.html](http://www.nationalrrmuseum.org/collections-018-historical-outline.html) “Nation Building 1860-1900”

<sup>132</sup> National Railroad Museum web site [www.nationalrrmuseum.org/collections-018-historical-outline.html](http://www.nationalrrmuseum.org/collections-018-historical-outline.html) “Nation Building 1860-1900”

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Court cases before the ICC could exert real control over the railroads, their unfair rate practices that were most destructive of communities and farmers, and their most brutal labor practices. The anti-trust laws were also created to deal with corporate and financial manipulation practices of the robber barons.<sup>133</sup>

The period of 1900 to 1945 is sometimes referred to as the Golden Age of the Railroad. During that period rail transit was a mature industry, with growing demand and the government had developed a reasonable means to regulate its excesses. However, this balance did not last long.<sup>134</sup>

After World War II, other means of transportation and communication provided increasingly stiffer competition with rail. The government invested in building the interstate highway system and many airports. Auto, truck, barge and air transportation became major competition for rail. Yet, the government retained a regulatory scheme based on the monopoly enterprise which rail transportation had been before these new developments. During the 1950's and 60's, although the rail system was losing passengers and freight to auto, truck and air transport, the railroads were not permitted to drop routes or change their highly regulated rate structure. By the end of the 1960's several of the nation's largest railroads were facing bankruptcy, and many others followed during the 1970's, leading to a major restructuring of the industry. This included substantial government investment, regulation and deregulation, the government's creation of the National Railroad Passenger Corporation, which created Amtrak<sup>135</sup>, and the formation of Conrail from the remnants of seven bankrupt railroads in the Northeast and Midwest.<sup>136</sup>

## ***2. Why was Conrail created?***

Penn Central was the largest transportation company in the U.S. when it formed in 1968 out of the merger of the Pennsylvania and New York Central railroads.<sup>137</sup> Due to competition from the trucking industry, increased labor costs, regulation of rates which lagged cost increases, and inability to truly merge the two companies, Penn Central lost \$5.2 million in 1968 and \$56.3 million in 1969. These losses continued to grow. In 1969-70 the losses in rail passenger services increased to \$375,000 per day. In May 1970 Penn Central sought emergency government assistance.<sup>138</sup> Unable to get initial assistance, Penn

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<sup>133</sup> National Railroad Museum web site [www.nationalrrmuseum.org/collections-018-historical-outline.html](http://www.nationalrrmuseum.org/collections-018-historical-outline.html) "Nation Building 1860-1900"

<sup>134</sup> National Railroad Museum web site [www.nationalrrmuseum.org/collections-018-historical-outline.html](http://www.nationalrrmuseum.org/collections-018-historical-outline.html) "The Golden Age 1900-1945"

<sup>135</sup> National Railroad Museum web site [www.nationalrrmuseum.org/collections-018-historical-outline.html](http://www.nationalrrmuseum.org/collections-018-historical-outline.html) "Decline and Revitalization 1945 – 1995"

<sup>136</sup> Penner, R.G., Director, Congressional Budget Office, U.S. Congress, "Economic Viability of Conrail" Part III, Summary, (August 1986)

<sup>137</sup> Comptroller General of the United States, Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities, GAO/GGD 84-34, March 29, 1984, p.8.

<sup>138</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, pp.8-9 Two assistance plans initially C:\Documents and Settings\ccooper\Local Settings\Temporary Internet Files\OLK6\FE Manuscript DRAFT No 12 created 091605.doc - last revised 9/27/2005 4:12 PM

Central filed for bankruptcy under Section 77 of the Bankruptcy Act, under which railroads were not permitted to go out of business. However, Penn Central's operating income could not cover its operating costs, costing more money to operate it than to shut it down. Thus in January 1974 the Congress passed the Regional Rail Reorganization Act (3R Act)<sup>139</sup>. The 3R Act's stated purpose was to "identify a rail system that would provide adequate and efficient rail service in the Northeast and Midwest, and reorganize the railroads in the region into an economically viable system that could provide that service."<sup>140</sup> It also provided for the establishment of the Consolidated Rail Corporation (Conrail) as a for-profit freight railroad and the United States Railroad Association (USRA) as a government corporation to fund and oversee Conrail's operations.<sup>141</sup>

Additional legislation used to nurse the railroad industry back to health under government investment and supervision and then turn it back to the private sector<sup>142</sup> followed, including:

USRA's final plan for the reorganization sought in the 3R Act<sup>143</sup> was created by Congress in Title VI of Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act) (P. L. 94-210). It amended the 3R Act to conform its provisions to the final structural, operational and financial system designed for by USRA Conrail. The 4R Act initiated the first significant reduction in federal regulation of railroads since the enactment of the Interstate Commerce Act 1887. Because regulatory restrictions had contributed to the bankruptcy of Conrail's predecessors, Congress began the process of regulatory reform in the 4R Act to prevent additional bankruptcies in the industry, and to

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discussed included a \$200 million loan guarantee from the Department of Defense and a \$750 million loan guarantee from the Department of Transportation.

<sup>139</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974

<sup>140</sup> Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) pp. 4-5

<sup>141</sup> Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) pp. 4-5 and Section 101 (a) of the 3R Act states that its intent to address these problems:

- The rail service providers in the Midwest and Northeast region of the U.S. were insolvent and preparing to enter bankruptcy.
- Rail services were threatened with cessation or significant curtailment because trustees were unable to formulate acceptable plans for reorganization. The rail service operates across properties that were acquired for public use but have deteriorated and require extensive rehabilitation and modernization.
- Public convenience and necessity require that adequate and efficient rail service in the region and throughout the Nation meets the needs of commerce, national defense, environment and passengers, U.S. mail, shippers, States and their political subdivisions and consumers.
- Continuation and improvement of essential rail service in this region is also necessary to preserve and maintain adequate national rail services and an efficient national rail transportation system.

Rail service and rail transportation offer economic and environmental advantages with respect to land use, air pollution, noise levels, energy efficiency and conservation, resource allocation, safety, and cost per ton-mile of movement to such extent that the preservation and maintenance of adequate and efficient rail service is in the national interest.

The Federal Government cannot meet these needs without substantial action.

<sup>142</sup> Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) pp. 2-7

<sup>143</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974

improve the opportunities for all railroads, including Conrail, to survive as private companies.<sup>144</sup>

In April of 1976 Conrail began operations in 16 states with 99,000 employees and a 17,000-mile route system. The system needed substantial repairs from years of neglect. The U.S. government subsidized these renovations by purchasing debentures and preferred stock in Conrail, and to subsidize its operating losses during this rebuilding period.<sup>145</sup>

The regulatory reforms in 4R Act proved insufficient. Lower traffic and higher operating costs than projected meant the financial health of the railroad industry was not improving. The U.S. government investment continued and grew by 1983 until it totaled over \$10.2 billion in 1985 dollars.<sup>146</sup> Conrail was doing worse than expected (as was the industry). Congress enacted two laws - the Staggers Rail Act of 1980<sup>147</sup> ("Staggers Act") and Northeast Rail Service Act of 1981<sup>148</sup> ("NERSA") to address these problems.

The Staggers Act significantly reduced the government's regulation of pricing and marketing activities for all railroads. It enabled railroads to restructure rates and services to improve profits and, if losses could not be avoided, they could abandon unprofitable routes and services. Conrail utilized these provisions extensively. Its success in 1980 stems from this ability to emphasize profitable services and drop unprofitable ones.

The Northeast Rail Service Act of 1981 (NERSA)<sup>149</sup> required Conrail to show by 1983 that it could be profitable. In 1983, USRA reported that Conrail met the NERSA profitability tests. The DOT was thus required to initiate return of Conrail to the private sector as a single entity through the sale of the government's Conrail common stock.<sup>150</sup>

The requirements for the Conrail stock sale under NERSA<sup>151</sup> were: to ensure continued rail service, promote competitive bidding for the stock, and maximize the return to the federal government on its investment. The details were left to the DOT. DOT solicited proposals for purchase in 1983 and in 1985 announced its intention to conclude a private sale of the stock to the Norfolk Southern Corporation, based on DOT's belief that Conrail's long-term viability would be more secure as a subsidiary of a larger, more

<sup>144</sup>Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) p. 5

<sup>145</sup>Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) p. 5

<sup>146</sup>Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) p. 2 Table 1

<sup>147</sup>Staggers Rail Act of 1990, Public Law 96-448

<sup>148</sup>Northeast Rail Service Act of 1981, 45 U.S.C. 20.

<sup>149</sup>Northeast Rail Service Act of 1981, 45 U.S.C. 20.

<sup>150</sup>Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) p. 7

<sup>151</sup>Northeast Rail Service Act of 1981, 45 U.S.C. 20.

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experienced railroad.<sup>152</sup> However the relevant Congressional subcommittee raised concerns about this private deal and requested a study from the Congressional Budget Office on the viability of Conrail and the options for its sale.<sup>153</sup> The study described the Norfolk deal and alternate proposals by two groups of investment bankers that would keep Conrail independent. The chief contention between the two groups was the likelihood of Conrail's long-term viability as an independent operator.<sup>154</sup>

### ***3. What benefit did the government and citizens get from the Conrail deal?***

By 1981 Conrail began a financial turnaround and no longer required government investment. It began to profit.

On March 26, 1987, the government sold its ownership interest in Conrail through what, at the time, was the largest initial public stock offering in nation's history. This transaction, with added cash payments from Conrail to the U.S. Treasury, produced about \$1.9 billion for the taxpayers and returned the Northeast-Midwest rail freight system to the private sector as a for-profit corporation, as Congress had envisioned when it created Conrail as a Consolidated Rail Corporation.<sup>155</sup>

In 1985, Conrail restored, retroactive to July 1984, industry-level wages that were reduced for three years in wage negotiations mandated by NERSA. DOT then selected Norfolk Southern Corporation as the preferred purchaser of government interest in Conrail.

In 1997, Norfolk Southern Corporation and CSX Corporation agreed to acquire Conrail through a joint stock purchase for \$10 billion<sup>156</sup>. The Surface Transportation Board officially approved the acquisition and restructuring of Conrail on July 23, 1998. The approved merger plan restructured Conrail into a switching and terminal railroad that operates as an agent for its owners, Norfolk Southern and CSX, in the Shared Assets Areas of Northern New Jersey, Southern New Jersey/Philadelphia and Detroit.

### ***4. The Conrail deal was not a Fair Exchange for the taxpayers***

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<sup>152</sup> Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) Id p. 8

<sup>153</sup> Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) Id Preface

<sup>154</sup> Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) Id p. 9

<sup>155</sup> Conrail Website, [www.conrail.com/history.htm](http://www.conrail.com/history.htm)—“A brief History of Conrail”

<sup>156</sup> CSX and Norfolk Southern press release, 3/19/98 (found at [www.prnewswire.com/cgi-bin/stories.pl?ACCT=105&STORU=www/story/3-19-98](http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=105&STORU=www/story/3-19-98)) entitled “Conrail Acquisition to Take Millions of Truck miles Off Pennsylvania Highways State to Save More than \$18.5 Million in Road Maintenance Costs” states “CSX and Norfolk Southern submitted their application to acquire Conrail to the U.S. Surface Transportation Board (STB) last June. The board is expected to issue its final decision on the \$10 billion transaction in July.”

The U.S. government invested \$10.2 billion in Conrail, and sold it for \$1.9 billion in 1987. CSX bought Conrail in 1997 for \$10 billion on the private market. The government lost \$8.3 billion in this deal. Had the government retained its stock for the 10-year period, it would have been able to recoup its investment. It is interesting to note that the Economic Viability of Conrail (EVCR) study determined the market value on the open market to be between \$1.2 – 4.9 billion, with a mid-range of \$2.8 billion.<sup>157</sup>

There is no question that the government needed to save the rail system when it was imploding in the 1970's. The fair exchange question is this. Why did the government require a complete sale of its stock as soon as the DOT determined that Conrail was viable? Unlike the later Chrysler deal, the government did not provide for any reward to the citizens or the government for the risk it took with the taxpayers' money. Conrail was a government success in that it revitalized the rail system at a critical moment. But the government did not make a good business deal for itself. Why not? One reason is that the legislation creating Conrail required the government to sell its interest into private hands at a very early set date. The law did not give the government the ability to act as a prudent investor would, to obtain a reasonable return for its risk.

### ***5. USRA/Conrail structure incorporates stakeholder governance***

The 3R Act of 1973<sup>158</sup> provided for two new entities: a non-profit association known as the United States Railway Association (USRA)<sup>159</sup> and a for-profit corporation known as Conrail<sup>160</sup>. The structure of these Boards of Directors may provides useful insights for those seeking to create Fair Exchange Commonweal Agencies or Community Trusts described later in this article. Their form and structure is outlined below.

#### **a) United States Railway Association (USRA)**

The USRA was a District of Columbia (DC) non-profit government corporation, directed by a Board of Directors. The individuals designated as the Government members of the Board were the incorporators of the Association and served as acting Board of Directors for a period of not more than 45 days after the date of its incorporation. Association employees were not government employees. The Association existed until dissolved by Act of Congress. The Board of Directors consisted of 11 individuals, described in Section 201 of the 3R Act– as follows:

- Under § 201(d)(1), the Chairman was appointed by the U.S. President with advice and consent of the Senate;

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<sup>157</sup> Rudolph Penner, Director, Congress of the United States, Congressional Budget Office, Economic Viability of Conrail, (August 1986) and Erratum dated August 1986.

<sup>158</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974

<sup>159</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974  
Title II, Sections 201-215

<sup>160</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974  
Title III, Sections 301-304

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- Under § 201(d)(2), the Secretary, the Chairman of the Interstate Commerce Commission and the Secretary of the Treasury, or their duly authorized representatives were the three government members of the board;
- Under § 201(d)(3), seven non-government members were appointed by the President with advice and consent of the Senate, on the following basis:
  - (A) One from a list of qualified individuals recommended by the Association of American Railroads or its successor representing profitable railroads;
  - (B) One from list of qualified individuals recommended by American Federation of Labor and Congress of Industrial Organizations or its successor representing railroad labor;
  - (C) One from list recommended by National Governors Conference;
  - (D) One from list of qualified individuals recommended by National League of Cities and Conference of Mayors;
  - (E) Two to be selected from lists of qualified individuals recommended by shippers and organizations representing significant shipping interests including small shippers; and,
  - (F) One from list of qualified individuals recommended by financial institutions, the financial community, and recognized financial leaders.

The lists of qualified individuals were required to include not less than three individuals. Also, except for members appointed under paragraphs (1) and (3) (A), (B), (E) and (F), no board member could have any employment or other direct financial relationship with any railroad. Those appointed under (2), (C) and (D) could be employed or have direct financial relationship with any railroad. The non-governmental members had staggered terms of office of 2, 4 or 6 years and the chair's term was 6 years. The President of the Association was to be chosen (from amongst recommendations made by the Secretary of Transportation) and serve at the pleasure of the Board.

The Board's primary duties were to study the regional rail transportation problem and produce a final plan to solve it by establishing Conrail as a self-sustaining, efficient rail system, providing service to as many current locations as possible, in a safe and environmentally friendly way, and providing it financial assistance "at the lowest possible cost to the general taxpayer"<sup>161</sup> and allocating routes between Conrail and other companies to ensure efficiency, service and promote competition. USRA had authority to make loans to Conrail and other railroads to accomplish the ends of its Final Plan.<sup>162</sup>

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<sup>161</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974  
at Sections 101(b)(9), 202 and 206

<sup>162</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974  
at Section 210

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All rail properties transferred to Conrail by other rail companies or trustees were to be paid for in stock and securities of Conrail. Conrail was to sell its rail properties for compensation. Much of its property would come from the bankruptcy judges placing assets of railroads that could not otherwise be reorganized into Conrail.

**b) Structure of Conrail**

Conrail was designed under Title III of the 3R Act. The USRA Executive Committee established and served as the incorporators for a for-profit corporation known as Consolidated Rail Corporation (Conrail) that was not an agency of the Federal Government with its principal office in Philadelphia. These incorporators would remain as the corporate Board of Directors until the stock of Conrail was distributed to the estates of the railroads from which it would receive rail properties. The Board of Directors consisted of 15 individuals selected in accordance with Conrail articles of incorporation and bylaws *provided that*, so long as USRA or the Federal Government held or guaranteed 50% or more of Conrail's outstanding indebtedness (as determined by the Secretary of the Treasury), three members of the Board shall be the Secretary of Transportation, the Chairman and the President of the USRA, and five members of the board shall be individuals appointed by the U.S. President with the advice and consent of the Senate.<sup>163</sup>

Conrail common stock was issued to the estates of bankrupt railroads in exchange for railroad properties, which the bankruptcy judges were instructed to transfer to Conrail, if they could not be used to successfully reorganize relevant railroad companies. Conrail was permitted to repurchase said stock in order to establish an employee stock ownership plan.<sup>164</sup>

**6. *Conrail was a Fair Exchange for Employees***

Section 102(5) of the 3R Act passed in 1974 included provisions requiring the creation of an Employee Stock Ownership Plan (ESOP), led by Senator Russell P. Long.<sup>165</sup> The final system plan required (under Section 206(e)(3) of the 3R Act) Conrail to set forth the manner in which ESOP plans could be practically used to meet the corporation's capitalization requirements including potential cost savings, improved labor relations, and improved service. Section 301(e) also contemplated repurchasing some of the stock sold to the public by the ESOP, or even total employee ownership.

In 1982, Congress proposed an amendment to the 3R Act (Sec. 1142, Title IV Transfer of Freight Service) that required the Secretary of Transportation (after July 1, 1982 and before December 31, 1983) to sell the common stock of the Corporation held by the

<sup>163</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974  
at Section 301

<sup>164</sup> Regional Rail Reorganization Act of 1973 (3R Act) (P. L. 93-236) January 2, 1974  
at Section 301(e)

<sup>165</sup> William Jones, *The Washington Post*, January 2, 1974

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federal government, if the Association determined that Conrail would be profitable. Because employee sacrifices were the key in making Conrail profitable, the Secretary was required to first offer the stock to the employees in the amount of wages, or wage increases, foregone by them. If the Secretary or his agent first offered the stock at one price and then lowered the price to attract additional purchasers, the Secretary was required first to offer the reduced price stock to the employees.

In October of 1986 the Conrail employees agreed to a wage package at 12% below the industry standard and obtained an employee stock ownership plan (ESOP) containing 15% (4.4 million shares) of the outstanding Conrail stock.<sup>166</sup> When Conrail stock was first made available for sale to the public, the employees received shares (based on a union agreement) valued at \$24 per share, equivalent to the wage sacrifice they made over the previous three years. Some employees sold their shares for cash on the market immediately. Many others saved them. Those who held their shares until they were forced to sell (by the CSX purchase of Conrail) received \$100 per share for their stock. John Fink, who began his railroad career in 1963 with the New York Central, received 237 shares of Conrail stock at \$24 per share. As of April 2005, the proceeds in his IRA from the sale of those shares are worth over \$100,000.00. There was no organized use of the shareholder vote by employees.<sup>167</sup>

### **7. Lessons from Conrail for Fair Exchange**

The taxpayers lost at least \$8.3 billion on the Conrail deal unnecessarily. Had Congress not required a sale to the private sector as soon as the company reached profitability, the taxpayers could have recouped their investment. Employees who held onto the stock they received got a fair return on the sweat equity comprised of their wage concessions.

The Conrail governance structure provides a model of a multi-stakeholder governance process. It is hard to evaluate whether this structure would have served the country well in the long run (as, for example, the TVA has) had it been allowed to continue ownership of Conrail. The requirement of immediate sale makes such consideration moot.

### **F. 1979 Chrysler Corporation Loan Guarantee Act and ESOP**

The summary version of the Chrysler Loan Guarantee of 1979<sup>168</sup> is this:

The Arab oil embargo caught Chrysler Corporation sitting on a mountain of debt as well as a huge inventory of gas-guzzlers. President Jimmy Carter agreed in 1979 to provide up to \$1.5 billion in loan guarantees, as long as Chrysler won \$2 billion in concessions from banks, suppliers and unions. New CEO Lee Iacocca cut costs to the bone, eliminating

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<sup>166</sup> Richard Gillespie, "Conrail sale gives ESOP as much as \$300 million", *Pensions and Investment Age*, Oct 13, 1986

<sup>167</sup> Deborah Olson telephone interview with John Fink, Executive Assistant to the President United Transportation Union International on 4/6/2005

<sup>168</sup> Chrysler Loan Guarantee Act of 1979, Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et. seq

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53,000 jobs. The company also cornered the booming minivan market. In 1983, the company paid off its loans seven years early, at a profit of \$350 million to the government.<sup>169</sup> Chrysler invented the minivan in 1983-84 and had no minivan competitors for several years thereafter<sup>170</sup>.

### **1. Why did the government agree to bail out Chrysler?**

Chrysler set sales records in 1972-73, but gasoline shortages, political uncertainty, high interest rates, severe inflation and weakening consumer confidence drove Chrysler into a financial crisis in the mid-70's. American consumer demand soared for smaller, more fuel-efficient cars. Japanese manufacturers were the first to respond, making great inroads into the U.S. market. The combined domestic market share of the total U.S. car market fell while the market share for imports rose to 23.4 percent.<sup>171</sup>

The major reasons advanced for passing the loan guarantee legislation were that Chrysler was the 17<sup>th</sup> largest company in the country (the 10<sup>th</sup> in 1978) and the 3<sup>rd</sup> largest automaker in the US. There had never been a bankruptcy of this size in the US. Chrysler employed 134,000 workers concentrated in the Detroit area, which already had a high rate of unemployment. There was concern about the effect of a Chrysler bankruptcy on the manufacturing sector, and Chrysler was the sole producer of the M-1 tank.<sup>172</sup> The UAW estimate of lost jobs if Chrysler failed was 500,000 including employees, dealers, and suppliers. The General Accounting Office later estimated the potential job loss at 700,000.<sup>173</sup>

#### **1. Terms of the Chrysler Loan Guarantee including Upside for the U.S. Government in Exchange for Risk**

The Chrysler Loan Guarantee Act of 1979<sup>174</sup>, signed in January 1980, provided for up to \$1.5 billion in loan guarantees. The five-person board administering the loan guarantee program included: as voting members, the Secretary of Treasury as Chair, the Federal Reserve Chair, and the U.S. Comptroller General as voting members; with the Secretaries of Labor and Transportation as non-voting members.<sup>175</sup>

In the Chrysler program most of the beneficiaries of the government assistance were required to make significant concessions. The government's aid was to be matched by concessions from U.S. and foreign banks, governments, creditors, stockholders, suppliers,

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<sup>169</sup> "America's Biggest Bailouts" *Business Week On-Line*, October 1, 2001.

<sup>170</sup> Email from Bob Jensen to author, dated 9/19/05, correcting earlier manuscript of this article.

<sup>171</sup> "The Troubled Years" www.AutoWorld.com, National Automobile Bankers Association/Vehicle Information Services (2001)

<sup>172</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, pp. 15-16

<sup>173</sup> Email from Bob Jensen to author, dated 9/19/05, correcting earlier manuscript of this article.

<sup>174</sup> Chrysler Loan Guarantee Act of 1979, Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et. seq

<sup>175</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 16.

dealers, and union and non-union employees.<sup>176</sup> The Loan Guarantee Board had a very active oversight role, adjusting the amounts of these concessions between parties, approving any assets sales over \$5 million, any contract of over \$10 million and approval of any financing and operating plans.<sup>177</sup> Chrysler was thus reorganized into a much more efficient firm without going through bankruptcy.<sup>178</sup>

Under the terms of the Guarantee Agreement, Chrysler issued to the government warrants for 14.4 million shares of Chrysler stock at \$13 per share. In 1983, after the guaranteed loan was fully repaid (7 years early), the government sold these warrants for \$311 million.<sup>179</sup>

## ***2. The Chrysler Program was a Success for the Government, the Company and its Workers<sup>180</sup>***

Chrysler ultimately used \$1.2 billion of the \$1.5 billion guarantee authority. There were very complex negotiations between the Loan Guarantee Board, U.S. senators, Chrysler management, and the International Union United Automobile, Aerospace and Agricultural Implement Workers of America (UAW). The UAW had made significant concessions to Chrysler before it sought the loan guarantee. The union reopened its contract three times in 13 months during the negotiations approving additional requests for concessions.<sup>181</sup> The total concessions given by the UAW during the period 1979-81 was \$1.1 billion.<sup>182</sup> Management also made significant concessions.<sup>183</sup> In exchange for these concessions, the employees received “\$100,000,000 of common stock of the Corporation”<sup>184</sup> (approximately 15% of Chrysler’s common stock)<sup>185</sup> through an

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<sup>176</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p.16; Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et seq. 93 Stat.1328, Sec. 4(b)

<sup>177</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p.16.

<sup>178</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 17.

<sup>179</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p.16.

<sup>180</sup> [Chrysler stock info?](#)

<sup>181</sup> Interview on 11/21/2004 by author of Douglas Fraser, President of the International United Auto Workers Union (UAW) at the time of the Chrysler Loan Guarantee.

<sup>182</sup> Jensen, Robert, *Chrysler Contract Talks 1979-1983*, summary for the negotiators of negotiations between the UAW, Chrysler and the government during the period of the loan guarantee negotiations and implementation. Robert Jensen was at that time Administrative Assistant to Marc Stepp, UAW Vice President and Director of the UAW Chrysler Department. Interview by author with Robert Jensen 12/19/2004.

<sup>183</sup> Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et seq. 93 Stat 1329, Sec. 6(a)(2) required at least \$125,000,000 in concessions from Chrysler employees not represented by a union.

<sup>184</sup> Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, Sec. 4(a)(4), 15 U.S.C. 1861 et seq.

<sup>185</sup> Ibid. Fraser interview and Ibid. Jensen Interview.

employee stock ownership plan<sup>186</sup> to be allocated equally amongst the plan participants.<sup>187</sup>

The Comptroller General of the United States concluded, upon comparing the government bailouts of Lockheed and Chrysler, the bankruptcy of Penn Central and the government's creation of Conrail, that "the Chrysler program has frequently been characterized as the most sophisticated in terms of how commercial lending principles were embodied in ... [its] ... structure".<sup>188</sup> He further concluded that in each of these experiences the government had learned from the previous one and had had better results by using more commercial lending principles. Concluding that similar future programs will benefit from that experience and "will result in an even more financially rigorous program if the circumstances warrant".<sup>189</sup> As the later section on the 2001 airline bailout shows, that advice was followed. However, the section on the Savings and Loan bailout shows that Congress has not consistently protected public funds invested in business bailouts.

The value of the Chrysler stock warrants to the government and of the stock given to the Chrysler ESOP in 1979 increased. The value of the stock warrants when the warrants were issued was \$3.00 per share. The warrants issued to the government allowed it to purchase Chrysler stock at \$13.00 per share exercisable in 1990.<sup>190</sup> Chrysler redeemed the warrants in 1983 when their market price was \$30.00 per share.<sup>191</sup> The company rebounded. The government came out ahead financially and the employees then owed 15% of the publicly traded Chrysler Corporation.<sup>192</sup>

### ***3. What did the employees do with their Chrysler ESOP stock?***

Ownership of 15% of a publicly traded company can be controlling ownership.<sup>193</sup> However, this was not a major focus of the UAW at the time of the Chrysler Loan Guarantee or thereafter. The UAW leaders were "in survival mode," consumed with their members' concerns about the huge concession package they took. The unions had not requested stock. Rather Senators Russell Long and Gaylord Nelson suggested it and

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<sup>186</sup> Chrysler Loan Guarantee Act of 1979, Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et. seq at, 93 Stat. 1330, Sec. 7.

<sup>187</sup> Chrysler Loan Guarantee Act of 1979, Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et. seq , at 93 Stat. 1330, Sec. 7 (c)(3)(C).

<sup>188</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p.17.

<sup>189</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 18.

<sup>190</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 16.

<sup>191</sup> Ibid Fraser interview and Ibid. Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 16.

<sup>192</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, p. 16.

<sup>193</sup> The SEC requires individuals as they acquire large blocs or 5, 10 and 20% of publicly traded stock to disclose it. Securities Act of 1934 Secs. 13(d) and 16(a).

included it in the loan guarantee legislation.<sup>194</sup> The UAW was interested in how it might vote the stock. The union leaders report that their lawyers, after researching the issue, found that it would be extremely expensive (in the millions of dollars) to organize the proxy votes of the union members.<sup>195</sup> Doug Fraser said, "We had no ESOP expert.... We did not focus on this.... We didn't think the stock would be worth anything. We were looking at how we could exercise control over the stock as an organization".<sup>196</sup>

The ESOP required in the Chrysler Loan Guarantee Act was a standard type of ESOP<sup>197</sup> that would have required, in a publicly traded company, pass through voting on all issues for the participants to direct the vote of the Trustee on allocated shares. The UAW was not familiar enough with ESOPs (which were only made tax deductible by Congress in 1974<sup>198</sup>) to know that they might have been able to obtain more influence over the voting of this stock had they insisted on having a major voice in choosing the ESOP trustee. Neither Mr. Fraser nor Mr. Jensen knew who the trustee was. It is unlikely they would have used any bargaining leverage to get a voice in selecting the trustee if it would have cost their members any further concessions, as their focus was on survival. Corey Rosen, one of the Senate staff who drafted the Chrysler Loan Guarantee Act, said that no one from the Union ever discussed the Act with him and that he had only one discussion with a Chrysler staff person. Neither labor nor management was very interested in the required ESOP when it was placed in the law. Rosen says he would have told the Union to ask for more stock had they asked him at the time bill was drafted. He believes they would have been able to negotiate for more stock or voice in appointment of the trustee.<sup>199</sup> However, the Union was focused on huge concessions demanded from them and had little faith that the stock would ever be valuable.

UAW President Douglas Fraser was given a seat on the Chrysler Board of Directors, but the seat was given to him personally, and was not made an institutional seat for the holder of the UAW presidency.<sup>200</sup> He used that position to raise issues of concern to the union members and as a person knowledgeable about the industry, but not as one who controlled a voting bloc. But in the 1982 negotiations the union pushed for and won a major workplace participation program to enable workers to have a greater voice in quality matters.<sup>201</sup> This joint program continues up to the present.<sup>202</sup>

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<sup>194</sup> Fraser interview (Interview on 11/21/2004 by author of Douglas Fraser, President of the International United Auto Workers Union (UAW) at the time of the Chrysler Loan Guarantee), and Note 52, Jensen IV Jensen, Robert, *Chrysler Contract Talks 1979-1983*, summary for the negotiators of negotiations between the UAW, Chrysler and the government during the period of the loan guarantee negotiations and implementation. Robert Jensen was at that time Administrative Assistant to Marc Stepp, UAW Vice President and Director of the UAW Chrysler Department. Interview by author with Robert Jensen

12/19/2004.

<sup>195</sup> Ibid. Fraser interview, Jensen interview.

<sup>196</sup> Ibid Fraser interview

<sup>197</sup> Chrysler Loan Guarantee Act of 1979, Public Law 96-185, 96<sup>th</sup> Congress, 93 Stat.1324, 15 U.S.C. 1861 et. seq , 93 Stat.1330 Sec. 7, and Internal Revenue Code 29 U.S.C. 4975(e)(7)

<sup>198</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. 1001 et seq

<sup>199</sup> Interview of Corey Rosen by author on March 1 , 2005.

<sup>200</sup> Ibid. Fraser interview

<sup>201</sup> Ibid Fraser interview and Jensen interview.

<sup>202</sup> Ibid. Jensen interview

In 1984-85, each individual UAW member's Chrysler ESOP account was worth approximately \$8,000. Marc Stepp, UAW Vice President in charge of Chrysler, wanted the members to keep their stock and build their personal savings.<sup>203</sup> The UAW members expressed, through their local presidents at their National Council meeting, a strong desire to get money back on the concessions they had made. Chrysler happily agreed with the UAW to buy back the shares of any UAW member who wanted to cash out of the ESOP. They were happy not to have such a large bloc of their stock in the hands of the workers. The agreement was that the UAW members would automatically receive the cash unless they made an affirmative decision to keep the stock. According to Douglas Fraser, most of the union members took the cash and most of the managers retained their stock.<sup>204</sup> The lowest value of the stock during the issuance of the loan guarantee was approximately \$3.00 per share. The stock value was \$30 in 1983 when the government exercised its warrants. The price later went up to \$50 per share, split and rose to \$50 again and split again.<sup>205</sup>

#### ***4. Daimler Buyout of Chrysler – Would the union members' 15% have mattered?***

In 1995, Kirk Kerkorian, who owned 10% of the Chrysler Corporation stock, began an effort to purchase the majority of the stock and take Chrysler private. He was working with former Chrysler President, Lee Iacocca. He planned a leveraged buyout including employee ownership.<sup>206</sup> He had complained for months about a low stock price (\$40 per share) and feeble dividends, when Chrysler was "a money machine throwing off \$1 billion in excess cash per quarter".<sup>207</sup> Management at Chrysler were not happy about the takeover plan and began looking for a white knight to keep Kerkorian from taking over Chrysler and using its cash to pay off his acquisition debt.<sup>208</sup> The white knight materialized in the form of the German automaker, Daimler Benz.<sup>209</sup> Shortly thereafter, Daimler Benz and Chrysler merged to form the DaimlerChrysler Company. Although after a short time it became clear that Daimler had taken over Chrysler, and that it was not a partnership of equals.<sup>210</sup> In September 1998, Germans replaced a large number of U.S. Chrysler managers, many more left, and Chrysler was again in major financial trouble.<sup>211</sup> "When Kerkorian agreed to the Daimler deal, Chrysler had close to \$10

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<sup>203</sup> Ibid. Jensen interview.

<sup>204</sup> Ibid. Jensen interview

<sup>205</sup> Ibid. Jensen interview

<sup>206</sup> Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) p.8

<sup>207</sup> Id. Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) p. 3

<sup>208</sup> Id. Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) p. 51

<sup>209</sup> Id. Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) pp.100-105

<sup>210</sup> Id Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) p.376

<sup>211</sup> Id Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) pp.370-73.

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billion in cash.”<sup>212</sup> DaimlerChrysler’s profits in 2000 would fall 40 percent from the year before, losing \$528 million in the last quarter compared to \$1.2 billion profit the year before.<sup>213</sup>

Had the employees kept their 15% ownership of Chrysler, would Daimler have been able to take over Chrysler? Might the union, with some sway over 15% of the company’s stock have been able to negotiate a deal to keep Chrysler locally owned, maintaining jobs in the U.S. and cash in Chrysler? Or could they have prevented the Kerkorian takeover without a partner? We will never know the answer. At the time of the Daimler takeover, UAW President Steven Yokich favored the Daimler merger as a means to save Chrysler UAW jobs. He saw Daimler as a much needed deep pocket with auto making experience. He saw that as the best protection for the US Chrysler workers. The union leadership was not fond of Kerkorian.<sup>214</sup> At the time of the merger there was no single shareholder with a 15% stake. Had the union members retained their shares, they might have had a strong or even a determining voice in defeating the Kerkorian takeover effort, or changing the direction the merger/takeover took. We will never know.

In 2005 it is the Chrysler part of the business that is supporting the ailing Daimler part.<sup>215</sup> How might that have strengthened the hand of the Chrysler workers if they were still major stockholders at DaimlerChrysler?

### ***5. Relevance of the Chrysler Loan Guarantee and ESOP to Fair Exchange***

The Chrysler Loan Guarantee Act of 1979 saved an important U.S. company from bankruptcy. The company recovered and paid back the government early. In addition the government made a profit. The workers acquired a large bloc of stock. Their sale of that stock helped to replace some of the wages they had given up as concessions. Had the workers not sold their stock, they might have played a major role in the decisions that led Daimler Benz to takeover Chrysler. Chrysler, a major U.S. employer and once an important pillar of the U.S. economy is now only a division of a German multi-national corporation, which can, at any time, decide to dump the Chrysler workforce or assets if it is in their corporate interest to do so. Although Chrysler was troubled when taken over by Daimler in 1995, Kerkorian said that if Chrysler had joined his leveraged buyout in 1995 instead of selling out to Daimler three years later, “We would have owned it clean as a whistle, with no debt... The union guys and the management, they’d have twenty percent. It would have been a real little jewel”.<sup>216</sup>

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<sup>212</sup> Id. Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) p. 366

<sup>213</sup> Id. Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) pp.364-65

<sup>214</sup> Ibid Note 53 Fraser interview, and Note 54 Jensen interview – Mr. Yokich passed away before these interviews took place.

<sup>215</sup> DaimlerChrysler Annual Results Conference Call presentation 2/10/2005

<sup>216</sup> Vlasic, B. & Stertz, B., *Taken for a Ride: How Daimler-Benz Drove Off with Chrysler*, Harper Business (2001) at 348.

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## **G. Lessons the Government learned from its Bailout experiences in the 1970s and 80s**

The U.S. General Accounting Office (GAO) Report to Congress “*Guidelines for Rescuing Large Failing Firms and Municipalities*”<sup>217</sup> (“1984 GAO Study”) recommended a set of guidelines for U.S. government loan and loan guarantee programs based on the bailout experiences at Chrysler, Lockheed, Penn Central/ Conrail and New York City. The report concluded that there should be a general policy governing these intervention situations. That, when it is determined that government intervention is in the national interest, Congress should:

- a) clearly describe the specific national interest served and congressional intent for the program including specific goals and objectives, and avoid conflicting intentions;
- b) use commercial lending principles to structure the transaction to protect the national interest;
- c) get risk compensation in the form of loan fees or more likely equity or warrants and loan priority over private lenders;
- d) get concessions from suppliers, unions management, etc.; and
- e) create a control board including the Secretary of Treasury, Secretary of Office of Management & Budget and Chair of Federal Reserve Board that would have some control over management.

## **H. Savings and Loan Bailout – the price of failing to require accountability or use fair exchange principals**

### **1. Corporate Welfare is the Opposite of Fair Exchange**

The folks who created the S&L crisis, developed its bailout, (and many of whom benefited directly from it) the Reagan and Bush administrations, ran on platforms of keeping government from interfering with business. They also sought to limit government expenditures on entitlements for the poor. The consequence of their deregulation of the S&Ls, and the bailout required to clean up from the deregulation mess, was to transfer billions of public dollars to a small number of wealthy S&L investors. Under their leadership, government has given the most to businesses without proper oversight or protection of the public interest. Whereas, the TVA, for example, was created by the New Dealers, who believed in government regulation of business. Yet, based on substantial planning and a concern that the government must protect the public interest when it invests taxpayers’ money, the TVA they created continues to serve multiple public purposes of economic development for a region, cheap power, and job creation. It made money for the region and the government, and became self-sustaining. This S&L bailout section is included to provide those interested in Fair Exchange with a fact source to use when confronted with arguments of those who claim to want to keep

<sup>217</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, pp.17-18

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government out of business. Many who preach that position did not hesitate to bail out S&L investors without providing protection for the public interests or purse.

### ***1. What caused the S&L crisis?***

The S&L bailout, when compared to the other examples discussed herein, looks more like a well organized swindle than like a problem arising from complex unanticipated events. However, had the government intervened appropriately and used fair exchange principals, the situation could have been resolved much earlier, with much less expense to the taxpayers, and the taxpayers could have gotten some benefit for the risk they took.

The thrift cleanup was Congress's response to the greatest collapse of U.S. financial institutions since the 1930's. From 1989 to 1996, the Federal Savings and Loan Insurance Corporation (FSLIC), the insurer of the thrift industry, closed or otherwise resolved 296 institutions with a total assets of \$125 billion...An even more traumatic period followed, with the creation of the Resolution Trust Corporation (RTC) in 1989, and that agency's resolution by mid-1995 of an additional 747 thrifts with total assets of \$394 billion. The combined closings by both agencies of 1,043 institutions holding \$519 billion in assets contributed to a massive restructuring ... (of the thrift industry). From January 1, 1986 through year-end 1995, the number of federally insured thrifts ...declined ...by... 50%.<sup>218</sup>

The savings and loan industry began over a century ago for the sole purpose of providing home mortgages. Until the 1930s, S&Ls ...got along quite nicely more or less on their own. But when nearly two thousand of them failed during the Great Depression, the government began regulating them in earnest, and providing deposit insurance to quell fears of further S&L failures. Compared to the greener pastures of the commercial banks, the S&Ls' opportunities for financial chicanery were slight, so there wasn't a great deal of corruption there.<sup>219</sup>

According to the Federal Deposit Insurance Corporation (FDIC) between 1966-1979, market interest rates fluctuated with increasing intensity and S&Ls experienced difficulty with each interest rate rise. Interest rate ceilings prevented S&Ls from paying competitive interest rates on deposits. Thus, every time the market interest rates rose, consumers withdrew substantial amounts of funds to replace them with securities getting higher rates of return. This process of deposit withdrawal... and the subsequent deposit influx when rates rose... left S&Ls highly vulnerable. Concurrently, money market funds became a source of competition for S&L deposits. S&Ls were additionally restricted by

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<sup>218</sup> Timothy Curry and Lynn Shubut, "The Cost of the Savings and Loan Crisis: Truth and Consequences" *FDIC Banking Review*, December 2000, (found at [www.fdic.gov/bank/analytical/banking/2000dec/brv13n2\\_2.pdf](http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf))

<sup>219</sup> Mark Zepezauer & Arthur Naiman, "The S&L Bailout: \$32 billion every year for 30 years" from *Take the Rich Off Welfare* Odonian Press (1996) found at [http://www.thirdworldtraveler.com/Corporate\\_Welfare/S&L\\_Bailout.html](http://www.thirdworldtraveler.com/Corporate_Welfare/S&L_Bailout.html), 3/13/05

not being allowed to enter into business other than accepting deposits and granting home mortgage loans.<sup>220</sup>

When Ronald Reagan took office in 1981, two-thirds of the nation's S&Ls were losing money and many were broke. If all the problem thrifts had been shut down right then, the government's insurance fund would have covered their debts. Instead, the government delayed an average of two years-and, in some cases, as many as seven years, thus allowing bankrupt S&Ls to go on losing billions of dollars.<sup>221</sup> This delay also gave S&Ls a chance to make questionable investments, in an attempt to regain solvency.<sup>222</sup>

The more expansive statutory and regulatory rules created in the 1980-82 period gave the S&L industry new powers in the hopes that the S&Ls would enter new areas of business and thus return to profitability. "For the first time, the government approve [d] measures intended to increase S&L profits as opposed to promoting housing and home-ownership."<sup>223</sup>

According to the FDIC, from 1982-1985 there were reductions in the Federal Home Loan Bank Board's regulatory and supervisory staff. In 1983, a starting S&L examiner was paid \$14,000 a year. The average examiner had only two years on the job. S& L industry growth increased by 56% between 1982 and 1985, during this period of supervisory and examination retraction. Forty Texas S&Ls tripled in size between 1982 and 1986; many of them grew by 100% each year. California S&Ls followed a similar pattern.<sup>224</sup>

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<sup>220</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 1, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

<sup>221</sup> During the 1986-89 period losses were compounded as insolvent institutions were allowed to remain open and grow, allowing ever increasing losses to accumulate, p.4 - Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 1, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

<sup>222</sup>Mark Zepezauer & Arthur Naiman, "The S&L Bailout: \$32 billion every year for 30 years" from *Take the Rich Off Welfare* Odonian Press (1996) found at [http://www.thirdworldtraveler.com/Corporate\\_Welfare/S&L\\_Bailout.html](http://www.thirdworldtraveler.com/Corporate_Welfare/S&L_Bailout.html), 3/13/05

<sup>223</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 2, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05) These included:

**"March, 1980--Depository Institutions Deregulation and Monetary Control Act (DIDMCA)** enacted. The law is a Carter Administration initiative aimed at eliminating many of the distinctions among different types of depository institutions and ultimately removing interest rate ceiling on deposit accounts. Authority for federal S&Ls to make ADC (acquisition, development, construction) loans is expanded. Deposit insurance limit raised to \$100,000 from \$40,000. This last provision is added without debate. **November, 1980**--Federal Home Loan Bank Board reduces net worth requirement for insured S&Ls from 5 to 4 percent of total deposits. Bank Board also removes limits on the amounts of brokered deposits an S&L can hold. **August, 1981**--Tax Reform Act of 1981 enacted. Provides powerful tax incentives for real-estate investment by individuals. This legislation helps create a "boom" in real estate and contributes to over-building.

**September, 1981**--Federal Home Loan Bank Board permits troubled S&Ls to issue "income capital certificates" that are purchased by FSLIC and included as capital. Rather than showing that an institution is insolvent, the certificates make it appear solvent."

<sup>224</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 2, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

The [St Germain Depository Institutions Act of 1982](#) (GARN) was enacted in December of 1982. This Reagan Administration initiative completed the process of expanding federally chartered S&Ls' powers, enabling them to diversify their activities to increase profits. Major provisions included: elimination of deposit interest rate ceilings; elimination of the previous statutory limit on loan to value ratio; expansion of the asset powers of federal S&Ls by permitting up to 40% of assets in commercial mortgages, up to 30% of assets in consumer loans, up to 10% of assets in commercial loans, and up to 10% of assets in commercial leases.<sup>225</sup>

The government's decision in the early 1980's to turn the S&Ls loose in the marketplace to compete with banks was the point at which a well constructed policy including fair exchange could have changed the course of S&L history to the advantage of the public. Savings and loans were created for the public purpose of making home ownership affordable for those who might otherwise be unable to own homes – a purpose very different from that of for-profit banks. When interest rate fluctuation began to make the S&Ls financially untenable, the government regulating them had at least these options: 1) close them down; 2) use government funds to recapitalize the industry in exchange for fair exchange equity and lifting of S&L interest rate rules; or 3) change the S&L regulations to enable them to make up for the losses and become profitable again. The government chose the third option, but also removed both regulations and oversight. The outcome, as noted below, was an enormously expensive fiasco paid for, not primarily by the private S&L investors, but by the taxpayers. So the taxpayers ended up with the risk of option 3 without any potential upside for the risk.

Had the government implemented a policy of recapitalizing the industry, allowing changed interest rate policies, but insisting on equity for the government or the citizens, there would likely have been much greater industry oversight. Under those circumstances they would likely have subjected the S&Ls to the type of oversight similar to that of the Chrysler Loan Guarantee Board or the ATSSSA Board, and the disasters described below could have been caught or prevented. The author claims no expertise in bank or S&L regulation, and does not claim that the recapitalization policy would necessarily have worked. The point is that the taxpayers paid hundreds of billions and got nothing in return. They made a huge investment in these private businesses without the normal oversight that accompanies such investments. Yet, individual investors in some of the S&Ls made out quite well, despite their mismanagement.

## ***2. S&L deregulation enabled substantial fraud that benefited well-connected people***

These changes in the early 1980's ended the requirement that S&Ls lend money only in their own communities, allowed them to offer 100% financing (i.e. no down payments), let real estate developers own their own S&Ls, and permitted S&L owners to lend money

<sup>225</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 2, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

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to themselves.<sup>226</sup> These changes were like taping a sign to the S&Ls' backs that read, "Defraud me". The GAO reported that "fraud played a significant role" in the S&L failures and that the Resolution Trust Corporation (RTC) "suspects that fraud or criminal activity on the part of directors, officers, or senior managers contributed to the failure of 40 percent of the thrifts it has investigated".<sup>227</sup>

These are some examples. "J. William Oidenburg bought State Savings of Salt Lake City for \$10.5 million, then had it pay him \$55 million for a piece of land he'd bought for \$874,000. With the help of ... Herman K. Beebe, who served a year for bank fraud, Don Dixon bought Vernon Savings and Loan (one of the nation's healthiest) and then set up a series of corporations for it to loan money to. Four years later, he left Vernon \$1.3 billion in debt. Beebe also had money in Silverado Savings, an S&L partly owned by President George H. W. Bush's son Neil. Silverado told a prospective borrower he couldn't have \$10 million; instead, he should borrow \$15 million and buy \$5 million in Silverado stock. Although federal examiners knew Silverado was leaking cash as early as 1985, it wasn't closed down until December 1988, a month after Bush was elected president. Because Silverado kept leaking cash for those three years, it ended up costing taxpayers more than a billion dollars."<sup>228</sup>

There are many stories about criminal activities connected with this crisis.<sup>229</sup> Numerous S&L bankruptcies followed.<sup>230</sup>

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<sup>226</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 5, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

<sup>227</sup> General Accounting Office (GAO) Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs "Savings & Loan Crisis: Federal Response to Fraud in Financial Institutions" by Richard L. Fogel, Assistant Comptroller General General Government Programs (8/1/1990);<sup>227</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 5, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05) including

" **January, 1982**--Federal Home Loan Bank Board reduces net worth requirement for insured S&Ls from 4 to 3 percent of total deposits. Additionally, S&Ls are allowed to meet the low net worth standard not in terms of generally accepted accounting principles (GAAP), but of even more liberal regulatory accounting principles (RAP). **April, 1982**--Bank Board eliminates restrictions on minimum numbers of S&L stock holders. Previously, it required at least 400 stock holders of which at least 125 had to be from "local community", with no individual owning more than 10% of stock and no "controlling group" more than 25%. Bank Board's new ownership regulation would allow a single owner. Purchases of S&Ls were made easier by allowing buyers to put up land and other real estate, as opposed to cash."

<sup>228</sup> Mark Zepezauer & Arthur Naiman, "The S&L Bailout: \$32 billion every year for 30 years" from *Take the Rich Off Welfare* Odonian Press (1996) found at

[http://www.thirdworldtraveler.com/Corporate\\_Welfare/S&L\\_Bailout.html](http://www.thirdworldtraveler.com/Corporate_Welfare/S&L_Bailout.html), 3/13/05

<sup>229</sup> Additional S&L crime stories can be found in these sources: Stephen Pizzo, Mary Fricker and Paul Muolo, *Inside Job: The Looting of America's Savings and Loans*. New York: McGraw-Hill, 1989; David Scheim *Trust of Hustle: The Bush Record* found at [www.campaignwatch.org/more1.htm](http://www.campaignwatch.org/more1.htm) 3/14/05; *LA Times*, 7/31/1990, p. 1; *Wall Street Journal*, 8/9/1988, p. A1; *Austin American-Statesman*, 5/17/92, p. G1; *Washington Post*, 7/4/1992, p. A1; *Washington Post*, 12/28/1989, p. A21; *San Diego Union-Tribune*, 1/1/1990, p. B8; and Jonathan Kwitny, "How Bush's Pals Broke the Banks," *The Village Voice*, 10/20/1992, p. 27. Black, William, *The Incidence and Cost of Fraud and Insider Abuse*, Washington, DC: National Commission on Financial Institution Reform, Recovery and Enforcement, Staff Report No. 13, 1993; Calavita, Kitty, Pontell, Henry N., and Tillman, Robert H. *Big Money Game: Fraud and Politics in the Savings and Loan Crisis*, Berkeley, Calif.: University of California Press, 1997; Ettleson, Sherry and Thomas Hilliard, *Crime and Punishment in the S&L Industry: The Bush Administration's Anemic War on Crime* C:\Documents and Settings\ccooper\Local Settings\Temporary Internet Files\OLK6\FE Manuscript DRAFT No 12 created 091605.doc - last revised 9/27/2005 4:12 PM

In 1987, losses at Texas S&Ls comprised more than one-half of all S&L losses nationwide, and of the 20 largest losses, 14 were in Texas. In January 1987, GAO declared the FSLIC fund insolvent by at least \$3.8 billion.<sup>231</sup>

Edwin Gray ended his term as chairman of Federal Home Loan Bank Board in June 1987. In April 1987, before his departure, he was summoned to the office of Sen. Dennis DeConcini. DeConcini, with four other Senators (John McCain, Alan Cranston, John Glenn, and Donald Riegle) questioned Gray about the appropriateness of Federal Home Loan Bank Board investigations into [Charles Keating's Lincoln Savings and Loan](#). All five senators, who have received campaign contributions from Keating, would become known as the "Keating Five". The subsequent Lincoln failure is estimated to have cost the taxpayers over \$2 billion.<sup>232</sup>

In November 1988, George Bush was elected President and the S&L problem was not part of election debate. In February 1989, President Bush unveiled the S&L bailout plan in. In August, [Financial Institutions Reform Recovery and Enforcement Act \(FIRREA\)](#)<sup>233</sup> FIRREA abolished the Federal Home Loan Bank Board and FSLIC, switched S&L regulation to the newly created Office of Thrift Supervision (OTS). The deposit insurance function shifted to the FDIC. A new entity, the Resolution Trust Corporation (RTC) was created to resolve the insolvent S&Ls.<sup>234</sup>

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*S&L Fraud*, Washington, DC: Public Citizen's Congress Watch, 1990;*Failed Thrifts: Internal Control Weaknesses Create an Environment Conducive to Fraud, Insider Abuse, and Related Unsafe Practices*, Washington, DC: U.S. General Accounting Office, 1989. T-AFMD-90-4;Gup, Benton, *Bank Fraud: Exposing the Hidden Threat to Financial Institutions*, Rolling Meadows, IL: Bankers Publishing Co., 1990;Mayer, Martin, *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry*, New York: Charles Scribner's Sons, 1990; O'Shea, James, *The Daisy Chain: How Borrowed Billions Sank a Texas S&L*, New York: Pocket Books, 1991;Pilzer, Paul Z. and Robert Deitz, *Other People's Money: The Inside Story of the S&L Mess*, New York: Simon and Schuster, 1989.;*The U.S Government's War Against Fraud, Abuse, and Misconduct in Financial Institutions: Winning Some Battles but Losing the War: Twenty-Ninth Report*, Washington, DC: U.S. House of Representatives. Committee on Government Operations, Committee Report 101-982, 1990;Whitford, Taylor & Preston, *Issues Regarding the Role of Fraud and Other Criminal Misconduct in Causing Failures in the Thrift Industry*, Washington, DC: National Commission on Financial Institution Reform, Recovery and Enforcement, Staff Report No. 14, 1993; *Why S&L Crooks Have Failed to Pay Millions of Dollars in Court-Ordered Restitution: Nineteen Case Studies*, Washington, DC: U.S. House of Representatives. Committee on Banking, Finance and Urban Affairs, Committee Print 102-11, 1992.;"William Black Tackles the Savings and Loan Debacle," in *Unsung Heroes: Federal Execucrats Making a Difference*, pp. 22-63 by Norma M. Riccucci, Washington, DC, Georgetown University Press, 1995. ;Wilmsen, Steven K., *Silverado: Neil Bush and the Savings and Loan Scandal*, Washington, DC: National Press Books, 1991.

<sup>230</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" pp.3 - 4, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

<sup>231</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 4, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

<sup>232</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 4, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

<sup>233</sup> [Financial Institutions Reform Recovery and Enforcement Act \(FIRREA\)](#), 12 U.S.C. 1181, PL 101-73, 108 Stat 183 (8/9/1989)

<sup>234</sup> Federal Deposit Insurance Corporation (FDIC) "The S&L Crisis: A Chrono-Bibliography" p. 5, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

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Other major provisions of FIRREA included: \$50 billion of new borrowing authority, with most financed from general revenues and the industry; meaningful net worth requirements and regulation by the OTS and FDIC; and allocation of funds to the Justice Department to help finance prosecution of S&L crimes. Additional bank crime legislation the next year (i.e., the Crime Control Act of 1990) mandated a study by the National Commission on Financial Institution Reform, Recovery and Enforcement to uncover the causes of the S&L crisis, and come up with recommendations to prevent future debacles.<sup>235</sup>

### **3. Who made money on it and what did the S&L cost American taxpayers?**

In 1989, Congress appropriated \$157 billion to bail out the S&Ls. But by that time, the costs were over \$200 billion and rising.<sup>236</sup> In 1990 the GAO estimated “that losses from thrift failures could be as much as \$500 billion in the next 40 years”.<sup>237</sup> To make up the difference, the Resolution Trust Corporation was formed; it sold off the assets of failed S&Ls. Often in deals the seem much more beneficial to the buyers than to the U.S. taxpayers.<sup>238</sup>

“For example, Robert Bass, one of the richest men in America, bought American Savings and Loan for \$350 million, then received \$2 billion in government subsidies to help him resurrect it. During one week in 1988, the government promised \$8 billion in assistance to nine S&L purchasers; one of them put \$20 million down, and the other eight paid nothing.”<sup>239</sup>

The GAO estimated as of January 1990 that \$325 billion would be needed over 33 years to pay off the FSLIC’s obligations, resolve problems of institutions awaiting resolution, pay interest on the \$30 billion in bonds ...of the Resolution Funding Corporation (REFCORP)...and administrative expenses.<sup>240</sup> As of August 1990 the GAO estimated the

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<sup>235</sup> Federal Deposit Insurance Corporation (FDIC) “The S&L Crisis: A Chrono-Bibliography” p. 5, FDIC web site found at [www.fdic.gov/bank/historical/s&l](http://www.fdic.gov/bank/historical/s&l) (3/7/05)

<sup>236</sup> Stephen Pizzo, Mary Fricker & Paul Muolo, *Inside Job, the Looting of America’s Savings and Loans*, New York: McGraw- Hill, 1989 p. 59, (also e-book format April 2002), Chapter 1.

<sup>237</sup> General Accounting Office (GAO) Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs “Savings & Loan Crisis: Federal Response to Fraud in Financial Institutions” by Richard L. Fogel, Assistant Comptroller General Government Programs (8/1/1990) p. 1.

<sup>238</sup> Mark Zepezauer & Arthur Naiman, “The S&L Bailout: \$32 billion every year for 30 years” from *Take the Rich Off Welfare* Odonian Press (1996) found at

[http://www.thirdworldtraveler.com/Corporate\\_Welfare/S&L\\_Bailout.html](http://www.thirdworldtraveler.com/Corporate_Welfare/S&L_Bailout.html), 3/13/05

<sup>239</sup> Mark Zepezauer & Arthur Naiman, “The S&L Bailout: \$32 billion every year for 30 years” from *Take the Rich Off Welfare* Odonian Press (1996) found at

[http://www.thirdworldtraveler.com/Corporate\\_Welfare/S&L\\_Bailout.html](http://www.thirdworldtraveler.com/Corporate_Welfare/S&L_Bailout.html), 3/13/05

<sup>240</sup> General Accounting Office “Resolving the Savings and Loan Crisis: Billions More and Additional Reforms Needed”, Statement of Charles A. Bowsher, Comptroller General of the United States before the U.S. Senate Banking, Housing and Urban Affairs Committee, April 6, 1990.

cost, including interest could be as much as \$500 billion, stating, “the taxpayers will have to pay for most of it.”<sup>241</sup>

According to Zepezaure, writing in 1996: “The actual total will depend on what interest rates end up being between 1990 and 2020, but estimates range from \$500 billion to \$1.4 trillion. (If one estimates by splitting) the difference between these two estimates ...the ultimate cost for the S&L bailout will be \$950 billion. That comes to about \$32 billion a year...for thirty years.”<sup>242</sup>

Curry, writing in 2000 after they claimed the S&L cleanup was complete, stated that due to the 1,043 thrift closures in the 1986-95 period, the insurance resources of FSLIC were overwhelmed, causing taxpayers to pay approximately \$124 billion to cover the depositors insurance and \$29 billion from the thrift industry for a total of \$153 billion<sup>243</sup>. However, Curry’s figures only count the interest payments on the bonds floated for the bailout to the extent that their rate exceeds the normal U.S. Treasury rate.<sup>244</sup> They do not appear to include any figures on the amount of government debt that could have been avoided entirely had the bailout not been necessary.

The bailout funds come from taxpayers and go to the people who buy the bonds, many of whom are the same ones who caused the problems. So, ultimately, the S&L bailout amounts to a massive transfer of wealth from ordinary people to investors (most of whom are wealthy)-as well as to the people who drained money out of the S&Ls. (Few of them were convicted, and the average sentence of those who were was less than two years... Charles Keating, who went to jail because his abuses were so extreme, was the exception, not the rule.)<sup>245</sup>.

Many sources reported that political connections helped protect S&L misconduct,<sup>246</sup> particularly in Florida and Texas.<sup>247</sup>

<sup>241</sup> General Accounting Office (GAO) Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs “Savings & Loan Crisis: Federal Response to Fraud in Financial Institutions” by Richard L. Fogel, Assistant Comptroller General Government Programs (8/1/1990) p.9.

<sup>242</sup> Mark Zepezauer & Arthur Naiman, “The S&L Bailout: \$32 billion every year for 30 years” from *Take the Rich Off Welfare* Odonian Press (1996) found at

[http://www.thirdworldtraveler.com/Corporate\\_Welfare/S&L\\_Bailout.html](http://www.thirdworldtraveler.com/Corporate_Welfare/S&L_Bailout.html), 3/13/05

<sup>243</sup> Timothy Curry and Lynn Shibus, “The Cost of the Savings and Loan Crisis: Truth and Consequences” *FDIC Banking Review*, December 2000, p. 33 (found at [www.fdic.gov/bank/analytical/banking/2000dec/brv13n2\\_2.pdf](http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf))

<sup>244</sup> Timothy Curry and Lynn Shibus, “The Cost of the Savings and Loan Crisis: Truth and Consequences” *FDIC Banking Review*, December 2000, p. 31, note f (found at [www.fdic.gov/bank/analytical/banking/2000dec/brv13n2\\_2.pdf](http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf))

<sup>245</sup> Mark Zepezauer & Arthur Naiman, “The S&L Bailout: \$32 billion every year for 30 years” from *Take the Rich Off Welfare* Odonian Press (1996) found at

[http://www.thirdworldtraveler.com/Corporate\\_Welfare/S&L\\_Bailout.html](http://www.thirdworldtraveler.com/Corporate_Welfare/S&L_Bailout.html), 3/13/05

<sup>246</sup> Jonathan Kwitny, “How Bush’s Pals Broke the Banks,” *The Village Voice*, 10/20/1992, pp.24ff.

<sup>247</sup> David Scheim *Trust of Hustle: The Bush Record* found at [www.campaignwatch.org/more1/htm](http://www.campaignwatch.org/more1/htm)

3/14/05; Scheim cites for the following facts are: *Washington Post*, 10/15/1990, p. A24; *Austin American-Statesman*, 5/17/92, p. G1, and *Washington Post*, 10/15/1990, p. A24. Jeb (Bush)’s defaulted loan from Broward Federal Savings and Loan in Sunrise, Florida transpired as follows. On February 1, 1985, Broward Federal loaned \$4,565,000 to real estate developer J. Edward Houston, secured only by Houston’s personal C:\Documents and Settings\ccooper\Local Settings\Temporary Internet Files\OLK6\FE Manuscript DRAFT No 12 created 091605.doc - last revised 9/27/2005 4:12 PM

In its August 1990 report “Savings and Loan Crisis: Federal Response to Fraud in Financial Institutions,” Richard Fogel of the GAO stated that of the annual appropriation in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)<sup>248</sup> of \$75 million (for each of 1990 1991,1992) to enhance the Department of Justice’s efforts against financial fraud, \$65 million went to fraud prosecutions and \$10 million to civil proceedings.<sup>249</sup> Fogel described the large number of investigations, prosecutions, indictments and convictions obtained by the FBI and US Attorneys, stressing the importance of the Dallas Bank Fraud Task Force,<sup>250</sup> 27 other special task forces and the Special Counsel for Financial Institution Fraud.<sup>251</sup> Fogel sought more funds for the special task forces and Special Counsel<sup>251</sup> and access for the Special Counsel to more timely and centralized data to effectively oversee the government’s effort to pursue financial institution fraud.<sup>252</sup> David Scheim reported that

“In December 1989, the Bush Administration dismantled all 14 of the regional strike forces and folded them into the Justice Department.<sup>1</sup> Attorney General Richard Thornburgh took this step despite widespread protests from Congress and law enforcement officials that it would cripple federal efforts against organized crime.<sup>2</sup> Indeed, during their two decades of operation, the independent strike forces had made enormous progress against organized crime, and had played key roles in convictions of Mafia bosses in major U.S. cities throughout the country.<sup>3</sup> .... Such strike forces nationwide prosecuted Mob figures involved in S&L fraud.<sup>6</sup> Strike Force efforts helped convict, among others, Mario Renda, who,

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guarantee. The same day, a company headed by Houston turned around and loaned the same amount to a partnership of Jeb Bush and Miami real estate developer Armondo Codina for them to buy a five-story building in Miami’s financial district. Curiously, the Bush-Codina partnership was required to repay the loan from Houston “only as, if and to the extent that the cash flow from the building was sufficient to support those payments.” In fact, Bush and Codina made no payments at all on the loan prior to the final default settlement. In 1987 Houston defaulted on the \$4.5 million Broward Federal loan, and the S&L sued both him and the Bush-Codina partnership. In an unusual settlement with the FDIC, Bush and Codina were obligated to repay just \$500,000 of the loan and got to keep the building in the Miami financial district that collateralized the loan. In 1991, federal regulators sued the officers and directors of Broward, charging that the loan used by Bush and Codina cost the savings and loan at least \$4.97 million and was representative of the association’s negligent lending practices. The Bush-Codina loan contributed to the collapse of the Florida S&L, which cost taxpayers \$285 million.

<sup>248</sup> Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), 12 U.S.C. 1181, PL 101-73,108 Stat 183 (8/9/1989)

<sup>249</sup> General Accounting Office (GAO) Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs “Savings & Loan Crisis: Federal Response to Fraud in Financial Institutions” by Richard L. Fogel, Assistant. Comptroller General Government Programs (8/1/1990) p.11.

<sup>250</sup> General Accounting Office (GAO) Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs “Savings & Loan Crisis: Federal Response to Fraud in Financial Institutions” by Richard L. Fogel, Assistant. Comptroller General Government Programs (8/1/1990) p.1-8.

<sup>251</sup> General Accounting Office (GAO) Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs “Savings & Loan Crisis: Federal Response to Fraud in Financial Institutions” by Richard L. Fogel, Assistant. Comptroller General Government Programs (8/1/1990) pp.1,14.

<sup>252</sup> General Accounting Office (GAO) Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs “Savings & Loan Crisis: Federal Response to Fraud in Financial Institutions” by Richard L. Fogel, Assistant. Comptroller General Government Programs (8/1/1990) p.1, 11-13.

working with the Mob, brokered deposits into 130 S&Ls nationwide, all of which failed.”<sup>253</sup>

***4. If a business is too important for the government to allow it to fail, then it is too big to be left free from organized responsibility to that government***

The S&L bailout provides a good example of a cyclical pattern in the relationship between government and business in the U.S. The pendulum seems to swing regularly from regulation to deregulation – from protection from the rich and powerful to protection for the rich and powerful. We saw that pattern with the railroads, from the land grants to the robber barons to the anti-trust laws to the implosion from regulation as rail ceased to be a monopoly to the Conrail bailout and then sale to CSX. With the S&Ls it was creation of S&Ls so the worker could get a home loan through a period of intense regulation after the markets imploded in the depression. As the economy heated up and the Depression sank further into memory, the S&L financiers were able to sell the virtues of deregulation. Deregulation led to uncontrolled profit seeking, to thievery and then to collapse. One would think that after enough of these cycles the pendulum could come to rest on the proposition that the market needs a certain amount of regulation to curb the greed of human nature and the ability of the rich to take unfair advantage of the less wealthy and the commonweal, but that regulation must keep current with market trends, so as not to kill the regulated industry.

The Fair Exchange lesson of the S&Ls is that any business that needs government investment must treat the taxpayers as investors, with the oversight, control and upside potential that any market investor would demand. And, where an industry was created to serve a specific public purpose, that oversight must also include protection of that public purpose.

## **I. 2001 Airline Bailout**

### ***1. Why was ATSSSA created?***

The primary concern of Congress in creating the Air Transportation Safety and System Stabilization Act<sup>254</sup> (“ATSSSA 2001” or “2001 Airline Bailout”) was to preserve the U.S. airline industry that was devastated by the terrorist attacks in New York and Washington D.C. on September 11, 2001 (hereinafter “9/11”). The country and Congress were in shock and focused on these acts as the worst attack on civilians in U.S. history. Congress was not focused on making industrial investment policy. Several airlines lost planes, all

<sup>253</sup> David Scheim *Trust of Hustle: The Bush Record* found at [www.campaignwatch.org/more1/htm](http://www.campaignwatch.org/more1/htm) 3/14/05; Scheim cites for these facts are: *Washington Post*, 12/28/1989, p. A21; *San Diego Union-Tribune*, 1/1/1990, p. B8; *San Diego Union-Tribune*, 1/1/1990, p. B8; *Wall Street Journal*, 8/9/1988, p. A1; and Pizzo, *Inside Job*, pp. pp. 112, 120-23, 303, 337.

<sup>254</sup> Air Transportation Safety and System Stabilization Act, 49 U.S.C. 40101 et seq. P.L. 107-42, September 22, 2001.

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lost revenue when the airports were closed for several days, and most suffered a loss of passengers for months after the 9/11 attacks. Of the \$15 billion appropriated for airline stabilization, \$5 billion was granted to the airlines by the Department of Transportation with no strings attached<sup>255</sup> for “losses incurred as a direct result of the 4-day government shut-down of air traffic and incremental losses stemming from the terrorist attacks.... DOT distributed \$4.6 billion in cash to 427 passenger and cargo air carriers.”<sup>256</sup>

## ***2. Did Congress follow the GAO 1984 study guidelines?***

Apparently the drafters of the Air Transportation Safety and System Stabilization Act<sup>257</sup> (“ATSSSA 2001” or “2001 Airline Bailout”) paid attention to the guidelines outlined in the 1984 GAO Study of earlier bailouts; utilized current business practices to protect the taxpayers’ interests as investors; and made efforts to prevent resort to government funds by those with other options. The Air Transportation Stabilization Board (“ATSB”) board is similar to those created for Conrail and Chrysler. Its voting members are the designees of the Federal Reserve Chair, the Secretaries of Treasury and Transportation, and the designee of the Comptroller General of the United States is a non-voting member.

The ATSB application<sup>258</sup> echoed many of the guidelines in the 1984 GAO Study. The application explicitly limited the salary and termination benefits of executives of any applicant. It required that there be no other available lending source. It required all the financial information a commercial lender would require and a detailed business plan including an analysis demonstrating precisely how the airline intended to repay the debt. The application states “the Board will give greater preference to those applications that meet the greatest number of evaluation criteria” These included: “a demonstration of concessions by the air carrier’s security holders, other creditors, or employees.<sup>259</sup>”, “a description of all security (if any) for the loan”<sup>260</sup> including real estate and financial statements of guarantors<sup>261</sup>; and “ a description of the Federal Government’s ability to participate...in the gains of the Borrower ...through the use of such instruments as warrants, stock options, common or preferred stock, or other appropriate equity instruments. “The Board will give greater preference to... applications that demonstrate

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<sup>255</sup> Press Release from Senators Fitzgerald and Corzine, September 21, 2001, announcing the addition of their provision to ATSSSA entitling the government to negotiate an equity stake in the airlines receiving loan guarantees.

<sup>256</sup> Report of the House Subcommittee on Aviation Hearing on The Financial Condition of the Airline Industry, June 3, 2004 p. 1

<sup>257</sup> Air Transportation Safety and System Stabilization Act, 49 U.S.C. 40101 et seq. P.L. 107-42, September 22, 2001.

<sup>258</sup> Air Transportation Stabilization Board Application for Air Carrier Loan Guarantee, Form # 001, OMB No. 0348-0059.

<sup>259</sup> Air Transportation Stabilization Board Application for Air Carrier Loan Guarantee, Form # 001, OMB No. 0348-0059 p. 5.

<sup>260</sup> Air Transportation Stabilization Board Application for Air Carrier Loan Guarantee, Form # 001, OMB No. 0348-0059 p. 6.

<sup>261</sup> Air Transportation Stabilization Board Application for Air Carrier Loan Guarantee, Form # 001, OMB No. 0348-0059 p. 6.

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that the proposed instruments would ensure that the Federal Government will ... participate in the gains of the air carrier and its security holders.”<sup>262</sup>

Despite the 9/11 crisis atmosphere, in the Senate debate<sup>263</sup> on September 21, 2001, Senators Fitzgerald (R - IL) and Corzine (D - NJ): 1) insisted on equity participation for all loan guarantees; 2) specifically referred to Chrysler loan guarantee warrants; 3) asked that Treasury seek warrants as a condition of each loan guarantee; 4) mentioned that the U.S. government made a \$350 million profit on Chrysler warrants; 5) and mentioned that FDIC wiped out the shareholders of Continental Bank in Chicago before they provided government assistance and came out of it with the FDIC owning 80% of Continental Bank.

Many senators raised concerns about employees and other businesses not protected by ATSSSA<sup>264</sup>.

The criteria utilized in ATSSSA provide a precise and businesslike model for some of the requirements that should be in a Fair Exchange law. Its limitation to a single industry at a time when many of the industry's employees, and many other businesses were deeply injured by the same event raises a logical question. Why shouldn't a policy like this be a general policy to cover all similar government investment situations?

### ***3. Outcome of ATSSSA Grants, Loans and Loan Guarantees***

In his report to the House Committee on Aviation, ATSB Executive Director Michael Kestenbaum stated:

The ATSB received sixteen loan guarantee applications prior to the June 28, 2002 application deadline established under the Board's regulations drafted by OMB. They included a range of large airlines, low-fare airlines, smaller airlines, charter and cargo carriers. The ATSB has approved seven applications, denied eight applications, and has one application pending. One of the approved applications was withdrawn prior to closing. The ATSB has issued six loan guarantees totaling \$1.56 billion supporting loans totaling \$1.74 billion. The carriers who have received ATSB

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<sup>262</sup> Air Transportation Stabilization Board Application for Air Carrier Loan Guarantee, Form # 001, OMB No. 0348-0059 p. 6.

<sup>263</sup> Senate debate on the Air Transportation Safety and System Stabilization Act, September 21, 2001, at pp. S9590

<sup>264</sup> Senate debate on the Air Transportation Safety and System Stabilization Act, September 21, 2001, at pp. S9592-S9595. It did not provide special unemployment benefits to airline workers who were laid off due to 9/11 despite loss of approximately 100,000 jobs in the airline industry due to 9/11. It was more money than the airlines needed to cover the loss from the ground order, and was helping them with their prior economic problems. It did not cover the losses for all the other companies stricken by 9/11 including New York businesses, taxi, hotel, travel agencies and others hurt by lack of flying. Many Senators wanted more money to go for airline security. Many wanted to ensure that air service to small communities would continue. Sen. Nickles mentioned that the loan guarantees to steel companies were for less than 100% of the needed money.

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guarantees are America West Airlines (\$380 million for a \$429 million loan), American Trans Air (\$148.5 million for a \$168 million loan), Aloha Airlines (\$41 million for a \$45 million loan), Frontier Airlines (\$63 million for a \$70 million loan), US Airways (\$900 million for a \$1.0 billion loan), and World Airways (\$27 million for a \$30 million loan). Evergreen Airlines received conditional approval for a loan guarantee but withdrew its application after obtaining a private loan. The loans range in maturity from five to seven years with final maturity dates between 2007 and 2009. The guarantees generally have represented about 90 percent of the total loan amounts, with roughly 10 percent of the risk assumed by private sources.<sup>265</sup>

*4. ATSB only provided loan guarantees to companies that agreed to compensate the taxpayer risk-taking with an equity type of upside benefits*

The statute also indicates that, to the extent feasible and practicable, the government should be compensated for the risk of extending loan guarantees. The ATSB has strived to ensure that the government has been compensated for the risk assumed in making the guarantees through fees and stock warrants. To date, the six ATSB borrowers have paid approximately \$145 million in guarantee fees to the Government. The ATSB also obtained stock warrants in the six air carriers to allow the government to participate in their financial success. For those air carriers, the warrants represent between 10 percent and 33 percent of each company's equity. Based on recent stock prices, the ATSB warrants currently have a "paper value" in excess of \$100 million. While they can be exercised and sold at the Board's discretion -- the Board is exploring different options for monetizing the warrants -- the actual value realized will be a function of a number of factors such as the size of the position offered, liquidity of the underlying stock and markets, investor interest, and the timing and manner in which the warrants are monetized. The warrants will have expired by 2012.<sup>266</sup>

Currently, all five of the outstanding ATSB guaranteed loans are performing.<sup>267</sup> See Table 2 below for loan guarantee amounts and Table 3 (see Appendix A) for equity provided to the government in exchange.

<sup>265</sup> Testimony of Michael Kestenbaum, Executive Director of the Air Transportation Stabilization Board before the Subcommittee on Aviation United States House of Representatives, June 3, 2004 p.1.

<sup>266</sup> Testimony of Michael Kestenbaum, Executive Director of the Air Transportation Stabilization Board before the Subcommittee on Aviation United States House of Representatives, June 3, 2004 p. 2.

<sup>267</sup> "The current amount of outstanding guarantees is \$1.19 billion. Frontier Airlines repaid its loan in full ahead of schedule in December of last year. However, there is always a risk of eventual defaults given the challenges the industry continues to face. The ATSB closely monitors the financial performance of all of its borrowers. The borrowers submit monthly financial reports to the ATSB, and the ATSB meets regularly with the borrowers to discuss the state of the business.

**Table 2. ATSB Loan Guarantees<sup>268</sup>**

Carrier	ATSB Loan \$ (millions)	Total Loan (including private loans) \$ (millions)
America West	380	429
American Trans Air	148.5	168
Aloha Airlines	41	45
Frontier Airlines	63	70
US Airways	900	1,000
World Airways	27	30

**5. Fair Exchange Requirement saved the taxpayers \$8.4 billion of available credit**

The airlines that sought loans or loan guarantees, but were unwilling to provide stock warrants, such as Northwest Airlines, did not receive loan guarantees<sup>269</sup>. The Act provided ATSB \$10 billion of loan guarantee authority during a specific time frame. At the end of that period, the ATSB approved seven out of 16 applications and issued \$1.6 billion in loan guarantees.<sup>270</sup> Thus the airline industry was preserved, but the taxpayers did not spend public funds needed for other important public functions, to subsidize any airline that did not have true need.

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On occasion, the Board has granted amendments and waivers to loan terms for several of its borrowers. In these cases, the ATSB strives to ensure that taxpayer interests are protected or enhanced. For example, the ATSB negotiated a prepayment of \$250 million from US Airways as part of an agreement to provide the company with flexibility to meet changing conditions in the airline industry.” Testimony of Michael Kestenbaum, Executive Director of the Air Transportation Stabilization Board before the Subcommittee on Aviation United States House of Representatives, June 3, 2004 p. 2.

<sup>268</sup> Statement by Brookly McLaughlin for Subcommittee on Aviation Hearing on the Financial Condition of the Airline Industry (Embargoed until June 3, 2004)

<sup>269</sup> Micheline Maynard, *New York Times* Business Section (on-line) “Airlines Shy Away from Loan Guarantees by U.S., January 3, 2002, [www.nytimes.com/2002/01/03/business/03AIR.html](http://www.nytimes.com/2002/01/03/business/03AIR.html). “The nation’s airlines, which pleaded for a federal bailout package to help them survive the impact of the Sept. 11 terrorist attacks, are shying away from applying for government loan guarantees after seeing” the 33% stock option requirements placed on America West as a condition of its loan guarantee. Immediately after the announcement of the America West deal Northwest said it would not submit an application that it had been preparing.

<sup>270</sup> Report of the House Subcommittee on Aviation Hearing on The Financial Condition of the Airline Industry, June 3, 2004 p. 1

### **III. CITIZEN SHAREHOLDERS: HISTORICAL PRECEDENTS of CITIZEN INCOME FROM GOVERNMENT/QUASI- GOVERNMENT INVESTMENT IN PRIVATE BUSINESSES – for the CASH DISTRIBUTION END of FAIR EXCHANGE**

Section II above (the cash infusion section) gave examples in which private companies sought and received financial assistance or investment from the public sector. In some of those instances, the government received a return on equity. This section (the cash distribution section) provides examples in which the citizens receive income or equity return from the public or quasi-public investment.

#### **A. Alaska Permanent Fund (APF) sharing oil and gas revenue with all Alaska citizens**

##### *1. History of APF*

In 1955, the drafters of the Alaska Constitution were acutely aware that the Alaskan economy had always been based on natural resource extraction, whether, gold, furs, fish or timber. They understood the inherently precarious position of an extraction based economy and thus provided in Article VIII, Sec.2 of the Alaska Constitution that the legislature would utilize, develop and conserve “all the natural resources belonging to the State...for the maximum benefit of its people.”<sup>271</sup>

The 1967 discovery of large oil reserves on state-owned land in the Prudhoe Bay area of Alaska resulted in a windfall to the State. The State, which had a total budget of \$124 million in 1969, before the oil revenues began to flow into the state coffers, received \$3.7 billion in petroleum revenues during the 1981 fiscal year. This income will continue and most likely grow for some years in the future. Recognizing that its mineral reserves, although large, are finite, and that the resulting income will not continue in perpetuity, the State took steps to assure that its current good fortune will bring long-range benefits.<sup>272</sup>

In 1969 Alaska, at its initial auction of leasing rights at Prudhoe Bay received a \$900 million lease bonus from the oil companies. The State was only 10 years old and opted to spend those funds on basic infrastructure needs, such as schools, water, sewers, roads, airports, health, education and social services. But shortly after spending these funds a consensus developed in the State that too much of the \$900 million had been spent too quickly and that the state needed to do a better job of saving its one-time oil money.<sup>273</sup>.

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<sup>271</sup> The Early History of the Alaska Permanent Fund, Trustee Papers # 5, Alaska Permanent Fund 1997

<sup>272</sup> *Zobel v. Williams*, 457 U.S. 55,56-57 (1982)

<sup>273</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of, Alaska Department of Revenue, and *An Alaskan's Guide to the Permanent Fund*, 10<sup>th</sup> edition (2001), Alaska Permanent Fund pp.2-3

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Therefore in the 1970s, with the development of the trans-Alaska oil pipeline that would finally turn North Slope oil into cash, Alaskans sought a way to retain long-term benefit from the oil revenue. Until the pipeline started eight years after the 1969 lease sale, there was no money and Alaskans were concerned about when they would see something more than the \$900 million lease bonuses.<sup>274</sup>

The outcome was a Constitutional Amendment approved via a general election in 1976 stating that “At least 25% of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the state shall be placed in a permanent fund, the principal of which shall be used only for those income producing investment specifically designated by law as eligible for permanent fund investments<sup>275</sup>. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.”<sup>276</sup> Subsequent legislation increased the minimum percentage from 25% to 50% for a small number of new leases, though the legislature repealed the change in 2003 and returned to the 25% standard.<sup>277</sup>

After the Fund was established there was a major debate about whether the Fund should be managed as a savings trust for the future or as a development bank. As a development bank it would have made loans to help create and expand businesses and jobs in Alaska by lending to companies. The alternative was the creation of a public trust in which the primary purpose was protection of the principal, with only the interest available for appropriation by the legislature. The latter argument won out.

In 1980 the Alaska legislature decided that the Fund should adhere to the “prudent investor rule” and its trustees should invest in diversified trust quality investments.<sup>278</sup> The Fund is managed separately from the other state investments.<sup>279</sup>

In 1980, the Alaska legislature created the first APF dividend program. It provided that a portion of the APF’s earnings annually be distributed to each Alaska citizen over the age of 18 based on a formula providing one dividend unit for each year of residency since 1959. A single unit was valued at \$50. So that a resident since 1959 would have received 21 units or \$1,050, while a one-year resident would have received \$50. The U.S. Supreme Court ruled this system unconstitutional as a violation of equal protection under

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<sup>274</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of, Alaska Department of Revenue.

<sup>275</sup> Alaska Constitution Article IX, Section 15, and **Alaska Statutes Sec. 37.13.010**.

<sup>276</sup> *An Alaskan’s Guide to the Permanent Fund*, 10<sup>th</sup> edition (2001), Alaska Permanent Fund p. 6

<sup>277</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

The Early History of the Alaska Permanent Fund, The Trustee Papers # 5, Alaska Permanent Fund 1997) p.37.

<sup>278</sup> An Alaskan’s Guide to the Permanent Fund, pp. 10-11.

<sup>279</sup> *An Alaskan’s Guide to the Permanent Fund*, pp. 10-11. Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

the U.S. Constitution's 14<sup>th</sup> Amendment.<sup>280</sup> (The current formula is in the 'Dividend Formula' section below.)

Separate from the legal battle over dividends, the legislature in 1981 made a special appropriation of \$1.8 billion in surplus oil revenue to the APF, an additional \$1.26 billion in 1986, and several hundred million dollars more in the following years.<sup>281</sup>

In 1982 the Legislature, at the request of the APF Trustees, enacted an "inflation proofing" program to protect the Fund's purchasing power by moving some of each year's investment earnings into the protected principal, to cover the "loss" to inflation.<sup>282</sup> In 1983 the Fund branched out from CDs and bonds and<sup>283</sup> first invested in the stock market and a year later in real estate. By 1987 the APF was larger than any other endowment or private foundation in the country. In 1990 its assets reached \$10 billion. In 1990 it began to invest outside the U.S.<sup>284</sup> In 1998 the APF's earnings first exceeded the State's general oil royalty and tax revenue, as it earned revenue of \$2.6 billion with assets of \$25 billion. APF's investment earnings had started exceeding its constitutionally mandated 25% deposits years earlier, back in the early 1980s.<sup>285</sup>

## **2. Legislative Mission of APF**

The Permanent Fund legislation AS 37.13.040 transferred management of the assets, investments and earnings from the Alaska Department of Revenue to the Alaska Permanent Fund Corporation in April 1980. The Corporation's mission under AS 37.13.020 is to:

- 1) ...provide a means of conserving a portion of the State's revenues from mineral resources to benefit all generations of Alaskans;
- 2) ...maintain safety of principal while maximizing total return; and
- 3) ...be used as a saving device managed to allow the maximum use of disposable income from the Corporation for purposes designated by law.

The 1980 law directed the Trustees to use the Prudent Investor Rule, to diversify investments, to invest only in income producing assets, and only to invest in specific

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<sup>280</sup> *Zobel v. Williams*, 457 U.S. 55 (1982)

<sup>281</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

<sup>282</sup> *An Alaskan's Guide to the Permanent Fund*, p. 14, A.S. 37.13.145 and Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

<sup>283</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

<sup>284</sup> *An Alaskan's Guide to the Permanent Fund*, p. 16

<sup>285</sup> Email from Laura Achee to author, 06/04/05, Alaska Permanent Fund Public Relations staff, correcting initial draft of this article; and Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

classes of assets permitted under AS 37.13.120.<sup>286</sup> The legislature gradually expanded the list of allowable investments, and then in 2005 eliminated the list entirely, directing that the Trustees only follow the Prudent Investor Rule.<sup>287</sup> The Rule means, among other things, that investments must be diversified and that any investment in Alaska must be held to the same investment criteria as any other investment. Though there is no statutory provision mandating Fund investments in Alaska, the APFC runs an internship program to train Alaskans in finance, and they invest through brokers with Alaska offices.<sup>288</sup> The Trustees' investment strategy seeks to obtain a 5% real rate of return (over inflation).<sup>289</sup>

### **3. Allocation of Funds**

Annually, at least 25% of the State's mineral royalties and lease bonuses must be placed in the APF<sup>290</sup>. The principal is invested, but cannot be spent without a vote of the citizens.<sup>291</sup> The income<sup>292</sup> can be spent by the Legislature or reinvested. The required percentage of oil and gas royalties goes into the "Reserved Fund Balance". The Reserved Fund Balance holds all such required annual deposits plus additional appropriations made by the Legislature from income for inflation proofing or any other purpose. It also includes all unrealized Fund gains (losses).<sup>293</sup>

The "Unreserved Fund Balance" also known as the "Realized Earnings Account" (REA) is the portion of the APF that may be spent by the Legislature. The Fund's Statutory Net Income is its Realized Earnings (consisting primarily of interest, dividends, rents from real estate or capital gains (losses) realized upon any asset sales) less the cost of managing the Fund assets.<sup>294</sup> The Statutory Net Income is available for appropriation by the Legislature, which, over the years, has chosen to spend the money for dividends for

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<sup>286</sup> *The Early History of the Alaska Permanent Fund*, The Trustee Papers Vol. No. 5, Alaska Permanent Fund (1997) p. 62

<sup>287</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>288</sup> An Alaskan's Guide to the Permanent Fund, p. 24

<sup>289</sup> *An Alaskan's Guide to the Permanent Fund*, p. 22; Email from Laura Achee to author, 06/04/05, Alaska Permanent Fund Public Relations staff, correcting initial draft of this article; and Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

<sup>290</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>291</sup> An Alaskan's Guide to the Permanent Fund, p. 18

<sup>292</sup> APF income is defined under AS 37.13.140 (1982)

<sup>293</sup> A.S. 37.13.140 (1982); Alaska Permanent Fund 2005 Financial Statement pp.4-5 Fund Financial History & Projections as of February 25, 2005 (found at [www.apfc.org/iceimages/financials/2005](http://www.apfc.org/iceimages/financials/2005) (3/23/05)

<sup>294</sup> Alaska Statutes 37.13.145; Alaska Permanent Fund 2005 Financial Statement pp.4-5 Fund Financial History & Projections as of February 25, 2005 (found at [www.apfc.org/iceimages/financials/2005](http://www.apfc.org/iceimages/financials/2005) (3/23/05)

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Alaskans and little else.<sup>295</sup> AS 37.13.145 mandates (among other things) the formulae for allocating dividends<sup>296</sup> to the Alaskan people and for inflation proofing<sup>297</sup> of the principal, which is merely moving the money from one column in the ledger (earnings) to another (principal) and really isn't spending the money at all.<sup>298</sup> After the Legislature provides these two mandatory items, the remainder stays in the unreserved portion of the Fund and is invested along with the principal.<sup>299</sup>

In most years the Fund produces income in excess of what is required for dividends and inflation proofing. Any remaining income becomes part of the Earnings Reserve Account (ERA). The Legislature may appropriate funds in the ERA for any lawful purpose<sup>300</sup>, but has never chosen to do so in any significant amount.<sup>301</sup> Some years the Legislature makes additional appropriations to the Reserved Fund (principal) after making appropriations required by Statute.<sup>302</sup>

#### ***4. Inflation proofing to make the Fund permanent***

The purpose of inflation proofing is to preserve the corpus of the Fund against inflation and the inevitable exhaustion of oil resources and revenue.

In 1982 the Legislature enacted the inflation proofing formula currently in use, which is to multiply the percentage change in the U.S. Consumer Price Index from one calendar year to the next by the principal balance at the end of the fiscal year.<sup>303</sup> For example, if the CPI went up 3%, and the Fund balance stood at \$20 billion, the formula dictates that

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<sup>295</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

·AS 43.23.025 This is the dividend formula. .Add together the fund's net income for the previous five years. Multiply that number by 21%. Divide by 2. Then divide by the number of eligible applicants.

<sup>297</sup> AS 37.13.145(c)

<sup>298</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>299</sup> Email from Laura Achee to author, 06/04/05, Alaska Permanent Fund Public Relations staff, correcting initial draft of this article

<sup>300</sup> An Alaskan's Guide to the Permanent Fund, pp. 32

<sup>301</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>302</sup> Alaska Permanent Fund 2005 Financial Statement pp. 4-5 Fund Financial History & Projections as of February 25, 2005 (found at [http://www.apfc.org/iceimages/financials/2005\\_2\\_Fin.pdf](http://www.apfc.org/iceimages/financials/2005_2_Fin.pdf) (3/23/05); and Email from Laura Achee to author, 06/04/05, Alaska Permanent Fund Public Relations staff, correcting initial draft of this article

<sup>303</sup> AS 37.13.145(c) (1982) and Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

the legislature move \$600 million from earnings to the Fund's principal to cover the loss to inflation. Depending on the rate of inflation, and the Fund's earnings, that transfer could represent a lot or a little of any one year's earnings.<sup>304</sup> For 1991, 53% of the Fund's income was needed for inflation proofing. While in 1987 with high earnings and low inflation only 14% was needed for inflation proofing.

In 2001, at the request of the Board of Trustees, legislation was proposed which would place before Alaska voters a constitutional amendment to provide complete and permanently protected inflation-proofing for the entire Fund rather than just the principal.<sup>305</sup> (The Legislature has consistently declined since then to place the constitutional amendment on the ballot for political rather than fiscal reasons<sup>306</sup>.) As of March 21, 2005 it was being reintroduced.<sup>307</sup>

The trustees' constitutional amendment proposal is to cap annual payouts from the Fund for any purpose at 5% of the Fund's total market value, in order to make APF a permanent resource. The trustees' long-term target is an 8% annual return, with an assumed annual inflation rate of 3% on average, leaving a real rate of return at 5%. Therefore, in the long term, to allow enough retained earnings to protect the entire Fund against inflation and to protect the Fund's principal from any incursion, the trustees believe the annual payout should be limited to no more than 5% of a rolling five-year average of total market value.<sup>308</sup>

### **5. Dividend Formula**

In 1982 the first \$1,000 dividend check was distributed to Alaska residents, based on a dividend formula revised in light of the *Zobel v. Williams*, 457 U.S. 55 (1982) case that

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<sup>304</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>305</sup> *An Alaskan's Guide to the Permanent Fund*, p. 17; and Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>306</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>307</sup> Deborah Olson interview with Laura Achee, Communications and Research Liaison Alaska Permanent Fund Corporation (3/22/05)

<sup>308</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

tossed out the original plan to base the amount of the dividend on years of Alaska residency. Under the new formula equal payments are made to every Alaskan who applies, resides in the State during the qualifying year and on the dividend application date, and was present in the State for at least 72 consecutive hours at some time during the prior 2 years (or is a child born of or adopted by such a person).<sup>309</sup>

The initial dividend payment was \$1,000 per eligible resident in 1982. Thereafter they were based on the earnings of the APF and divided equally for the accounts of every eligible resident.<sup>310</sup> The current dividend formula adds together the Fund's net income for the previous 5 years, multiplies it by 21% and divides by 2. The effect is that about half of the Fund's realized earnings for the average of the previous five years is paid out in annual dividends each year.<sup>311</sup> That amount is then allocated equally among all eligible Alaska residents. Based on that formula the dividend has ranged from an annual low of \$331.29 in 1984 to a high of \$1,963.86 in 2000.<sup>312</sup> Investment earnings, not oil prices, drive the dividend, and the poor stock market returns of 2001 and 2002 have cut into the payments to Alaskans.<sup>313</sup> Regardless of that temporary setback, the dividends have had an important impact on the Alaskan economy, and have been an especially important source of income in rural Alaskan communities.<sup>314</sup>

## 6. APF Structure

The Fund is managed independently from the state treasury to separate the saving from spending functions<sup>315</sup>. The initial APF legislation<sup>316</sup> created a quasi-independent Alaska Permanent Fund Corporation (APFC) to be insulated from day to day politics and yet accountable to the Alaskan people. This critical balance is accomplished by having: a) a board made up of independent trustees, b) a requirement that the APFC report annually to the Legislative Budget and Audit Committee and c) the APFC's annual budget approved by the legislature.<sup>317</sup>

There are six trustees. The four public members, all appointed by the governor serve four-year terms, and the two members of the governor's cabinet serve until they leave their post, or the governor removes them. The public trustees are supposed to be

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<sup>309</sup> Alaska Statutes 43.23.005. Some residents, such as incarcerated criminals, AS 43.23.028 (a), are ineligible to receive dividends. There are various exceptions to the residency requirements for students, those on active military service, etc. AS 43.23.008.

<sup>310</sup> *The Early History of the Alaska Permanent Fund*, The Trustee Papers Vol. No. 5, Alaska Permanent Fund (1997)

<sup>311</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>312</sup> An Alaskan's Guide to the Permanent Fund, pp. 28 – 29.

<sup>313</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>314</sup> An Alaskan's Guide to the Permanent Fund, pp. 29

<sup>315</sup> An Alaskan's Guide to the Permanent Fund, p.11

<sup>316</sup> AS 37.13.010

<sup>317</sup> *An Alaskan's Guide to the Permanent Fund*, p.33. Alaska Statutes Sec. 37.13.050

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experienced people in the fields of business and finance. The two cabinet members are the Commissioner of Revenue and another trustee of the governor's choice.<sup>318</sup>

Investment decisions are based on an investment strategy adopted by the six-person Board of Trustees. The strategy is designed to protect the principal and produce an average annual real rate of return of five percent over the long term. Expecting the Fund to outperform inflation by five percent is realistic given the Fund's relatively diverse investment portfolio in stocks, bonds, real estate and private equity holdings.<sup>319</sup>.

To achieve a five percent real rate of return, the Trustees established and continuously review an asset allocation target. Asset allocation determines the types and percentages of investments, e.g. the 2001 asset allocation was 35% in domestic bonds, 2% in non-dollar bonds, 37% in domestic stocks, 16% in international stocks and 10% in real estate<sup>320</sup>.

Trustees employ an executive director who hires staff to conduct the day-to-day operations of the corporation. By design, the APFC outsources with investment professionals as needed to manage, analyze and monitor investments and returns. In-house staff work in the following functional areas: executive, investments, finance, information technology, administration, and communications<sup>321</sup>.

## **7. Economic Impact of APF**

For over 20 years every eligible Alaska citizen has received an equal share annual dividend distribution from the Alaska Permanent Fund (APF), capitalized by a portion of the revenues from oil and gas production on publicly owned lands. As the Fund has grown in value, the size of the annual dividend has increased so that in 2005 about \$600 million will be distributed to 600,000 citizens.<sup>322</sup> In 2002, almost \$1 billion<sup>323</sup> was distributed to 600,000 citizens – directly accounting for 6 percent of total household income in Alaska.<sup>324</sup>

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<sup>318</sup> An Alaskan's Guide to the Permanent Fund, p.34, Email from Laura Achee to author, 06/04/05, Alaska Permanent Fund Public Relations staff, correcting initial draft of this article; and Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>319</sup> An Alaskan's Guide to the Permanent Fund, p.21-22, and Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue

<sup>320</sup> An Alaskan's Guide to the Permanent Fund, p.22

<sup>321</sup> An Alaskan's Guide to the Permanent Fund, p.35

<sup>322</sup> Alaska Permanent Fund Dividend Annual Report 2004 Executive Summary p 5,

<http://www.pfd.state.ak.us/forms/Annual%20Reports/2004%20Annual%20Report.PDF> (found on internet 08/29/05).

<sup>323</sup> Alaska Permanent Fund Dividend Annual Report 2002 Executive Summary p 5,

<http://www.pfd.state.ak.us/forms/Annual%20Reports/2002%20Annual%20Report.PDF> (found on internet 08/29/05).

<sup>324</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, "The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution" paper for 9<sup>th</sup> Congress of Basic Income European Network (2002).

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The Dividend program has disproportionately increased the incomes of the poor and rural Alaskans, and has been found the most successful means to encourage economic activity in Alaska.<sup>325</sup>

University of Alaska, Economics Professor, Scott Goldsmith<sup>326</sup> notes that although there is a lot of interest in the macroeconomic effect of the Permanent Fund Dividend (PFD) on job creation, wage rates, personal and family income generated by the PFD and the effect on Alaskans' spending and saving habits since the inception of the PFD, there is not much information available on these matters. He says that in spite of the fact that PFD is the "largest appropriation of state government (exceeding in high dividend years even that for primary and secondary education) there has never been an audit to determine how the funds have been used –including what parents are doing with their children's PFDs."<sup>327</sup> Goldsmith attributes two reasons to the reluctance to study these matters. 1) Alaskans feel that they personally own a portion of the oil and thus what they do with their oil dividends is private. 2) Politicians are loath to study the subject because they do not want to give the impression they are considering changing this extraordinarily popular program.<sup>328</sup> Goldsmith says "there is no evidence that the dividend has led to significant investment in new business activity, although it has undoubtedly resulted in significant investment in human capital."<sup>329</sup>

The APF dividends are distributed in October. Based on anecdotal evidence, many economists believe that Alaskans see this distribution, shortly before Christmas, as a year-end bonus and use a lot of it on consumer durables.<sup>330</sup> Appliance, furniture and auto merchants, and travel agents do a lot business immediately after the dividends are distributed and advertise and compete for that business declaring "Dividend Days"<sup>331</sup>.

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<sup>325</sup> Trustee Papers #5, p. 38, 74

<sup>326</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, "The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution" paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) pp.8-9.

<sup>327</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, "The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution" paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 9.

<sup>328</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, "The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution" paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 9.

<sup>329</sup> Email to author from Scott Goldsmith dated 5/25/2005 upon review of an earlier version of this article.

<sup>330</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, "The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution" paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 9.

<sup>331</sup> Tony Lewis, "Devoted to the Dividend: Budget Crisis or Not, Alaskans love getting their share of oil wealth", *Alaska Magazine*, September 2004, (found at

[www.alaskamagazine.com/stories/0904/feature\\_pdf.shtml](http://www.alaskamagazine.com/stories/0904/feature_pdf.shtml) (9/9/04) with additions from Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of , Alaska Department of Revenue.

Goldsmith states that there is no evidence of a large impact on the current labor force participation, but that there may be a negative impact on wages, which is offset by the dividend. There is some evidence that the dividend may induce some in-migration by large poor families, but this temptation is moderated by the one-year residency requirement<sup>332</sup> (not to mention the difficult climate). “Under the residency rules, a family that moved to Alaska in May 2005 would not receive their first Permanent Fund dividend until October 2007, a long time to wait for “free” money if they are poor.”<sup>333</sup>

Nonetheless, Goldsmith contends “the dividend has had a dramatic effect making the distribution of income in Alaska among the most equitable in the entire United States. ...data reported by the Economic Policy Institute show ... that in the last 10 years the income of the poorest fifth of Alaska families increased 28 percent compared to a 7 percent increase of the richest fifth. In contrast, for the entire United States over the same period, the increase for the poorest fifth was 12 percent compared to 26 percent for the richest fifth.”<sup>334</sup> From 2000-2003, the poorest fifth of U.S. households have had income declines of 6.0%. Incomes in the highest 5% of U.S. families for that period remained flat.<sup>335</sup>

“The dividend should help to empower low income Alaskans in various ways ... (including) “increase in volunteer work, ... increase in wage rates in unattractive work situations or reduction in instances of spousal abuse.”<sup>336</sup> The PFD stabilizes the cash flow to rural areas where the per capita money incomes are amongst the lowest in the U.S., and non-governmental sources of income are variable and uncertain. This is particularly true of communities dependent on production of fish or natural resources, which fluctuate dramatically based on changes in harvest or prices.<sup>337</sup> “In some areas the PFD now directly accounts for more than 10 % of cash income.”<sup>338</sup> It has also had a general stabilizing effect on the State economy for similar reasons.

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<sup>332</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 9.

<sup>333</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

<sup>334</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 9.; and Economic Policy Institute, State Income Equality Continued to Grow in Most States in the 1990’s Despite Economic /growth and Tight Labor Markets, news release data 1/18/00, accessed from the internet 7/02/02 at <http://www.chopp.org/1-18-00-sfp.htm>

<sup>335</sup> Economic Policy Institute (EPI) Income Picture, <http://www.epinet.org>, accessed August 26, 2004.

<sup>336</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) pp. 11 – 12.

<sup>337</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 12.

<sup>338</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 12.

## ***8. Social Impact***

An entire generation of Alaskans has grown up in a State where no income or broad based sales taxes are collected. “The legislature abolished Alaska’s personal income tax in 1979, after it had been in effect for 30 years, and the state has never had a state sales tax.”<sup>339</sup> Instead the State sends each resident an annual check. How has this affected social discourse on matters of public policy or public spending? No one has formally studied this.<sup>340</sup> Goldsmith says many feel this has created a generation whose only relationship to the State comes when they cash the check. He contends that it has created an “environment preoccupied with consumption that may be detrimental to investment and the longer-term needs of society.” He says that: many young Alaskans do not understand the source of the PFD; politicians fall over each other to protect this popular program; and that this obsession with the PFD threatens normal discourse over the state budget, since every issue is seen through the lens of its potential impact on the dividend. “This is a problem because now oil revenues have fallen to the point where earnings from the Permanent Fund might logically be used as a replacement source of revenue.”<sup>341</sup> Yet the communal mindset of taxpayers who are used to paying for such things has never existed for young Alaskans.

With the decrease in oil revenue, Alaska will inevitably have to either reduce the dividend to pay for state services or implement an income tax. There are numerous arguments on both sides of the question whether to decrease the dividend or implement a state income or sales tax or drastically cut services – or a combination of the above<sup>342</sup>. One argument in favor of continuing the dividend while instituting an income tax is that, at least then the government would have to ask the citizens for tax funds rather than the government simply taking what it wanted from the Permanent Fund.<sup>343</sup> Another is that some out-of-state residents or visitors would pay the income or sales tax, and that the state income tax is deductible from federal income taxes. There is an argument that reducing the dividend would put the burden of government disproportionately on the poorest Alaskans.

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<sup>339</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

<sup>340</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 12.

<sup>341</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p. 13.

<sup>342</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

<sup>343</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) pp. 13 – 14.

Although many believe the Fund was originally envisioned as a means to help pay for government in the future, “a significant minority of the population feels that under no circumstances should the earnings of the fund be used to help pay for state government.”<sup>344</sup> Separating management of the Fund from the government has exacerbated this problem. For most of the decade from 1992-2002 the state government has operated at a deficit, while the Fund has operated with a surplus. This message confuses the public.<sup>345</sup> The PFD has fostered “a feeling that the government exists to distribute cash to its citizens, but that individuals do not need to contribute to public life. These young people have not been schooled in the responsibilities that come with living in a representative democracy.”<sup>346</sup>

The PFD is a less significant factor in life choices as income increases, because it is a smaller percentage of income and much of it may be dissipated in taxes. This use of public funds is not well focused on serving the needs of the poorest, although it has the greatest positive impact on them.

#### ***9. APF Lesson for Creating Fair Exchange Programs***

APF provides an excellent model for the front or income-capturing end of a Fair Exchange program. The Alaska Constitution, Article VIII, Sec.2, provides an excellent example of the concept that the State’s natural resources belong to the people and should provide benefit to all the people whenever they are exploited.

Its administration provides many examples of good balance between public and private. The creation of the APFC as a corporation separate from, yet accountable to, the government is a valuable model. APFC must have its budget approved by the state legislature, and the governor appoints most of its trustees. Yet most of the trustees are expected to possess significant financial skills and knowledge. Initially the trustees’ investment authority, including the classes of investments in which they were permitted to invest fund assets, was legislatively mandated and limited, although these limits have been removed and replaced solely by the Prudent Investor Rule.<sup>347</sup> The trustees can propose new methods for inflation-proofing or allocating dividends, but these must be approved by the legislature. The principal cannot be used for any purposes except those approved by the citizens, through a constitutional amendment. “An advantage of

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<sup>344</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p.14..

<sup>345</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p.14..

<sup>346</sup> Scott Goldsmith, Prof of Economic, Institute of Social and Economic Research, University of Alaska, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution” paper for 9<sup>th</sup> Congress of Basic Income European Network (2002) p.17.

<sup>347</sup> Email attachment of 8/1/05 to author, correcting facts on earlier article draft from Larry Persily, City of Anchorage Finance and Budget Coordinator and former Deputy Commissioner of Alaska Department of Revenue.

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managing the fund separate from the rest of the government is transparency. The state budget is a black box, the Permanent Fund is not.”<sup>348</sup>

The distribution end of APF, providing a non-wage income stream to all Alaskans, is another feature that might well be incorporated into a Fair Exchange program. Although, in many states, the value per capita is likely to be much smaller than in Alaska.

Alaska’s situation is also quite unique. Alaska sits on a huge reserve of one of the most sought after and dwindling natural resources, which is able to produce a huge amount of income. It also has a smaller population than most of the other states. Thus, the per capita allocation of the mineral resource income is more significant than it would be if Alaska had a population the size of California’s.

The foresight shown by Alaska when it decided to inflation-proof the APF is an extremely important example for any Fair Exchange program to emulate.

The APF’s social impact is much less impressive. The PFD has not helped create a stronger sense of community in Alaska. There is some evidence that it has had a somewhat opposite effect. Since Alaska’s natural resource wealth is a limited resource, the consumer oriented, individualistic mentality created by the current structure of fund distributions may serve the state poorly if a time comes when the citizens need to pull together for self-preservation in the face natural resource scarcity or global corporate pressure.

If a Fair Exchange program is to provide long-term strength to a community, it must be structured to instill community values in its citizens. It must help them work together for joint benefit, even if some portion of it provides individual benefits, like the APF’s PFD.

The APF principal is invested without any social investment criteria. Its sole investment focus is to achieve a target return. The highly commendable aspect of this policy is that it has consistently grown the fund and provided dividends to citizens. The downside of this strategy, from a Fair Exchange perspective, is that the Fund does not help broaden the active shareholder base of global corporations. One focus of Fair Exchange is to broaden that base and, over time, to exert increasing citizen control over corporate governance and decisions.

Some combination of the APF mechanism for collecting revenue for citizens from private companies that exploit public assets, and the LSIF (described in Section III (D) below) method of reinvestment in entities that commit to serve as exemplary corporate citizens, would be an ideal Fair Exchange program.

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<sup>348</sup> Email to author 5/25/05 from Scott Goldsmith upon review of an earlier version of this article.  
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## B. Alberta Heritage Fund

The statutory mission of the Alberta Heritage Savings and Trust Fund (“Heritage Fund”) is: “To provide prudent stewardship of the savings from Alberta’s non-renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans.”<sup>349</sup>

In 1936, Alberta was the only province in Canadian history to go bankrupt. Alberta was then obligated to pay off every penny of its debt to the government and banks. It could not borrow any money until six years after its debt was paid. Alberta floated a debt bond that allowed it to function and then developed budgets that both paid down the debt and operated the province at the same time, including the introduction of progressive legislation and social programs. The foreign debt was paid in full by 1945 and the domestic debt was paid off in 1949. In 1950 the Heritage Fund was established, with the intention that in 1975 it would start paying each citizen a monthly dividend check. The money that had been going to pay down the debt then was put into a fund that became the Heritage Fund and it was structured in the same form as the Alaska Fund. Ted Hinman, Alberta Treasurer, from the Social Credit Party, went to Alaska to help Alaska get the APF started in 1960. It was anticipated that the Alberta Fund would start paying dividends, like that in Alaska, in 1975, but the government of the day changed its structure and plan.<sup>350</sup>

Politicians and the media told the people of Alberta that the Heritage Fund had reached \$C 40 Billion (rounded) at the same time as the debt also reached \$C40 Billion (rounded). The province operated debt free until 1971 and in that time the province did away with provincial income tax. The income tax was reintroduced by the government of the day in 1982.<sup>351</sup>

According to government and media reports, in March of 2005 the entire debt has been paid off and just yesterday, they announced that there will be a prosperity dividend paid to every Albertan very shortly. It will be a one-time payment, however, not an annual event.<sup>352</sup> The payment is expected to be approximately \$400 per person.<sup>353</sup>

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<sup>349</sup> Alberta Heritage Fund Web Site “FAQ” found at  
<http://www.finance.gov.ab.ca/business/ahstf/history.html> (3/24/05)

<sup>350</sup> Email to author from Chick Hurst, ASCP Historian (Alberta Social Credit Party), 9/13/05; See also Alberta Social Credit Party, “The Heritage Fund & Dividends” found 9/15/05 at  
[http://www.socialcredit.com/subpages\\_history/heritage\\_fund.htm](http://www.socialcredit.com/subpages_history/heritage_fund.htm)

<sup>351</sup> Email to author from Chick Hurst, ASCP Historian (Alberta Social Credit Party), 9/13/05; See also Alberta Social Credit Party, “The Heritage Fund & Dividends” found 9/15/05 at  
[http://www.socialcredit.com/subpages\\_history/heritage\\_fund.htm](http://www.socialcredit.com/subpages_history/heritage_fund.htm)

<sup>352</sup> Email to author from Chick Hurst, ASCP Historian (Alberta Social Credit Party), 9/13/05; See also Alberta Social Credit Party, “The Heritage Fund & Dividends” found 9/15/05 at  
[http://www.socialcredit.com/subpages\\_history/heritage\\_fund.htm](http://www.socialcredit.com/subpages_history/heritage_fund.htm)

<sup>353</sup> Darcy Henton, “Cheques to go to all Albertans Except residents of our prisons, premier says”, *Edmonton Sun*, Sept. 22, 2005.

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In 1957 – 58 the Alberta government experimented with paying direct dividends to citizens.<sup>354</sup> The dividends were in the \$20 range. “The program was suspended when popular opinion indicated people would prefer the money be spent on schools, roads, hospitals and municipalities.”<sup>355</sup> They also had numerous problems of administration and cases of fraud involving people collecting as many as 50 payments.<sup>356</sup> This debate has reopened in Alberta over the proposed 2005 dividend to be distributed directly to Alberta citizens.<sup>357</sup>

### ***1. Alberta Heritage Fund Structure***

A percentage of Alberta’s non-renewable resource revenue is transferred from its General Revenue Fund to the Heritage Fund in any year when the Legislature has passed a Special Act authorizing it.<sup>358</sup> The Provincial Treasurer administers the Heritage Funds and maintains separate accounting records for two Heritage Fund funds: the Endowment Fund and the Transition Fund.<sup>359</sup> The funds in the endowment portfolio have an investment objective of “maximizing long-term financial returns.”<sup>360</sup> Whereas, transition portfolio (which is to cease no later than December 31, 2005), investments “must be made with the objective of supporting the Government’s short-term to medium-term income needs as reflected in the Government’s consolidated fiscal plan.”<sup>361</sup> There is a Standing Committee on the Heritage Fund, which oversees the Treasurer, reviews and approves the Fund’s annual business plan and financial statements. It consists of 9 members of the Alberta Legislature of which at least 3 must be from the opposition party.<sup>362</sup>

Annually, the income of the Heritage Fund is transferred to the provincial General Revenue Fund, less funds appropriated or allocated by the Legislature to the Heritage Fund.<sup>363</sup> Beginning with the 1999-2000 fiscal year and thereafter, the Heritage Fund has been allowed to retain a portion of its income for inflation proofing. The Treasurer takes from the Fund income an amount (equal to the percentage increase in the Canadian gross domestic product price index times the total equity of the Heritage Fund, so long as this

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<sup>354</sup> Patricia Beuerlein, “Socred Oil Dividends” *Edmonton Journal*, p. A2, Sept. 22, 2005.

<sup>355</sup> Patricia Beuerlein, “Socred Oil Dividends” *Edmonton Journal*, p. A2, Sept. 22, 2005.

<sup>356</sup> Patricia Beuerlein, “Socred Oil Dividends” *Edmonton Journal*, p. A2, Sept. 22, 2005.

<sup>357</sup> Patricia Beuerlein, “Socred Oil Dividends” *Edmonton Journal*, p. A2, Sept. 22, 2005.; Editorial “Alberta deserves more than rebates”, *Edmonton Journal*, p. A18, 9/22/05; Graham Thompson, “Prosperity bonus blamed on media: Alberta government backed into a corner by reports of \$300 per person payouts”, *Edmonton Sun*, Sept. 22, 2005.

<sup>358</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002, Section 1(e) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>359</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 3(1) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>360</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 3(2) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>361</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 3(3) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>362</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 6(1)-(4) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>363</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 8(2) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

number is higher than zero) and deposits it in the Fund endowment portfolio.<sup>364</sup> However, until the Province's accumulated debt is eliminated, the Treasurer, is not required to make the full amount of these inflation-proofing contributions to the endowment, but may instead contribute an amount he "considers advisable".<sup>365</sup>

In 1996 the Legislature decided to phase out the Transition Fund portfolio by requiring the Treasurer to transfer assets at the rate of \$1,200,000,000 Canadian per year from the transition portfolio to the Endowment Fund portfolio.<sup>366</sup>

Prior to 1987, Heritage Fund had five Divisions, each with a distinct objective.

The Alberta Investment Division (AID) made debt or equity investments to strengthen and diversify Alberta's economy. They expected to make a reasonable return, but not necessarily a commercial return. There was little upside to these investments, while risk of default was more likely. They did make one profitable investment in 1977 of \$180 million Canadian that was sold at a profit in 1995 for \$352 million.<sup>367</sup>

The Canada Investment Division (CID) lends to other Canadian provinces at concession level interest rates.<sup>368</sup>

The Capital Projects Division (CPD) invested in projects to provide long-term social or economic benefits to Albertans, and no financial return was contemplated. This fund invested in medical research facilities, education facilities, agriculture, transportation, and telecommunication projects. There has been controversy over the CPD because these projects were kept on the Heritage Fund books as "deemed assets" although they were not expected to yield market returns. In 1987 the Auditor General disallowed this accounting practice.<sup>369</sup> An example of such assets includes Heritage Funds used to purchase rail cars to aid its grain farmers in their dispute with the national railway company. However, under federal law, they were prohibited from creating a railway company, i.e. using their own locomotives. So this investment was seen by many as

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<sup>364</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 8(2) and 11(1)-(3) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>365</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 11(4) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>366</sup> Alberta Heritage Savings Trust Fund Act (RSA 2000 cH-A-23), Revised 1/1/2002 Section 12 (1)-(2) (found on 3/24/05 at <http://www.qp.gov.ab.ca/>)

<sup>367</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.5.

<sup>368</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.5.

<sup>369</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.6.

more of a protest gesture against the federal government, than as a capital investment likely to produce an economically justifiable return.<sup>370</sup>

The Commercial Investment Division (CMID) was established to invest in Canadian stocks and market securities. Although expected to yield a commercial return its investments to date have been an inconsequential portion of the Heritage Fund. In 1997 the Heritage Fund was restructured to increase its focus on market rate investments.<sup>371</sup>

The Energy Investment Division (EID) was established in 1980 and designed to invest in debt or equity to further develop the Canadian energy sector. Due to inconsequential amounts of investment, its returns have been insignificant. Due to Canadian energy policy it remained empty until 1997.<sup>372</sup>

## ***2. Alberta Heritage Fund History***

When the Alberta Heritage Savings Trust Fund Act<sup>373</sup> was passed in 1976, the Fund had three objectives: 1) to save the proceeds of the non-renewable resource wealth of Alberta for the benefit of future generations, 2) to strengthen or diversify the economy, and 3) to improve the quality of life of Albertans. In accordance with the Act, the Heritage Fund received funds from two basic sources during 1976-77. The Fund received 30% of the Alberta government's non-renewable resource revenue from April 1, 1976 to March 31, 1977. This amounted to \$620 million. In addition, a special contribution of \$1.5 billion of cash and other financial assets was transferred from Alberta's General Revenue Fund to the Heritage Fund on August 30, 1976.

Between 1977 and 1982, six provinces borrowed a total of \$1.9 billion from the Heritage Fund - Manitoba, Quebec, Newfoundland, New Brunswick, Nova Scotia and Prince Edward Island at below market rates.

In the late 1980's some money from the Heritage Fund was used for capital projects, such as developing parks, enhancing libraries, and maintaining forests and to diversify the economy. These projects included the Alberta Heritage Foundation for Medical Research, Alberta Heritage Scholarship Fund, Alberta Children's Provincial General Hospital (Calgary), Walter C. Mackenzie Health Services Centre (Edmonton), University of Alberta Clinical Research Building, Pine Ridge Reforestation Nursery Enhancement,

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<sup>370</sup> Deborah Olson interview with Robert Warren, Executive Director, Asper School of Business Centre for Entrepreneurship, University of Manitoba on April 21, 2005.

<sup>371</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.6

<sup>372</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.6.

<sup>373</sup> Alberta Heritage Savings Trust Fund Act, Chapter A-23 Preamble  
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Alberta Family Life and Substance Abuse Foundation, renewable energy research, and applied cancer research.

In 1987 the government ceased the transfer of natural resource royalty revenues to the Fund.

In 1995 the government surveyed Albertans about the future of the Heritage Fund . Of the over 50,000 responses, Albertans decided to keep the Fund for future generations and focus on generating better returns on long-term investments.

As a result of the 1995 survey, the Heritage Fund Act was amended and the Fund was restructured, so that the government could no longer use it for direct economic development or social investment purposes. A new business plan was implemented to increase long-term investments. The Act created a new Legislative Standing Committee operating at arms-length from the government to review and approve the business plan and ensure that the objectives and goals of the Fund are met.

In 1998 the government surveyed Albertans about their fiscal priorities. Albertans rated elimination of debt, tax reduction and increased spending in priority areas ahead of increasing savings in the Heritage Fund. In the fall of 2000 the government surveyed Albertans about their priorities after the debt is eliminated. Their highest priority was one-time tax rebates, then saving for the future, and a much lower percentage favored one-time government spending.

In December of 2000, all the loans made to other provinces from 1977 to 1982 had been repaid in full.

In a March 2003 survey of over 77,000 Albertan households, 61% agreed that the Fund should continue to operate primarily as an endowment fund. The Fund 2003 annual report showed that the Fund closed out the year with a fair value of \$11.1 billion, a decrease of \$1.3 billion from the previous year, losing equity due to the poor stock market results, which were offset by other investments, such as real estate. In the first quarter of 2003 the Heritage Fund transferred \$199 million in earnings to the General Revenue Fund to support program spending in health care, education and infrastructure.

During the first nine months of the 2004-05 fiscal year, the Alberta Heritage Savings Trust Fund contributed nearly \$850 million to Alberta's General Revenue Fund (GRF). Net income for the Fund for the nine months ended December 31, 2004 amounted to \$848 million.

As of February 2005, the Heritage Fund's fair value stood at \$12.2 billion, down \$187 million from the beginning of the fiscal year.<sup>374</sup> Note that although they began at roughly

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<sup>374</sup> The information in this historical section is summarized from the Alberta Heritage Fund Web Site "Heritage Fund Historical Timeline" found at <http://www.finance.gov.ab.ca/business/ahstf/history.html> (3/24/05)

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the same time with Alberta initially having more funds appropriated, the total fund balance of the Alaska Permanent Fund as of February 2005 was \$47.8 billion.<sup>375</sup>

### **3. Heritage Fund Fund Results**

Over the past 28 years, investment income more than \$26 billion in investment income from the Heritage Fund has been transferred to the Province's General Revenue Fund to support program spending in areas such as health care, education, infrastructure, debt reduction and social programs.<sup>376</sup>

About \$3.4 billion<sup>377</sup> was invested in capital projects at least some of which provide ongoing economic and social benefits for Albertans.

Alberta has managed the Heritage Fund as an income fund rather than as an endowment. It has provided its residents with lower taxes and utility rates than they would have otherwise had, and created jobs that would not have existed but for Heritage Fund funding of projects that were otherwise unaffordable.<sup>378</sup> From an investment standpoint it probably misallocated funds by subsidizing its own Crown corporations such as telephone service and natural gas. There was no explicit policy or formula created to describe or measure a proper social rate of return. "To determine a social rate of return on the funds used by Heritage Fund, the private rate of return would need to be taken and adjusted with both positive and negative externalities. No attempt has been made here to measure externalities."<sup>379</sup>

However, the Albertans were aware of the Alaska Permanent Fund. As time went on, the Alaska Fund grew and the Alberta Fund remained stagnant. In response to a 1995 survey of Albertans, in January 1997 steps were taken to restructure the Heritage Fund. Two new portfolios were created, Endowment and Transition. Transition was created to hold the old fund assets in the five divisions. Over 10 years \$1.2 billion per year was to be transferred to the Endowment Portfolio. The asset mix in the Endowment Portfolio will be 35-65% fixed income securities and 35-65% equities, similar to a traditional endowment portfolio. By comparison, at the end of 1996, the Heritage Fund was only 8% invested in equities.<sup>380</sup> In addition, the post 1997 fund has an inflation-proofing

<sup>375</sup> Alaska Permanent Fund 2005 Financial Statement pp.4-5 Fund Financial History & Projections as of February 25, 2005 (found at [www.apfc.org/iceimages/financials/2005](http://www.apfc.org/iceimages/financials/2005) (3/23/05)

<sup>376</sup> Alberta Heritage Fund Web Site "FAQ" found at <http://www.finance.gov.ab.ca/business/ahstf/history.html> (3/24/05)

<sup>377</sup> The information in this historical section is summarized from the Alberta Heritage Fund Web Site "FAQ" found at <http://www.finance.gov.ab.ca/business/ahstf/history.html> (3/24/05)

<sup>378</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.7.

<sup>379</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.7.

<sup>380</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.7.

mechanism.<sup>381</sup> Yet, all these funds are still operated directly within the government. There is no separate trust, with independent trustees, such as they have in Alaska.

### C. Comparison of Alaska and Alberta Fund Intentions and Outcomes

Alberta and Alaska have many similarities. They are relatively young as human settlements, sparsely populated, have substantial mineral resources, which forms a large portion of their economic base. Both share a northern climate. Both inaugurated resource funds in 1976 based on their substantial mineral wealth and a desire to reduce the volatility of their economies.<sup>382</sup>.

One can reasonably compare them as comparables that pursued different paths. Alberta made very different choices than Alaska. The Alberta system is more focused on community needs, while the Alaska system focuses on benefit to individual Alaskans. Alberta administered its Heritage Fund from within the government. And, unlike Alaska, Alberta has used more of its Fund to pay for economic development projects and regular government expenses.

Alaska's Fund arose in a much more deliberate and rigorously debated fashion than Alberta's. Creation of the Alaska Fund required a Constitutional amendment including a statewide referendum. A three-year process determined its objectives.<sup>383</sup> Alberta's Fund was created by the legislature and functions as a part of the provincial government. Consequently, it has been more a creature of politics, subject to politics' constantly shifting winds, so its vision hasn't been as clear as the Alaskan vision.

The difference in Canadian and U.S. political culture also plays a significant role. Alaska, as the last frontier, exemplifies and espouses individualistic American culture more strongly than many other areas of the U.S.

Alberta started with more typically Canadian community-focused investment strategy. Canadians (as will be demonstrated in the section on Labor Sponsored Investment Funds below) have an historic concern about growing indigenous Canadian economic institutions, so as not to become a financial colony of the U.S. For the Alaskans, investment in the U.S. stock market did not raise the kind of patriotism issues that such investments present to Canadians.

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<sup>381</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.9.

<sup>382</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.3.

<sup>383</sup> Allan Warrack & Russel Keddie, "Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin* No.72, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p 14. (3/25/05)

In recent years, Alberta has begun to realign its investment strategy to obtain more market level returns. Alberta has struggled over the right mix of market investment and community investment.

It is difficult to properly compare the results of the Alberta and Alaska Funds because so many of the non-financial impacts ("externalities" is the economists term) have not been measured. Below are a chart and several bar graphs created by Allen Warrack that compare the two programs based on available data.

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NATURAL RESOURCE TRUST FUNDS:

A COMPARISON OF ALBERTA AND ALASKA RESOURCE FUNDS

By Allan A. Warrack and Russell R. Keddie

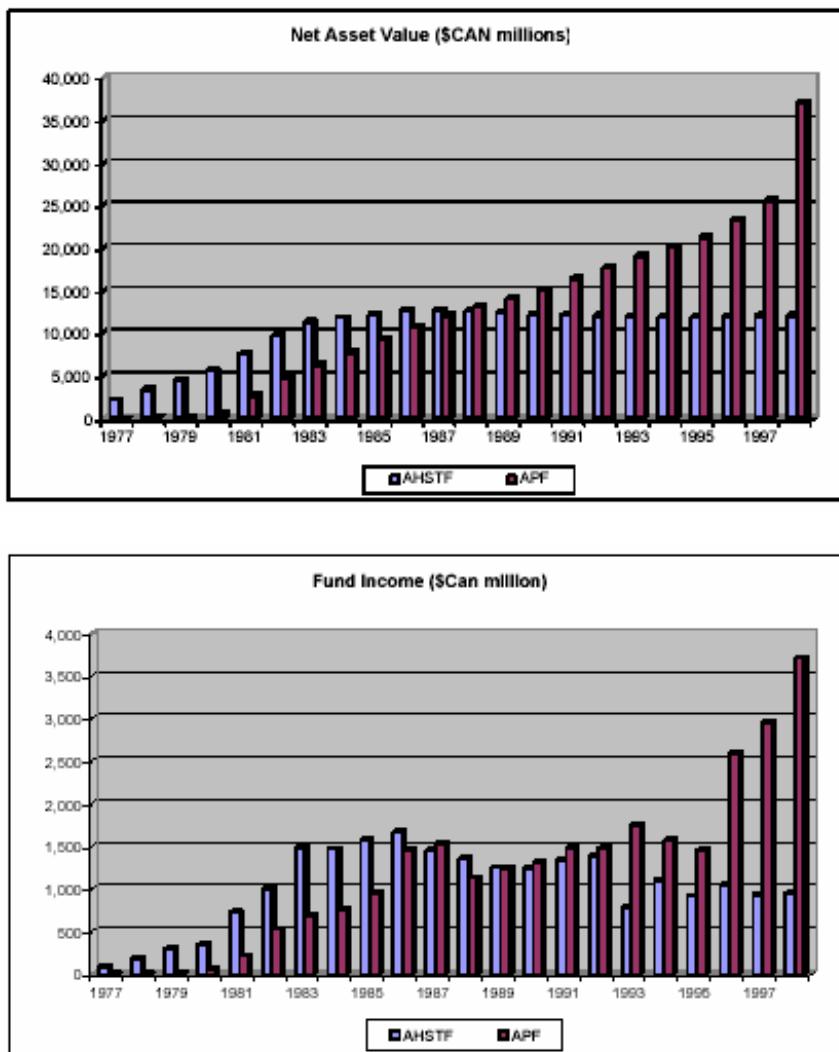
Western Centre for Economic Research School of Business, University of Alberta

Edmonton, Canada T6G 2R6 [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER)

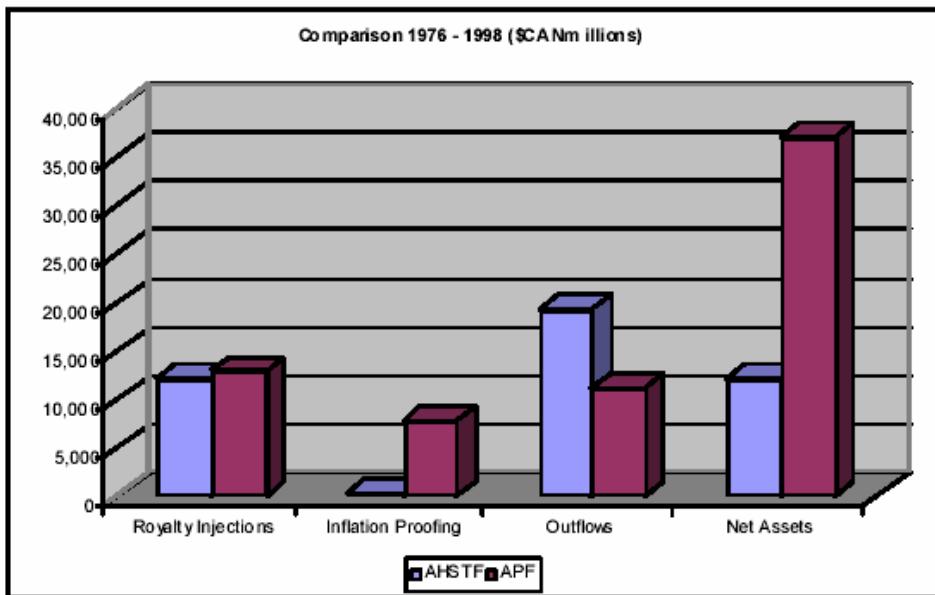
**Figure 5. Comparisons: Alberta Heritage Fund vs. Alaska Permanent Fund**

	<b>Heritage Fund</b>	<b>APF</b>
Time Era	Mid-1970s	Mid-1970s
Resources Base	Hydrocarbons	Hydrocarbons
Philosophy	Nationalization	Privatization
Establishment	Legislation	Referendum
Governance	Bureaucracy	Trustees
Economic Development	Yes	No
Social Dividends	Yes	No
Financial Management	Income	Endowment
Stocks Holdings	No/Changing (1997)	Yes
Inflation Proofing	No/Changing (1997)	Yes
Investment Profile	Inward/Changing (1997)	Outward
Fund Size	Smaller	Larger
Fund Growth	No	Yes

**Figure 4. Comparison Charts**



Source of Figure 4. Allan Warrack & Russel Keddie," Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds" *Western Centre for Economic Research Information Bulletin No.72*, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.21



Source of Figure 4. Allan Warrack & Russel Keddie," Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds " *Western Centre for Economic Research Information Bulletin No.72*, September 2002, School of Business University of Alberta, [www.bus.ualberta.ca/CIBS-WCER](http://www.bus.ualberta.ca/CIBS-WCER) (3/25/05) p.21

Clearly, the Alaska Fund is much richer than the Alberta Fund as of 2005. (See comparison charts Figure 4 above.) The consequences for the social fabric are much harder to compare. The Albertans continue to use their Fund income (beyond inflation proofing) to provide services to the community traditionally provided by government out of taxes, with allocation decisions being made by the government. However, according to First Ontario Fund Director, Ken Delaney, Alberta is the only debt free province and has lower taxes than the others.<sup>384</sup> In Alaska, a large portion of the Fund income goes directly to individuals. Such distributions have helped decrease the gap between rich and poor, particularly aiding poorer communities. It is hard to make a comparison to Alberta on that front because the Canadian social economy is much larger than that in the U.S. Canadians already have programs, such as national health insurance, which decreases important quality of life differences between rich and poor in important, but difficult to measure ways.

Alberta has income taxes and government is a respected institution in Canada. The concern Goldsmith raises, about the detrimental effect the PFD has on the ability of young Alaskans' to function as contributing citizens, is an important concern. As the oil resources are depleted, and the Alaskan population grows, only time will tell whether dependence on the dividend has undermined social cohesion.

<sup>384</sup> Interview of Ken Delaney, Executive Director, First Ontario Fund, by author 8/5/05.

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The Alaska Permanent Fund trustees invest as traditional endowment trustees. They use no social criteria at all for their investments. They are not pro-active on governance issues as is the California pension fund (CalPERS). They do not screen for social criteria, as does a social index fund like the Domini Social Investment Fund, or the Canadian Labor Sponsored Investment Funds. Thus, for example, they have no mechanism by which the APF Trustees could be instructed not to invest in one or more companies seen as particularly destructive to Alaskan environmental, economic or social interests.

#### **D. Lessons from APF and Heritage Fund for Fair Exchange**

There are few regions in the world containing both huge natural resource wealth and a small population. So neither the Alaska nor Alberta situations are easily replicable. (There are, however, suggestions that the oil wealth of Iraq should be owned and managed for the Iraqi people in a manner similar to the APF.<sup>385</sup>) But these models provide examples that can be used on a smaller scale. They enable us to compare the pros and cons of using a trust to hold and invest citizen funds compared to a government. They demonstrate the importance of inflation proofing for fund longevity.

In Alaska, the fund income is divided to provide for inflation proofing and citizen dividends, while leaving some of the fund available for the legislature to allocate to government functions. Even if the portion available for government is not sufficient long term, the structure is in place when the political will is.

Alaska's sophistication in caring for the Fund's survival, income to citizens and government provides a good platform from which to develop a Fair Exchange model. It is quite possible that, in 50 years, we may see an impressive outcome from Alberta's infrastructure investments.

A Fair Exchange model would add a mechanism to use the government investment in private and public companies to impact their corporate governance and investment or disinvestments policies. The Canadians lead in that category with the Heritage Fund and the LSIF's (discussed below). The Alberta Fund focused on developing the Albertan economy, decreasing the cost of utilities for its citizens, creating jobs in Alberta and making low interest loans to other Canadian provinces. Undoubtedly, it has served a social/economic function in Canada, which is real, although hard to measure.

#### **E. Canadian Labor Sponsored Investment Funds (LSIFs)**

<sup>385</sup> U.S. Secretary of State Colin Powell this morning, in Congressional testimony, specifically mentioned the Alaska dividend model for Iraq in response to question from Senator Allen. "AN ENLARGED NATO: MENDING FENCES AND MOVING FORWARD ON IRAQ" HEARING BEFORE THE COMMITTEE ON FOREIGN RELATIONS, UNITED STATES SENATE 108<sup>TH</sup> CONGRESS, FIRST SESSION, April 29, 2003 at pg. 38, <http://www.access.gpo.gov/congress/senate/> U.S. Government Printing Office, Washington, 2003

Considering LSIFs in the Fair Exchange context we must view them in at least two ways; 1) as private companies receiving government subsidies for which a fair exchange is expected; and 2) as a model for the distribution mechanism of the fair exchange proposals described in this article.

Canadian innovations in labor-friendly asset management offer rich lessons for those seeking new ways to organize and control capital. .... The best of the LSIFs mobilize workers' savings to invest in good jobs within local communities. The investment strategies of these LSIFs are rooted in a broader social agenda that promotes worker participation, training, and respect for stakeholders.<sup>386</sup>

### ***1. What are LSIFs?***

Labor Sponsored Investment Funds (LSIFs) are union-sponsored, tax incented investment funds that supply venture capital (VC) financing to small and medium sized enterprises in Canada. They were first created in the mid-1980's, and have grown in number, size and importance over the past 20 years. The funds are established to fulfill specific federal and/or provincial goals, with each level of government enacting statutory restrictions to help guide investments to achieve their public policy objectives.

Since 1991, they have raised the largest amount of capital (\$10.6 billion or 44 percent of the VC market) and invested the largest amount of total VC (\$5.3 billion or 24% of the VC market.) They currently have the largest share of VC under management in Canada (\$9.2 billion or 41% of the Canadian market as of 2003). These fundraising and investing activities, however, have not been without costs – the federal government alone has foregone \$1.8 billion in tax revenue to cover tax credits since 1991.<sup>387</sup>

Since 1991, 90% of LSIF capital has been raised in Ontario and Quebec and 85% has been invested in those two provinces.<sup>388</sup>

The vast majority of the funds' billions in assets come from small investments made by average working people.<sup>389</sup>

### ***2. How and Why LSIFs Were Created***

The specific trigger for the creation of the initial funds was the 1981-83 recession and persistent levels of high Canadian unemployment. The labor sponsored venture capital corporation model was initiated by the Quebec Federation of

<sup>386</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p.128

<sup>387</sup> Macdonald & Associates.

<sup>388</sup> Macdonald & Associates. April 2005

<sup>389</sup> Sherman Kreiner, former Chief Executive Officer Crocus Fund, with assistance by Kenneth Delaney President & Chief Executive Officer First Ontario Fund "[Labor-Sponsored Investment Funds in Canada](http://www.uswa.org/uswa/program/content/437.php)" (found at <http://www.uswa.org/uswa/program/content/437.php>) (no date, but after 1995)

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Labor (FTQ) in the Province of Quebec in 1984 to meet identified equity capital gaps for small and medium sized businesses in a manner which would address additional social policy concerns. The idea of a labor sponsored fund was the most recent development in a long tradition of capital retention strategies in Quebec, which include the pooling of pension funds to assist local economic activity, and the development of a comprehensive network of credit unions which re-lend deposits locally.<sup>390</sup>

Four<sup>391</sup> additional funds have been created which follow the Quebec model, the Working Opportunity Fund in B.C.<sup>392</sup>, the Worker Investment Fund in New Brunswick<sup>393</sup>, the Crocus Fund in Manitoba<sup>394</sup> and the First Ontario Fund in Ontario<sup>395</sup>. These funds are committed to earning competitive returns. At the same time, the funds set out to provide capital to needed sectors, and, in addition, to meet social goals the unions have established, including job creation and retention, and regional economic development. As part of their social mandate, each fund undertakes some form of "social audit" of each firm it finances, which includes examining labor relations, health and safety, ethical employment and environmental practices. The funds also take a proactive approach to the workforce - encouraging improvements such as financial education for workers, encouraging a high performance workplace, participatory management, and worker ownership.<sup>396</sup>

The only fund with a formal social audit was the Crocus Fund. However, First Ontario Fund uses a seven-page "Economic Impact Assessment" questionnaire filled out by prospective investee companies that covers all the same subjects.<sup>397</sup>

"The target market is small and medium sized businesses. Typically, an equity interest is sought in companies employing less than 500 workers that have total assets of less than \$50 million. Most investments range from \$C 500,000 to \$C 2 million. In raising capital these funds are committed to participation by a broad base of average working people, through marketing by the sponsoring unions or labor federations. The maximum annual

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<sup>390</sup> Sherman Kreiner, former Chief Executive Officer Crocus Fund, with assistance by Kenneth Delaney President &Chief Executive Officer First Ontario Fund "[Labor-Sponsored Investment Funds in Canada](#)" (found at <http://www.uswa.org/uswa/program/content/437.php>) (no date, but after 1995)

<sup>391</sup> Don Allen, Regional Data Corp. (author of "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity (May 2005)", email to Deborah Olson 8/2/05

<sup>392</sup> Employee Investment Act [RSBC 1996] Chapter 112

<sup>393</sup> Registered Labour-sponsored Venture Capital Corporations Regulation - New Brunswick Income Tax Act, N.B. Reg. 2001-11; Enabling Statute: New Brunswick Income Tax Act, S.N.B. 2000, c. N-6.001

<sup>394</sup> Crocus Investment Fund Act, C.C.S.M. c. C308, assented to July 26, 1991

<sup>395</sup> Community Small Business Investment Funds Act, S.O. 1992, Chapter 18

<sup>396</sup> Sherman Kreiner, former Chief Executive Officer Crocus Fund, with assistance by Kenneth Delaney President &Chief Executive Officer First Ontario Fund "[Labor-Sponsored Investment Funds in Canada](#)" (found at <http://www.uswa.org/uswa/program/content/437.php>) (no date, but after 1995)

<sup>397</sup> First Ontario Fund Economic Impact Assessment Parts I and II, provided by Kenneth Delaney President &Chief Executive Officer First Ontario Fund 8/25/05.

individual investment which qualifies for tax credits is legislatively mandated and has ranged from \$C 3,500 to \$5,000.”<sup>398</sup>

### ***3. Quebec Solidarity Fund (Solidarity FTQ) – the first LSIF model***

The Fonds de Solidarité des Travailleurs du Quebec (Solidarity FTQ)<sup>399</sup> was the first fund to be created. The initial plan called for a 35% provincial tax credit only for individual investors. The plan was then presented to the Federal government, which agreed to match the seed equity commitment of the provincial government (\$C10 million each) and to provide matching tax credits, provided that the total tax credits did not exceed 40% (20% Provincial and 20% Federal).<sup>400</sup> However, in the 1996 federal and Quebec budgets each tax credit was reduced from 20% to 15%.<sup>401</sup>

The Fund undertook negotiations with the provincial securities commission to permit sales to be made by volunteer members of the Solidarity FTQ. The Fund raised approximately \$C 500,000 during its first sales season. The Fund... (as of 1995 had) ... \$1.5C billion dollars in assets. The bulk of sales are made through lump sum investments into from their Registered Retirement Savings Plans (RRSP), which is the Canadian equivalent of an Individual Retirement Account (IRA) in the U.S.. These revenues are supplemented by investment via payroll deduction. In addition to mandating employers to implement payroll plans, Solidarity FTQ affiliated unions have undertaken a major initiative to establish collective bargaining agreement language which compels employers to match employee contributions made via payroll deduction on a dollar for dollar basis. Statistics as at December 31, 1995 indicate that about 65% of the Solidarity Fund's 238,000 shareholders are affiliated with the labor movement, the highest percentage among all Canadian labor sponsored venture capital corporations.<sup>402</sup>

The Solidarity FTQ has several features that made its LSIF model a unique innovation. Quebec legislation provides that the Quebec Federation of Labor (FTQ) is the sole sponsor of the Solidarity FTQ. FTQ appoints 10 of the 16 Fund board members and has

<sup>398</sup> Sherman Kreiner, former Chief Executive Officer Crocus Fund, with assistance by Kenneth Delaney President &Chief Executive Officer First Ontario Fund “Labor-Sponsored Investment Funds in Canada” (found at <http://www.uswa.org/uswa/program/content/437.php>) (no date, but after 1995)

<sup>399</sup> Cite statute that created it

<sup>400</sup> Sherman Kreiner, former Chief Executive Officer Crocus Fund, with assistance by Kenneth Delaney President &Chief Executive Officer First Ontario Fund “Labor-Sponsored Investment Funds in Canada” (found at <http://www.uswa.org/uswa/program/content/437.php>) (no date, but after 1995)

<sup>401</sup> Don Allen, Regional Data Corp. (author of “Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity (May 2005)”, email to Deborah Olson 8/2/05

<sup>402</sup> Sherman Kreiner, former, Chief Executive Officer Crocus Fund, with assistance by Kenneth Delaney President &Chief Executive Officer First Ontario Fund “Labor-Sponsored Investment Funds in Canada” (found at <http://www.uswa.org/uswa/program/content/437.php>) (no date, but after 1995)

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input on the appointment of the other six, including the chief executive officer.<sup>403</sup> The Fund goals as stated in the legislation indicate the importance of collateral benefits beyond the purely financial. The stated purposes of the Fund<sup>404</sup> are to:

“Invest in firms within Quebec whose total assets are less than \$50 million, or whose net assets are not greater than \$20 million, to create, maintain and protect jobs; promote the training of workers in economic matters and enable them to increase their influence on Quebec’s economic development; stimulate the Quebec economy; and invite workers to subscribe to the Fund.”<sup>405</sup>

Individual workers invest in LSIF’s by contributions from their RRSP. The LSIF tax credit allows a maximum of \$C 5,000 to be invested by a person each year, and he receives a 15% federal tax credit and a \$15% provincial tax credit, for a maximum rebate of \$C 1,500. Because the contribution can be made with tax deferred RRSP funds, for the average earner the deferral is generally worth an additional approximate 30% of the contribution.<sup>406</sup>

LSIF investments are intended to be long-term patient capital. Thus, the Quebec Fund requires contributions to remain in the fund until retirement, or the contributor will incur tax penalties. The other LSIFs allow for a withdrawal after 8 years without a penalty.<sup>407</sup>

The provinces of Quebec, Manitoba and British Columbia have each added a second LSIF, under pressure to end the monopoly of their first fund. A number of other LSIFs have been created in the provinces of Ontario and Saskatchewan, which may be considered more private sector oriented and less social goals oriented, although they are also mandated to invest in small/medium business and create employment. Therefore, Canada now has 27 labour-sponsored investment funds.<sup>408</sup>

Although there is now another LSIF in Quebec, the Solidarity FTQ Fund is unique. It is the oldest and largest LSIF. The strong link between the labor movement and the Quebec government enabled it to establish itself as a substantial economic force in Quebec with a uniquely close involvement with the economic development functions of the Quebec government. Its economic strength and size have been enhanced by its low cost structure, which is a consequence of having functioned for many years with no LSIF competition. It has economies of scale that none of the other LSIFs have, and it has had many years to

<sup>403</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor’s Pensions*, Cornell University Press (2001) p.130.

<sup>404</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor’s Pensions*, Cornell University Press (2001) p.130

<sup>405</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor’s Pensions*, Cornell University Press (2001) p.130

<sup>406</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor’s Pensions*, Cornell University Press (2001) p.130

<sup>407</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor’s Pensions*, Cornell University Press (2001) p.130

<sup>408</sup> Don Allen email to Deb Olson 8/2/05.

grow as the sole Quebec LSIF, without need to market in competition with others in Quebec. It garnered the support and participation of most of the unions in Quebec. Whereas there are 18 LSIF funds in Ontario that compete with each other for investors from their various sponsor unions or organizations, and by paying big commissions to brokers and financial planners to sell to the public. In Quebec, union members can sell LSIF stock directly, in Ontario such sales must be supervised by a licensed broker.<sup>409</sup>

#### **4. Impact of LSIFs**

##### **a) Filling the Capital Gap**

Canada historically has not had adequate access to venture capital.<sup>410</sup> The LSIFs made a huge contribution to filling the venture capital gap for small and medium sized companies in Canada. In 1990 when LSIF vehicles were not fully developed the Canadian venture capital industry stood at \$3 billion with investments of \$200 –300 million annually. By 1998 the total sector stood at \$8.4 billion. In 2000, the LSIFs accounted for 50% of the venture capital in Canada, and was the fastest growing segment of the market.<sup>411</sup>

In 1997, the entire Canadian venture capital industry invested \$1.8 billion in 794 companies. Of that the LSIFs invested \$671 million. In fiscal year 1997-98, the Solidarity FTQ Fund alone invested \$614 million. Due to the work of the Solidarity FTQ Fund, Quebec went from being a province with limited venture capital sources to one gathering the largest share of overall venture capital in the country.<sup>412</sup>

On August 29, 2005 the Ontario government announced its intention to end its 15% tax credit no earlier than the end of the 2005 tax year for LSIFs in Ontario. The reason they gave was that that Ontario now had enough available venture capital and that no subsidy was necessary any longer to make such venture capital available.<sup>413</sup> This contention is contested by the Ontario LSIFs.<sup>414</sup> In 2005, the Association of Labour Sponsored Investment Funds (ALSIF)<sup>415</sup> responded to the Institute for Competitiveness and Prosperity's contentions<sup>416</sup> that LSIF government incentives were unnecessary because

<sup>409</sup> Ken Delaney, President and CEO, First Ontario Fund, interview with author 8/2/05.

<sup>410</sup> Canadian Venture Capital and Private Equity Association, "2004 Review of Venture Capital Investment Activity in Canada" 2/16/2004 pp. 2, 3, 5, 8.

<sup>411</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p.138.

<sup>412</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) pp. 139-140.

<sup>413</sup> Press release from Manuel Alas-Sevillano, Ontario Minister of Labour, 8/29/05 "Ontario Plans to End Tax Credit for LSIFs: Incentive to investor no longer needed in healthy venture capital market".

<sup>414</sup> David Levi, President and CEO of GrowthWorks (an Ontario LSIF) in its press release August 29, 2005 stated "There is already a shortage of venture capital in Canada and this decision will make the situation even worse for emerging Ontario companies."

<sup>415</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005.

<sup>416</sup> Institute for Competitiveness & Prosperity, Working Paper 6, Reinventing innovation and commercialization policy in Ontario, October 2004

Canadian companies had an adequate supply of venture capital, and that the quality of the LSIF loans was not advantageous to the Canadian venture capital market.

The ALSIF showed emerging Canadian technology companies where lack of capital access as a major problem, and a competitive disadvantage compared to comparable American companies.<sup>417</sup> The ALSIF response concluded that the supply of venture capital problem was becoming worse<sup>418</sup>, in the years since LSIFs were created, that the LSIFs did not crowd out other types of venture capital firms<sup>419</sup>; that there had been an increase in foreign (primarily U.S.) venture capital funds in Canada, since the LSIFs were created. The ALSIF study states that LSIF's had performed at least as well, if not better than other Canadian venture capital funds during the previous 5 years (2000-05) and better than the Canadian technology funds.<sup>420</sup>

The two largest sources of VC in Ontario are LSIFs and foreign companies.<sup>421</sup> From 2002-04 foreign VC companies directed only 9.6% of their Ontario investments to first round investments, while Canadian VC firms (LSIFs holding the majority of these assets) invested 35% of their assets to companies not previously receiving VC.<sup>422</sup> This study concludes that "Ontario companies generally only succeed in attracting foreign venture capital if they already have domestic investors in place."<sup>423</sup> Whereas "LSIFs are guaranteed to invest domestically."<sup>424</sup>

### b) Job Creation

A 1997 study showed that on average venture backed investee firms increased their employment base by 26% per year as compared to 1.2% for the Canadian economy as a whole. As of 1998 the five Alliance LSIFs claimed to have saved, retained or created 72,163 jobs.<sup>425</sup> A strong critic in the labor movement claimed that they were only responsible for creating 15,000 -20,000 jobs during that period due to direct

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<sup>417</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 16 – 17.

<sup>418</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 14

<sup>419</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 11

<sup>420</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 9

<sup>421</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 14

<sup>422</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 14.

<sup>423</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 14.

<sup>424</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005, at 14.

<sup>425</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p.146

investment.<sup>426</sup> A 2004 study of economic impact of Ontario LSIFs found that a sample of 187 investees of the funds had a total work force of 9,000 at the time that the funds first invested in these firms. By 2002, their work forces had grown to 32,000. If the firms had grown at a pace consistent with all Ontario firms of the same size, they would have reached only 11,000 by 2002.<sup>427</sup> The estimated direct, indirect and induced impact of the Ontario LSIFs through 2001 on employment was 27,000 jobs in Ontario and 29,400 jobs for all Canada.<sup>428</sup>

### **c) Return to Government on LSIF Tax Credit Investment**

The above-mentioned 2004 study of fiscal and economic impact of Ontario LSIFs estimated that the cumulative fiscal cost to taxpayers of Ontario funds from inception during the 1990s to tax year 2000 was \$C494 million for the Ontario government and \$C489 million for the federal government. Most of the funds raised are placed in company investments, although a portion is placed in marketable securities, to reduce risk. The funds placed in companies led to an economic impact in terms of start-up, growth and maintenance of firms. In the year 2002, this economic impact was estimated to have led to incremental government revenues of \$357 million for Ontario and \$449 million the federal government. This implies a payback period of costs since inception of 1.4 years for Ontario and 1.1 years for the federal government. Therefore, by mid-2003, all of the cost invested up to 2000 would have been recovered and incremental government revenues would have carried on subsequently, since the vast majority of investees were still operating and growing.<sup>429</sup>

### **d) Broader Social Return on LSIF Investment**

In addition to the benefits noted above, in Ontario LSIF investees invested in research and development at quadruple the rate (from \$137 million to over 700 million) of comparable Canadian firms that did not receive LSIF investments.<sup>430</sup> Through 2001, beyond what would have otherwise been expected without them, Ontario LSIFs created a large export income gain of \$1.5 billion, and,<sup>431</sup> contributed \$C2.3 billion to the Ontario GDP and \$C2.6 billion to the Canadian GDP.<sup>432</sup> All have been created to provide venture

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<sup>426</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p.147

<sup>427</sup> Regional Data Corporation, *Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds*, May 2004.

<sup>428</sup> Regional Data Corporation, "Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds", May 2004, Executive Summary p. 2.

<sup>429</sup> Regional Data Corporation, "Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds", May, 2004

<sup>430</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005 at 3.

<sup>431</sup> Regional Data Corporation, Jay Heller & Don Allen, "Review of Financing Issues Raised by the Institute for Competitiveness and Prosperity, May 2005 at 8.

<sup>432</sup> Regional Data Corporation, "Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds", May 2004, Executive Summary p. 2.

capital for local Canadian firms using capital from a source formerly largely untapped, individual investors, and particularly union members. The LSIF funds enable, many working people to save more for their retirement than they otherwise would have.<sup>433</sup> The union connection appears to make LSIF investments more accessible or worthwhile to workers with incomes under \$100,000 per year<sup>434</sup>. Some LSIFs perform social audits and have high labor and environmental standards as well (see following sections.).

The LSIFs have been a good investment for the communities. So for the community it is a fair exchange.

### **e) Creation of Regional Financial Networks**

In the early days of the Solidarity FTQ Fund, its officials realized that there were many investment opportunities outside the Montreal area that never came to the attention of the Fund. Often firms from such rural areas did not approach the Solidarity FTQ Fund because it seemed too removed from their community or because it required travel to Montreal. The Solidarity FTQ Fund overcame this barrier by developing a regional partnership with the government of Quebec. The network now operates seventeen regional funds, each with offices and managers assigned to local areas which had invested \$C41.7 million in 155 firms with investments in the \$C50,000 –500,000 range. Proximity to the investments increases knowledge of the opportunities and enables closer monitoring of the loans. It also builds the involvement of local people who, in turn, are more likely to invest in the trust, and to obtain financial education offered by provided by the Solidarity FTQ Fund.<sup>435</sup> This led to an even more localized development of SOLIDE funds to provide pre-start-up financing in the \$5,000 to \$50,000 range. As of 2001 there were 86 SOLIDES in Quebec that had invested in 490 enterprises.<sup>436</sup>

### **f) LSIFs throughout Canada – creation and waning of the Alliance vs. Non-Alliance Funds**

In 1988 Canada passed national legislation followed by provincial legislation in British Columbia, Manitoba, Ontario and New Brunswick. In four of these five a sole labor sponsor, the provincial labor federation, was named in the legislation. However, in Ontario, which includes Canada's financial center, Toronto, the financial community fought creation of a labor-controlled fund. There was strong disagreement within the Ontario labor movement about the appropriateness of LSIFs. Thus, when LSIF legislation passed in Ontario, the labor federation could not be named as the sole sponsor. Rather, any labor organization or trade association could sponsor an LSIF. Consequently, 15 of

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<sup>433</sup> Regional Data Corporation, "Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds", May 2004, Executive Summary p. 2 and report p. 5.

<sup>434</sup> Regional Data Corporation, "Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds", May 2004 p.5.

<sup>435</sup> Archon Fung, Tessa Hebb & Joel Rogers, Working Capital: the Power of Labor's Pensions, Cornell University Press (2001) p. 150 -152.

<sup>436</sup> Archon Fung, Tessa Hebb & Joel Rogers, Working Capital: the Power of Labor's Pensions, Cornell University Press (2001) p. 150

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Canada's 21 LSIFs exist under Ontario legislation.<sup>437</sup> As of July 2005, 18 of 27 LSIFs exist under Ontario legislation.<sup>438</sup>

Five of the six funds<sup>439</sup> with a sole labor federation sponsor formed an alliance and created a Statement of Principles to set a standard for themselves, and to distinguish themselves from what they perceived of as a lack of concern, in many of the Ontario LSIFs, for the social benefits, beyond rate of return, which they believe are fundamental to LSIFs. The Statement of Principles of the Labour Sponsored Investment Fund Alliance is:

- 1) organization and direction by a labor body (meaning a board of directors controlled by a labor organization with at least 100,000 members);
- 2) commitment to meeting social goals (including job retention, regional economic development, social audit, and requiring investee companies' commitment to improvement of labor-management relations);
- 3) commitment to provide an equitable rate of return to shareholders, risk capital in a diversified portfolio, and participation by a broad base of average working people; and,
- 4) facilitation of cooperation between labor and business.<sup>440</sup>

As of 2005 the Alliance had not met since 1998 and, the Alliance/ Non-Alliance distinction is no longer very helpful.<sup>441</sup> A number of funds have merged or been restructured so that only two now meet the original criteria, Solidarity FTQ and First Ontario Fund<sup>442</sup>.

### **g) Social Audit and Worker Education**

The Alliance LSIFs require their investees to be fair, safety conscious employers and good environmental stewards. They do not require them to be unionized firms. All the funds provide worker education to train their sales force, which is made up of union members. They provide financial literacy classes for their investors to learn to manage their retirement accounts. The Solidarity FTQ Fund requires management in its investee firms to open their books to their employees and to provide training (with Fund help) so the employees can understand the books. As the year 2000, sixteen thousand workers in Quebec had participated in these 2-day financial courses. A 1999 study found that all

<sup>437</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p.131

<sup>438</sup> Don Allen email to Deb Olson 8/2/05

<sup>439</sup> Solidarity Fund (FTQ), Working Opportunity Fund (WOF) in British Columbia, Crocus in Manitoba, Workers Investment Fund in New Brunswick, and the First Ontario Fund. Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p.132

<sup>440</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) pp. 133-134.

<sup>441</sup> Deborah Olson interview with Ken Delaney, Executive Director, First Ontario Fund (the only Ontario fund in the LSIF Alliance) 8/2/05.

<sup>442</sup> Deborah Olson interview with Ken Delaney, Executive Director, First Ontario Fund (the only Ontario fund in the LSIF Alliance) 8/2/05.

surveyed investee companies reported varying degrees of improvement in labor management trust and communication after these training programs.<sup>443</sup>

### ***5. Financial Performance of LSIFs compared to Comparable Commercial Funds for Individual Investors***

LSIFs have provided clear benefits to Canadian communities. As of May 2005, the LSIFs now have \$C 5.955 billion in assets Quebec and \$C3.386 billion in the rest of Canada for a total of \$C9.3 billion invested in funds aimed at building the local economy<sup>444</sup> as outlined above in the section entitled “Broader Social Return on LSIF Investments.” LSIFs repay the government for its investment. So they provide a fair exchange. The issue of return on individual investment is not really a Fair Exchange issue.

#### **a) Impact on Individual Investors**

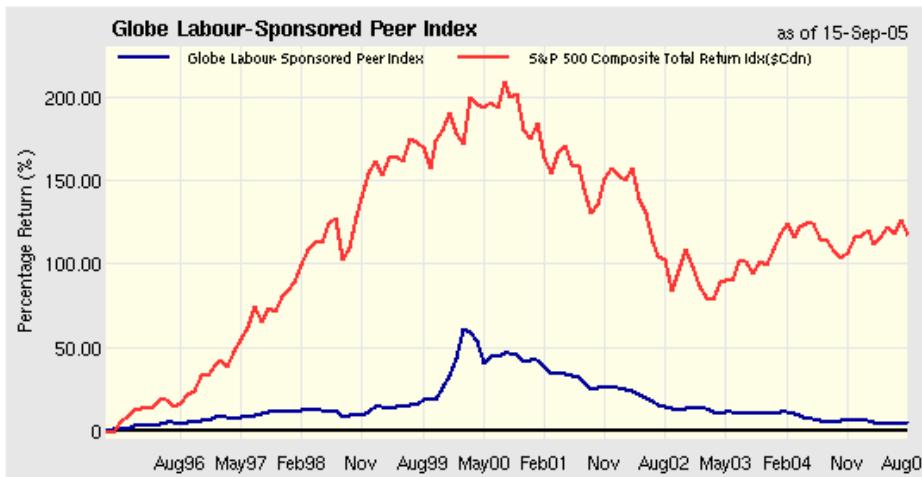
Although the following questions are somewhat outside the scope of this paper, both author and knowledgeable readers are concerned about how the average citizen investor is treated. So we will explore briefly these three questions. 1) Should unsophisticated investors be putting their discretionary savings in venture capital funds? 2) If unsophisticated, working-class investors are using LSIFs to save for retirement, are they getting an appropriate return on investment for the risk they take? 3) Do LSIF worker-investors have different LSIF investment objectives than commercial venture capitalists?

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<sup>443</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p. 152 cite a 1999 study by Paul Laliberte at the University of Massachusetts.

<sup>444</sup> Thomson Macdonald 2005 (Thomson Macdonald is the main source of data on the Canadian venture capital market. Some specific data cited in this article is from an unpublished study that may have relied proprietary information from Thomson Macdonald. The owner of the proprietary data gave the author permission to use the data in that report, but did not give permission to cite the owner's document directly. They gave permission only to cite the sources named in the unpublished report, such as, in this case, Thomson Macdonald. Thomson Macdonald publicly available data can be found at <http://www.canadavc.com/> 9/22/05.

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Most investment advisors would not advise unsophisticated investors to put a large portion of their discretionary savings in traditional venture capital funds. Figure 7 provides a comparison of the *Toronto Globe & Mail's LSIF Index* compared with the S&P 500 Composite in Canadian dollars<sup>445</sup> to give a general idea of the alternate equity investment returns available to an RRSP investor. The LSIFs have not performed as well as the S&P 500. The section below ‘Financial Return Comparison Data’ shows that the LSIFs have not performed as well as small cap funds since 1999, although they outperformed them up to 1998. Many Ontario modest income investors who have not otherwise made RRSP contributions, have invested in LSIFs.<sup>446</sup> The proportion of union members who invest in LSIFs is larger than their proportion amongst Ontario taxpayers.<sup>447</sup> Canada has a national pension system to which everyone contributes and from which everyone receives benefits. The RRSP is an inducement to personal savings via income tax incentives and is strictly voluntary.<sup>448</sup> The LSIF investors are likely making small LSIF investments for reasons not completely based on financial return, but perhaps based on concern for maintaining the local economy and jobs.

One theory is that individual investors are less sensitive to rates of return given the up-front tax credit and the small amount of each investment. By comparison, those that invest in private funds tend to be sensitive to rates of return and have large amounts of capital at stake. This theory suggests that LSVCC (LSIF) managers are less driven to produce high returns than their private sector

<sup>445</sup> Found at [http://globefunddb.theglobeandmail.com/gis/home/plsql/gis.show\\_chart?comp\\_id=0&fid1=5117&period=120&indx1\\_id=3140&fid2=0&pi\\_mov\\_type=SMA&pi\\_mov\\_avg1=&pi\\_mov\\_avg2=&pi\\_mov\\_avg3=&action=Go&pi\\_universe=PUBLIC\\_FUND](http://globefunddb.theglobeandmail.com/gis/home/plsql/gis.show_chart?comp_id=0&fid1=5117&period=120&indx1_id=3140&fid2=0&pi_mov_type=SMA&pi_mov_avg1=&pi_mov_avg2=&pi_mov_avg3=&action=Go&pi_universe=PUBLIC_FUND) 9/12/05

<sup>446</sup> Regional Data Corporation, “Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds”, May 2004 pp.4-5.

<sup>447</sup> <sup>447</sup> Regional Data Corporation, “Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds”, May 2004 p5.

<sup>448</sup> Keith Wilde, senior model analyst, DYNACAN, Micro-simulation, Canadian Social Security, email to author 9/22/05.

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counterparts. Theoretically, this may manifest itself in investments that private funds would have rejected or negotiated for a better position, a more passive approach to investment monitoring and offering little value added to the investee firm.<sup>449</sup>

If unsophisticated, working-class investors are using LSIFs to save for retirement, are they getting an appropriate return on investment for the risk they take? When compared to the whole Canadian venture capital industry<sup>450</sup> (See Figure 6D below and the discussion of it there.) LSIFs, particularly the Solidarity FTQ, make a concerted effort to provide financial literacy training to their worker-investors<sup>451</sup> so that they do not remain unsophisticated investors and can properly judge the risk of investing in the LSIFs compared to alternative RRSP investments.

### **b) Methodology Problems Comparing LSIF Returns to Commercial Returns**

It is not proper to compare the *Toronto Globe & Mail* globeinvestor.com LSIF index<sup>452</sup> with other non-venture capital stock indices, as they really represent other asset classes. There are additional problems with comparing other stock fund data. It is hard to use the existing fund indices to compare, return on investment with other similar stock or venture capital funds because the LSIFs report their return on investment after costs and not including tax benefit, whereas the other Canadian venture capital funds report their return on investment before expenses<sup>453</sup>. The tax benefit of an LSIF may not legally be included in the return on investment calculations shown in any offering publication or LSIF participants<sup>454</sup>.

An example will demonstrate why this matters. The author compared various small cap and venture indices against the LSIF index. The 10-year cumulative return for BMO Nesbitt Burns Small Cap Index had a return on investment over 10 years of 10.33%. The LSIF Index had a return on investment of 0 .53%. If a worker invested \$100 in an LSIF with provincial and federal tax credits, his \$100 investment at the end of 10 years would be \$105.30, but his actual investment would have been \$70, not \$100. Whereas the person who invested \$100 in BMO Nesbitt would have \$110.30 on his \$100 investment. So the LSIF investor made \$105.30-70 = \$35.30 on his investment, and the BMO Nesbitt

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<sup>449</sup> Sandler, D. and MacIntosh, J. 2003b. "Mutual Funds that Invest in private Equity? An Analysis of Labour Sponsored Investment Funds." Working paper, University of Alberta and University of Toronto. Found at p., 33

<sup>450</sup> Many of the LSIFs, like the First Ontario Fund, and GrowthWorks Working Opportunity Fund, are included in the Canadian Venture Capital and Private Equity Association, Press Release "Canadian Venture Capital & Private Equity Industry Performance Data" May 20, 2005 p.4.

<sup>451</sup> The second of four key objectives of the Solidarity Fund FTQ is "To promote economic training of workers in order to enhance their contribution to Quebec's economic development" found at <http://www.fondsftq.com/internet/fonds.nsf/VwebTempAN/AprAcc?opendocument> on 9/12/05

<sup>452</sup> a fund index listing 130 Canadian LSIF funds and sub-funds, found on 9/12/05 at [http://globefunddb.theglobeandmail.com/gis/home/plsql/gis.gen\\_fr?in\\_rep\\_type+ADM&in...](http://globefunddb.theglobeandmail.com/gis/home/plsql/gis.gen_fr?in_rep_type+ADM&in...)

<sup>453</sup> Ken Delaney interview

<sup>454</sup> Ken Delaney interview

investor made  $\$110.30 - \$100.00 = \$10.30$  on his investment. In this case, the LSIF investor made over 3 times the return of the small cap investor. The LSIFs are explicitly prohibited by law from showing prospective customers return on net (after tax credits) costs.<sup>455</sup>

The LSIF index, although it lists the Solidarity FTQ, it does not have cumulative data for return on investment or many other categories on that fund, as Solidarity FTQ does not provide that information to the index makers. So the absence of the Solidarity FTQ data skews the LSIF index considerably.

However, Solidarity FTQ has \$5.9 billion in assets, whereas the rest of the LSIFs combined have \$3.38 billion in assets. Solidarity FTQ, in its own reports shows much better performance than the other LSIFs, which is likely due to its economies of scale, historic monopoly on LSIF business in Quebec from the early 1980's until after 2000; and its size in relationship to the entire Quebec economy.<sup>456</sup> This author found only annual, and not cumulative rates of return in the English language data available on the Solidarity FTQ website<sup>457</sup>. It did show an average annual rate of return since inception of 4.9%,<sup>458</sup> which is substantially better than that of the rest of the LSIFs, and would clearly change the overall LSIF figures if included in the index. Table 6 D (below) shows this comparison. Any proper comparison between the other indices and the LSIFs would need to include the Solidarity data, as it comprises almost half the LSIF funds invested in Canada.

### c) Financial Return Comparison Data

Table 6.4<sup>459</sup> (See Table 6A below) in Fung, Hebb and Rogers showed one, three and five year returns as of December 1998 from the February 1999 *Globe and Mail Fund Report*. It shows the Alliance LSIF Funds outperforming the non-Alliance LSIF funds substantially on one, three and five year average rates of return. Fung, Hebb and Rogers attributed some of this Alliance LSIF success to the strengths their social audits gave to their investment decision-making process.

By using social audits, investors screen out attributes that can be associated with bad management, including poor labour relations, dangerous environmental practices, and disregard for consumers and communities. Economically Targeted Investments (ETI) opponents see these screens as distractions from securing the best possible return. The Alliance funds contend that social performance improvements require the sacrifice of profitability is simply inaccurate. At the close of 1998, Alliance-controlled funds, operating with a broad social and

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<sup>455</sup> Ken Delaney interview

<sup>456</sup> Ken Delaney interview

<sup>457</sup> Fonds du Solidarit' FTQ Website found on 9/9/05 at

<http://www.fondsftq.com/internetfonds.nsf/VwebTimpAN/AprAcc?open> document

<sup>458</sup> Fonds du Solidarit' FTQ Website found on 9/9/05 at

<http://www.fondsftq.com/internetfonds.nsf/VwebTimpAN/AprSta?open> document,

<sup>459</sup> Archon Fung, Tessa Hebb & Joel Rogers, Working Capital: the Power of Labor's Pensions, Cornell University Press (2001) p.143.

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economic agenda, solidly outperformed mixed-board LSIFs, small-cap funds, and the Toronto Stock Exchange total return for that year.<sup>460</sup>

Below is a summary of the information on Fung, Hebb and Rogers, table 6.4 (Table 6A below) and more recent data from the Canadian Social Investment Organization (SIO). The SIO data does not compare Alliance with non-Alliance funds. In 1999 (Table 6B) it compares Alliance funds against the average for small and mid –cap funds and in 2004 (Table 6C) it compares a group of LSIFs including Alliance and non-Alliance funds to a small cap index.

**Table 6A**

As of 12/31/98 % return	1-year	3-year	5-year
Alliance Fund Average	6.27	6.94	7.01
Non-Alliance Fund Average	-5.33	0.16	2.11

From p. 143 of *Working Capital: The Power of Labor's Pensions*

While the assertion about outperforming other funds may have been true in the late 1990's, since the bursting of the technology bubble in 2000, weak private equity markets, and decreases in the tax incentives provided to LSIF investors, their performance compared to listed small cap stock funds has not been good.<sup>461</sup>

**Table 6B**

As of 12/31/99 % return	1 mo.	3 mo.	1-year	3-year	5-year	10-year
Alliance Fund Average	5.6	11.3	17.9	5.4	5.6	NA
All Canadian Small to Mid Cap Equity Funds Average	8.5	9.3	17.6	2.8	9.9	8.3

From *Socially Responsible Investment Organization Newsletter* Feb.2000 p.8 – Fund Performance

**Table 6C**

12/31/2004 % return	1 mo.	3 mo.	1-year	3-year	5-year	10-year
Labour Sponsored	-	0.6	-1.3	-7.3	-6.0	0.9

<sup>460</sup> Archon Fung, Tessa Hebb & Joel Rogers, *Working Capital: the Power of Labor's Pensions*, Cornell University Press (2001) p142.

<sup>461</sup> Deborah Olson interview with Ken Delaney, Executive Director, First Ontario Fund (the only Ontario fund in the LSIF Alliance) 8/2/05.

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Venture Capital Funds*				
BMO Nesbitt Burns Canadian Small Cap Index	-	9.9	14.1	17.3

From *Socially Responsible Investment Organization Newsletter* Website – Fund Performance 2004 ([www.socialinvestment.ca/MutualFunds/Dec322004](http://www.socialinvestment.ca/MutualFunds/Dec322004)) This list includes Alliance and some of the non-Alliance LSIFs.

First Ontario's Ken Delaney opined that it was inappropriate to compare the LSIFs, which are required to invest in small and medium sized local businesses, to small cap stock indices comprised of publicly traded companies such as those in Tables 6B and 6C.<sup>462</sup> He said that the better comparison is to the rest of the venture capital industry. Indeed, a number of the LSIF funds are included in the Canadian Venture Capital and Private Equity Association data on venture capital companies.<sup>463</sup> When compared to the whole Canadian venture capital industry<sup>464</sup> the LSIF returns seem comparable. Since 1996, LSIFs tend to invest a majority of their funds in later stage venture capital rounds. So it seems reasonable to compare their return on investment to those of other later stage venture capital investors in Canada. (See Table 6 D) By that measure, they are behind their cohort in one and 5-year rate of return, but ahead of them in 3 and 10- year rates of return. So they are on a par with their cohort.

**Table 6D – Comparing Rate of Return for of LSIF Index<sup>465</sup> with Canadian Venture Capital index<sup>466</sup>**

<i>Investment % Returns</i>	<i>Total Assets</i>	<i>1 - year</i>	<i>3 - years</i>	<i>5 - year</i>	<i>10 - year</i>	<i>15 - year</i>	<i>From Inception</i>
<i>Later Stage Venture Capital in</i>	<i>NA</i>	<i>5.6</i>	<i>- 4.3</i>	<i>- 4.3</i>	<i>0.0</i>	<i>NA</i>	

<sup>462</sup> Deborah Olson interview with Ken Delaney, Executive Director, First Ontario Fund (the only Ontario fund in the LSIF Alliance) 8/2/05.

<sup>463</sup> Canadian Venture Capital & Private Equity Association, May 20, 2005 press release "Canadian venture Capital & Private Equity Performance Data" – the list of firms included traditional venture capital companies and some LSIFs – found 9/12/05 at [http://www.cvac.ca/files/CVCA\\_Press\\_Release\\_Performance\\_Study\\_Dec\\_2004\\_final\\_May\\_20\\_2005\\_R.pdf](http://www.cvac.ca/files/CVCA_Press_Release_Performance_Study_Dec_2004_final_May_20_2005_R.pdf)

<sup>464</sup> Many of the LSIFs, like the First Ontario Fund, and GrowthWorks Working Opportunity Fund, are included in the Canadian Venture Capital and Private Equity Association, Press Release "Canadian Venture Capital & Private Equity Industry Performance Data" May 20, 2005 p.4.

<sup>465</sup> Toronto Globe and Mail financial web site [globefunddb.theglobeandmail.com/gis/home/plsql/gis.gen\\_fr?in\\_rep\\_type+LT&in\\_sor](http://globefunddb.theglobeandmail.com/gis/home/plsql/gis.gen_fr?in_rep_type+LT&in_sor)

<sup>466</sup> Canadian Venture Capital & Private Equity Association, May 20, 2005 press release "Canadian venture Capital & Private Equity Performance Data" – the list of firms included traditional venture capital companies and some LSIFs – found 9/12/05 at [http://www.cvac.ca/files/CVCA\\_Press\\_Release\\_Performance\\_Study\\_Dec\\_2004\\_final\\_May\\_20\\_2005\\_R.pdf](http://www.cvac.ca/files/CVCA_Press_Release_Performance_Study_Dec_2004_final_May_20_2005_R.pdf)

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<i>Canada as of 12/31/04</i>						
<i>Toronto Globe Labour Sponsor Peer Index<sup>467</sup> 8/31/05</i>	\$3.4 billion <sup>468</sup> - 1.3	-3.23	-6.21	0.53	1.54	
<i>Solidarity FTQ<sup>469</sup> as of 5/31/04</i>	\$5.9 billion <sup>470</sup> 5.0	NA – but annual return in 2002 -11.4%	NA but annual return in 2000 8.6	NA but annual return in 1995 11.6%		Average annual return since inception 4.9%

#### d) Do LSIF Rules Negatively Affect Returns on Investment

Do the LSIF rules regarding reinvestment within the province and the pacing rules put too many restraints on LSIF management, decreasing the available eligible deal flow and forcing them to make some riskier investments than they would otherwise make if they had more latitude? Unlike private venture capital funds, LSIFs are required to reinvest in their home province and have “pacing rules” which require them to invest 50% of capital raised in January-February by December 31 of that year and another 20% in the next year.<sup>471</sup> The geography may limit the available deals, especially when some qualified investments must be made within a time period in which the deal flow is not good. This author could not find sufficient data to address this question. But it is a question that should be considered by anyone seeking to replicate the LSIF model. Mismanagement seems to have been the primary problem leading to the Manitoba Crocus Fund going into receivership in 2005.<sup>472</sup> However, there is also speculation that Manitoba was too small a

<sup>467</sup> This index does not include 3,5,10 and 15-year cumulative figures for Solidarity FTQ, so it covers only 43% of the LSIFs.

<sup>468</sup> Author added all the assets listed for the 130 funds on the globeinvestor.com Labour Sponsored Venture Funds. Some of them did not list assets, including Solidarity FTQ. Found on 9/12/05 at [http://globefunddb.theglobeandmail.com/gis/home/plsql/gis.gen\\_fr?in\\_rep\\_type+ADM&in...](http://globefunddb.theglobeandmail.com/gis/home/plsql/gis.gen_fr?in_rep_type+ADM&in...)

<sup>469</sup> The remaining 57% of the LSIF results are these from Solidarity FTQ, “Financial Highlights, Fund Returns” found on 9/9/2005 at <http://www.fondsftq.com/internfonds.nsf/VwebTimpAN/AprSta?opendocument>

<sup>470</sup> “Financial Highlights, Fund Returns” found on 9/9/2005 at <http://www.fondsftq.com/internfonds.nsf/VwebTimpAN/AprSta?opendocument>

<sup>471</sup> Office of the Canadian Auditor General, Jon W. Singleton, Examination of the Crocus Investment Fund May 2005, Appendix G – Sections of the Income Tax Act Related to the Pacing Requirements of a Labour-Sponsored Fund.

<sup>472</sup> Office of the Canadian Auditor General, Jon W. Singleton, Examination of the Crocus Investment Fund May 2005, Executive Summary p. 1

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market to be able to successfully manage a fund with the requisite geographic and pacing restrictions. As a province with only one million people and 35,000 businesses, there may not have been adequate deal flow for Crocus to choose better investments and still follow the rules.<sup>473</sup>

Do the LSIFs have adequate business oversight to protect them from making investments based on political pressure? A labor-sponsored fund is inherently subject to pressure from the labor unions that sponsor it to make investments to protect jobs in companies where its members work. However, a fund cannot survive if it gives in to such pressures. If labor is to have a major ownership position in such a fund, it must provide fund managers enough protection to allow them to do what is financially necessary, regardless of politics. The First Ontario Fund (FOF) has such a mechanism, which was sorely tested in a recent case of a USWA organized firm that was an FOF investee was losing substantial market share to Chinese competition. The FOF board of directors had 11 members, 6 from labor and 5 from business. However, the investment committee is comprised of the 5 business members. So when a decision had to be made whether to reinvest in the company in question, the investment committee determined that reinvestment was unwise, and FOF let the company close instead of reinvesting.<sup>474</sup>

#### ***6. Devaluation of the Crocus Fund and its Implications***

The Manitoba Crocus Investment Fund was one of the small LSIFs, with total assets of approximately \$100 million or less in 2004.<sup>475</sup>

On April 4, 2005, the Manitoba Securities Commission issued allegations against the Crocus Fund for mismanagement leading to a sharp drop in share value from \$10.45 per share to less than \$7 per share, which was not determined or reported in a timely manner to investors. The Crocus Board of Directors were obligated under the Crocus Fund legislation and procedures to certify the net asset value (NAV) of the Fund's shares every Friday by means of a certificate signed by two officers of Crocus and two Board members.<sup>476</sup>

Between April 2004 and September 2004 there were no meetings of the Board's valuation sub-committee, nor timely certifications of value by the board, because the staff did not have the necessary valuation information. The Board did not raise any concerns about the failure of the valuation sub-committee to meet. The Fund continued to sell and redeem shares during the April to September period on an outdated value. At its

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<sup>473</sup> Robert Warren interview

<sup>474</sup> Ken Delaney interview 8/2/05

<sup>475</sup>Office of the Canadian Auditor General, Jon W. Singleton, Examination of the Crocus Investment Fund May 2005, pp. 30-31...However, the exact value of the Crocus assets is a key question in the Auditor General's report, as the Fund was placed in receivership by the Canadian Securities Commission in 2005, when serious questions arose about overvaluation of its investments.

<sup>476</sup>In the Matter of : The Securities Act and In the Matter of the Crocus Investment Fund – Statement of Allegations of Staff of the Manitoba Securities Commission pp. 1 - 6, April 4 ,2005 found on 4/25/2005 at [www.msc.gov.mb.ca/investigation/hearings/corcuosa.html](http://www.msc.gov.mb.ca/investigation/hearings/corcuosa.html)

September 23, 2004 Board meeting, the senior officers, based on valuations they then had on 23 of 50 investee companies reported to the Board that the Fund asset value should be written down by \$15 million. The Board provided the staff with no specific directions on how to proceed. They did not suggest asking the Securities Commission for permission to suspend trading in the shares.<sup>477</sup>

From September 28 to December 3, 2004, the staff person who normally prepared the certificates and sent them to the Board members was absent. On November 15, 2004, the Board's Finance & Audit Committee learned that the Fund valuation was likely to be written down further, by an as yet unknown amount. Nonetheless, two of the Board members signed certifications for the share value for eight prior weeks in September, October and November 2004. This was after sales and redemptions had already been made for these amounts based on staff determined prices not approved by the Board. On December 5, 2004 several Board members asked senior staff if they would sign the valuation for a less deflated value. The senior staff refused. Based on all of the above, the Securities Commission issued a set of 13 allegations against various Board members for: routinely and consistently failing to determine the fair value of the shares; retroactively certifying share values after the Fund had already bought and sold shares at those prices; failing to timely disclose to investors devaluation in the share; failing to seek a suspension of trading in the shares until November 18, 2004; signing certificates in November after being told there was a material change in value that was not yet calculated; signing certificates retroactively; and asking the senior staff to change the certificate value so it would not look so bad.<sup>478</sup>

In its investigation, the Auditor General found many instances of mismanagement at Crocus<sup>479</sup>. But did not at all generalize these to the LSIF industry. In fact, the Auditor General's report described the socially responsible investment process, as one that was a good Crocus safeguard, which was unfortunately not followed in one case leading to a bad investment.

Socially Responsible Investing (SRI) reviews have had a positive impact on the investment decision-making process. However, there have been instances where the former CEO and former CIO have curtailed the review process. Had these SRI reviews been completed, the results may have influenced the Board's decision to invest.<sup>480</sup>

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<sup>477</sup> In the Matter of: The Securities Act and In the Matter of the Crocus Investment Fund – Statement of Allegations of Staff of the Manitoba Securities Commission pp. 1 - 6, April 4 ,2005 found on 4/25/2005 at [www.msc.gov.mb.ca/investigation/hearings/corcuosa.html](http://www.msc.gov.mb.ca/investigation/hearings/corcuosa.html)

<sup>478</sup> In the Matter of: The Securities Act and In the Matter of the Crocus Investment Fund – Statement of Allegations of Staff of the Manitoba Securities Commission pp. 7-8, April 4, 2005 found on 4/25/2005 at [www.msc.gov.mb.ca/investigation/hearings/corcuosa.html](http://www.msc.gov.mb.ca/investigation/hearings/corcuosa.html)

<sup>479</sup> Office of the Canadian Auditor General, Jon W. Singleton, Examination of the Crocus Investment Fund May 2005,pp. 6-12.

<sup>480</sup> Office of the Canadian Auditor General, Jon W. Singleton, Examination of the Crocus Investment Fund May 2005,p 10.

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The Crocus board of directors was comprised primarily of union leaders. The board members had little experience sitting on fund boards or dealing with venture capital decisions. It is likely that they relied heavily on their staff. Their staff was small and had not only the normal venture capital staff duties of seeking, analyzing, structuring and financing deals, but also had to perform social audits, train union leaders to sell securities and sold securities to inexperienced investors, who are their Board members union constituents. Unlike the First Ontario Fund, whose investment committee is made up of its board members from the business community (who have the final say on investment decisions), Crocus left this work to its staff.<sup>481</sup> Staff can have trouble staying detached from companies they know very well as investees.<sup>482</sup> The Crocus Fund lacked the oversight of a sufficient number of hard-nosed business people. It may also be that Crocus was operating in too small a universe to successfully accomplish all its diverse objectives. The pacing rules, requiring fairly quick investment of funds, upon receipt, may have contributed to Crocuses problems. It was required to invest in Manitoba companies within tight time limits. Yet, the provincial population is 1,000,000 and has only 35,000 businesses.<sup>483</sup> In such a small universe they likely lacked the diversity and size of deal flow necessary to choose optimum investments. So far, although operating with the same limitations, but operating in the larger Quebec economy, the very large Solidarity FTQ, has avoided these problems.

The LSIF model is not inherently flawed, but if it is to be used as a model for Fair Exchange community trusts, several important lessons must be taken from the Crocus experience. A Fair Exchange trust board must have a more balanced board including a more equal distribution of labor, business and government members. Additionally, any founding legislation must provide latitude to invest as slowly as necessary in the local community to make sound investments. It should also provide guidance similar to the Alaska Permanent Fund legislation regarding specific types of safer investments permitted or even required for some portion of the fund.

#### ***7. Difficulty in Comparing Performance of LSIFs (Alliance and Non-Alliance) to Comparable Commercial Funds***

It is as difficult to compare the Alliance LSIFs with traditional investment funds, as it is to compare the Alaska Permanent Fund and the Alberta Heritage Fund. Just as the Heritage Fund seeks to provide a variety of non-financial community benefits to Albertans, the Alliance LSIFs are focused on job retention and investing in successful local companies that are socially and environmentally responsible. These criteria narrow considerably the universe of companies in which the Alliance LSIFs can invest. The universe of potential investments is especially restricted for an LSIF such as Crocus in Manitoba. Whereas the Alaska Funds' goals are to grow, inflation-proof itself and generate dividends, regardless of the social impact of the companies in which it invest; the Alberta Fund and the Alliance LSIFs have numerous other social goals.

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<sup>481</sup> Ken Delaney interview 8/2/05.

<sup>482</sup> Ken Delaney interview 8/2/05.

<sup>483</sup> Deborah Olson interview with Robert Warren, Executive Director, Asper School of Business Centre for Entrepreneurship, University of Manitoba on April 21, 2005.

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Measurement of these alternate goals is difficult because there is not an alternate reality for comparison. Whatever the socially active funds did to change employment or environmental circumstances, they changed the circumstances against which they would otherwise be measured. This issue presages a discussion in the section below on Community Benefit Agreements about developing metrics to measure social and community benefit. As we do not yet have these metrics, or at least no consensus on them, it is easy to overlook these benefits and concentrate on the available hard numbers. The three studies by Regional Data Corporation cited above, have attempted to measure them by creating a model of the economy as it would likely have grown without the LSIFs, and measuring the additional impact of the LSIFs.<sup>484</sup>

The hard numbers are provided in Tables 6A-D above. But they do not present the whole story.

Economist Melissa Moye discussed this issue in her comparison of three early studies on the efficacy of the LSIFs.<sup>485</sup> Because of the virtual replication of method in two of the studies, Moye treated them together as one study.<sup>486</sup> Moye argued that,

The narrow cost-benefit analysis method, used primarily in evaluating private sector investments, compares only direct dollar benefits with direct costs in assigning a value to an investment project. In the public setting, however, most economists reason that such narrow cost-benefit analyses should not be the only method used for valuing a potential public investment. The narrow cost-benefit study should be used to identify and minimize costs. However, most analysts agree that indirect effects (such as increased tax revenue due to increased production among supplier firms), induced effects (such as increased tax revenue from higher consumer

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<sup>484</sup> Regional Data Corporation, "Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds", May 2004 pp.6-15.

<sup>485</sup> Melissa Moye, "Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada," Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) The three analyses of LSIFs she examined were: "*The Fonds de Solidarité des Travailleurs du Québec: A Cost-Benefit Analysis* by Suret, *Impact Economique et Fiscal Des Investissements du Fonds de Solidarité des Travailleurs du Québec (FTQ), 1984-1993*, by Lamond, Martineau and Allen and *Economic and Fiscal Impacts of the Fonds de Solidarité des Travailleurs du Québec's Investments, 1984-93* by Jackson and LaMontagne. The Suret study was commissioned by the Fraser Institute and resulted in a negative evaluation of the net benefit of the FTQ. The Lamond, Martineau and Allen study was commissioned by the FTQ through Quebec's Institut National de la Recherche Scientifique (INRS) to assess the overall fiscal impacts of the fund's investments on the Quebec economy. The results of the INRS study, in contrast to those of the Suret study, showed a positive net impact. The INRS study's methods for computing the costs and benefits of the FTQ became the basis for a study by the CLMPC research team of Jackson and LaMontagne. The latter study used essentially the same methodology on an expanded sample of cases of seven FTQ investee firms and three investee firms of the Working Opportunities Fund in British Columbia."

<sup>486</sup> Melissa Moye, "Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada," Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 4

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spending resulting from more employment) and intangible or qualitative effects (such as increased networking among regional businesses) should also be considered when making public investment decisions.”<sup>487</sup>

Moyle stated that Suret used a narrow cost-benefit analysis method limiting effects measured to those with direct impact. He compared government expenditure with the returns to individual investors. He looked at the returns to individual investors by comparison to markets, and he did not measure the impact on any other public policy objectives, such as job creation or increased personal and business income tax revenue, nor the multiplier effect of job creation. Suret argued that the average annual return on equity of 5% and of 5% on investment during the 1986-92 period did not justify the public subsidies from foregone taxes.<sup>488</sup>

By contrast, Moyle stated that the Jackson and LaMontagne study (J&L Study) employed “a cost-benefit analysis as well as a qualitative analysis of a set of ten case studies of investee firms. The authors chose a comprehensive social cost-benefit analysis approach.”<sup>489</sup>

The J&L Study assessed “direct, indirect and induced fiscal benefits using the Quebec government’s provincial input-output model.”<sup>490</sup> They counted increased employment and tax revenue caused by investee firms, but only the portion equal to the ’s percentage of the LSIF’s investment in the company to the investee company’s total invested capital. Where there were other domestic competitors that could fill a supply gap, the J&L Study made a downward adjustment in the tax revenue caused by the LSIF investment. They counted one indirect job for each direct job created by an investee company. They counted increased tax revenue and spending from the investee companies, their workers and suppliers, and decreases in government program costs because of the increased employment.<sup>491</sup>

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487 Melissa Moyle, “Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada,” Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p.3

488 Melissa Moyle, “Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada,” Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 5

489<sup>490</sup> Melissa Moyle, “Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada,” Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 6

490 Melissa Moyle, “Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada,” Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 6

491 Melissa Moyle, “Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada,” Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 7

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The J&L Study did not consider opportunity loss costs to the worker investors, because the workers were not sophisticated investors, and generally were not investing in equities.<sup>492</sup> Most of the workers held their savings in savings accounts prior to the LSIFs.

The J&L Study found that the discounted annual benefit of \$C 13.8 million from the investee companies they studied, when deducted from the \$C 37.5 million costs to the various governments, provided a payback period for the government investment of less than three years.<sup>493</sup>

The J& L Study also looked at qualitative benefits and concluded that the,

LSIFs have been very successful at: drawing in new individual investors and mobilizing a large pool of venture capital across Canada; employment retention in investee firms, many of which had been candidates for closure; generating development spin-offs; improving labor relations; developing good relations with the local business community encouraging of strategic alliances involving business, labor and government to meet shared objectives and manage economic change; and providing economic and financial education of workers. Additionally, most of the surveyed managers reported that they had not been able to obtain financing from other sources, suggesting that LSIF investments have not displaced private venture capital.<sup>494</sup>

They also found the Solidarity FTQ obtained a 1:3 investment leverage for each Solidarity FTQ invested dollar.<sup>495</sup>

Moye concluded that the J&L Study methods were more comprehensive than those of Suret by including the collateral effects, and yet they made conservative assumptions to guard against exaggerating the benefits.<sup>496</sup>

The figures in the Tables 6 B and C above make a comparison similar to that of the Suret study. Fair Exchange, community benefit agreements, LSIFs, the Alaska and Alberta Funds and all similar ventures would benefit greatly from a comprehensive, uniform and

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492 Melissa Moye, "Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada," Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 7

493 Melissa Moye, "Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada," Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) pp. 6 - 7.

494 Melissa Moye, "Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada," Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 7

495 Melissa Moye, "Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada," Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 7

496 Melissa Moye, "Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada," Work & Technology Institute, (no date, after 1995) **found at** <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) p. 8

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agreed-upon system for measuring collateral social benefit, just as financial markets benefit from the existence of Generally Accepted Accounting Practices (GAAP).

### ***8. Lessons for Fair Exchange from the LSIFs***

The LSIFs have a 15-20 year history of providing a critically important community based source of capital, creating and saving local jobs. In this era of mobile capital having a source and mechanism for generating and growing productive capital is important for maintaining communities. LSIFs are a new and complex phenomenon. Just as the Alberta Heritage Fund stumbled a bit before it reorganized itself as an endowment, the LSIFs undoubtedly will make mistakes from which it is hoped they will grow wiser and stronger. Fair Exchange community trusts will do well to study the various LSIF funds as they develop. They have a rich and diverse experience because they operate under different provincial laws and economic conditions. It is important to note that the size and diversity of Solidarity FTQ have enabled it to reap economies of scale and its stock value to rebound to reasonably good returns after taking a value hit in 2002-03.<sup>497</sup> Learn from the governance and management problems that undermined Crocus. Note that the sheer number of LSIFs in Ontario plus the requirement that union member salespeople must be supervised by a licensed broker (unlike the rule in Quebec) causes each of those funds to have much higher expenses than Solidarity.<sup>498</sup>

The language in the Airline Stabilization Act, the Chrysler Loan Guarantee Act or the Alaska Constitution seem like the best models for Fair Exchange programs to acquire equity or funds. LSIFs provide important models and lessons to consider in structuring asset management and distribution mechanism for the Fair Exchange Community Trusts described in the Fair Exchange model legislation section IV below. Those interested in Fair Exchange would do well to consult with the executive staff of the LSIFs, as many of them have ideas about how they would invent a better LSIF if they could start from scratch.<sup>499</sup> Perhaps the best asset management and distribution model would combine the best features of LSIF and Alaska Permanent Fund models, and come up with portfolio diversity rules that used the conservative Alaska investment rules for a portion of the fund, and a well-governed and socially responsible focus on local re-investment. Or provide that a portion of the Community Trust interest or dividends would go into individual citizen accounts, as in Alaska, but the actual equity shares or funds would be controlled by a board similar to, but more diverse than, an LSIF board. In order to ensure that the individual accounts were used for economic development, one might limit citizens' uses of their individual account assets for education, business investment, home purchase, retirement and medical emergencies.

The advantage of using an LSIF-type entity for asset management and distribution is that its investment strategy has a clear focus on the needs of the local citizens, and strive to e

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<sup>497</sup> "Financial Highlights, Fund Returns" found on 9/9/2005 at  
<http://www.fondsftq.com/interntefonds.nsf/VwebTimpAN/AprSta?opendocument> .

<sup>498</sup> Ken Delaney interview

<sup>499</sup> Ken Delaney interview, and author's telephone interview with Lawrence Euteneier of Industry Canada on 9/16/05 in which he described an upcoming meeting of LSIF leaders to discuss best practices.

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maintain a clear business focus and discipline when making investments. Their success at maintaining this discipline has been hampered by size and pacing rules, which must be considered when adapting them to Fair Exchange models. Whereas, the Alaska Permanent Fund Trustees do not focus their investments in Alaska, and do not use any social investment criteria, they do use standard endowment management practices and investment discipline successfully. By contrast, Alberta found its Heritage Fund is less focused and too susceptible to political pressure when making Heritage Fund investments because it is operated entirely within the government. LSIFs such as Solidarity FTQ seem to balance those concerns well by using the provincial labor federation as a stand-in for informed citizen interest. The labor federations include financial professionals on the LSIF boards and hire professional staff to perform both financial due diligence and social audits.

Thus, the LSIF boards serve a function similar to the Alaska Fund Trustees, with a greater focus on preserving local jobs and economic vigor, but without the pressure of being elected government officials. The role of the labor movement in Canada enables labor to serve as a well-informed-citizen-surrogate. In states and countries where a social contract is understood to exist between labor, management and government, this arrangement should be replicable. In countries such as the U.S. a tri-partite board is a more attainable objective.

To make the LSIF model work one must find a strong organization committed to working people, with checks and balances that help it withstand corruption and ensure proper financial and social oversight, to fill the well-informed-citizen-surrogate role. A cooperative federation might also fill this function, as in Mondragon.<sup>500</sup>

It is worth considering the TVA board as an alternative model that could be used in a large community trust. Its advantage over the well-informed-citizen-surrogate leadership model is that such board members are usually part-time or volunteer. The TVA board members work full-time in their TVA leadership roles. They are appointed by the President and can be removed by Congress. This is similar to the role of the Alaska Permanent Fund Trustees. But unlike the Alaska Fund trustees, who invest in Wall Street, the TVA invests its resources entirely for local development.

There have been suggestions of creating a TVA to deal with rebuilding Louisiana, Mississippi and Texas after the enormous damage caused by hurricanes in 2005.<sup>501</sup>

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<sup>500</sup> Mondragon a cooperative community in Spain that has created and operates over 100 cooperative industrial businesses over the past forty years that now operate as a corporation externally. They created a community bank that enabled their phenomenal growth. Mondragon is likely one of the models considered by those who created the LSIFs. See Race Mathews, *Jobs of Our Own, Building a Stakeholder Society*, Pluto Press (1999) and William Foote Whyte and Kathleen King Whyte, *Making Mondragon, the Growth and Dynamics of the Worker Cooperative Complex*, ILR Press (1988)

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Sen. Edward M. Kennedy, D-Mass., proposed that Congress create a Gulf Coast Redevelopment Authority, modeled after the Tennessee Valley Authority, to oversee the reconstruction. TVA, created during the Depression as an independent federal agency, is widely credited with the revitalization of the seven-state Tennessee Valley region. Other lawmakers have called for a domestic version of the Marshall Plan that helped revive Europe after World War II, or something akin to President Franklin D. Roosevelt's Work Projects Administration, which put millions of unemployed people to work -- mainly on road, bridge and dam projects -- during the Great Depression of the 1930s.<sup>502</sup>

#### F. New York State Investment Funds

The State of New York has several public investment funds that incorporate some aspects of Fair Exchange and some aspects of the LSIFs.

The New York State Common Retirement Fund (CRF) has \$120 billion in assets. Its sole trustee is Alan Hevesi, State Comptroller. The CRF created an "in-state private equity investment program" and committed \$364 million to 11 private fund managers throughout the state. "The program provides market rate returns to the pension fund while providing capital for New York businesses."<sup>503</sup> July 26, 2005 CRF announced that through a fund managed by one of the 11 private equity funds it had invested \$2.1 million with an option to invest an additional \$450,000 in Knovel Corporation, a provider of online information services for scientists and engineers. The company plans to create 20 new jobs in three New York communities between 2005 and 2008.<sup>504</sup> The advantage of this arrangement by comparison to provision of tax abatements with job promises is that even if all the jobs do not materialize in New York State, the Common Retirement Fund will benefit from success of this company. Alternatively, if Knovel is a smashing success, the CRF will see significant upside benefit on its investment, and the State of New York may obtain more than the 30 jobs. In this instance the public's money is being invested for a true market type of Fair Exchange. Of course \$364 million is a small fraction of the \$120 billion fund. But, as a pension fund, it would be imprudent for a large portion of the fund to be invested in such venture capital schemes.

New York also has a Small Business Technology Investment Fund (SBTIF)<sup>505</sup> SBTIF makes early stage equity and debt investments in New York State technology based

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<sup>502</sup> WSVN-TV and Associated Press, "Rebuilding Gulf Coast after Katrina most expensive U.S. reconstruction project to date", 9/23/05, found at <http://www1.wsfn.com/news/articles/national/MIA7332>

<sup>503</sup> Alan G. Hevesi, New York State Comptroller, press release "To Announce Investment in Binghamton Firm Knovel Corp. to Use Funds to Create 30 Jobs in Binghamton, Norwich and New York City", July 26, 2005.

<sup>504</sup> Alan G. Hevesi, New York State Comptroller, press release "To Announce Investment in Binghamton Firm Knovel Corp. to Use Funds to Create 30 Jobs in Binghamton, Norwich and New York City", July 26, 2005.

<sup>505</sup> Jack VanWie, retire Executive Director of SBTIF. Everything in this section is taken from a PowerPoint presentation created by Jack VanWie for a Fair Exchange conference held on October 7, 2005.

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companies. The companies must have innovative products that materially advance technology, and provide the state and local communities with an economic benefit. Established in 1981 with federal and state funds, its total capitalization from 1981-1995 was \$15.3 million. It approved over 180 investments, closed 110, and 38 remain active. Using funds acquired from returns on its equity investments the Fund had \$40 million invested in 2005. It had created more than 2,500 jobs with average salary of \$60,000. SBTIF achieved evergreen status in 1995, with all expenses being paid by the Fund since 1990. The Fund operates at no expense to taxpayers. Similar funds include Connecticut Innovations, the Ben Franklin Fund of Pennsylvania and U.S. government funded research and development initiatives.<sup>506</sup>

These New York funds demonstrate pro-active fair exchange investments, where the government gets an upside reward for taking risk, and reinvests those funds to create additional jobs and economic activity. These models are likely easier to replicate than the LSIF or Alaska models. However, the government ownership aspect of the New York funds may be more politically acceptable in liberal New York, than in other states. For those situations the models, such as the Alaska Permanent Fund, that provide direct payback to citizens may be more politically viable.

## **G. Community Land Trusts (CLT)**

### *1. What is a CLT?*

A community land trust (CLT) is a private non-profit corporation created to acquire and hold land for the benefit of a community. CLTs are commonly used by community development organizations to provide secure affordable access to land and housing for community residents<sup>507</sup>. Environmental groups commonly used them to obtain land that might otherwise be developed to preserve it in its natural state or to have significant leverage in negotiations with governments or developers concerning contiguous developments.

Although, different communities use them for different purposes, the E.F. Schumacher Society, which provides technical assistance in creating CLT's, defines a CLT thus:

A Community Land Trust (CLT) is a form of common land ownership with a charter based on the principles of sustainable and ecologically sound stewardship and use. A democratically governed group holds the land in a CLT in trust, while individuals own the buildings and the improvements created by their own labor and investment. Through an inheritable and renewable 99-year lease, the trust removes land from the speculative market and facilitates multiple uses such as affordable housing, agriculture, and open space preservation.<sup>508</sup>

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<sup>506</sup> Jack VanWie, retire Executive Director of SBTIF. Everything in this section is taken from a PowerPoint presentation created by Jack VanWie for a Fair Exchange conference held on October 7, 2005.

<sup>507</sup> Institute for Community Economics web site [www.iceclt.org/clt](http://www.iceclt.org/clt) (found on 3/28/05)

<sup>508</sup> E.F. Schumacher Society web site; [http://www.schumachersociety.org/frameset\\_land.html](http://www.schumachersociety.org/frameset_land.html) (found 3/28/05)

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For example the Institute for Community Economics (ICE) uses CLTs to:

attempt to meet the needs of residents least served by the prevailing market. Community land trusts help communities to: gain control over local land use and reduce absentee ownership; provide affordable housing for lower income residents in the community; promote resident ownership and control of housing; keep housing affordable for future residents; capture the value of public investment for long-term community benefit; and build a strong base for community action.<sup>509</sup>

ICE's model CLT provides affordable housing by allowing the homeowner to purchase a home on land leased from the CLT. The 99-year renewable lease permits the homeowner and his descendants to live there for as long as they wish to live there. However, when they want to sell the house the land lease requires that they sell back to the CLT or sell to another low-income household at an affordable price.<sup>510</sup>

The ICE model is a membership organization with two classes of voting members. One group is all the people who live in the homes or use the land in other ways (for agriculture, etc.). The other is made up of other community members or organizations interested in the goal of the CLT and perpetuating it. Usually a CLT board has three types of members: 1) representatives of the land users; 2) representatives of the non-resident members; and 3) representatives of the broader community interest.<sup>511</sup>

If the founding organization is a community development corporation it may fill the role of non-resident members and have a strong voice in filling the broader community interest seats. For example, the Cowichan Community Land Trust Society objective is this: "In the face of increasing pressure on land, CCLT is committed to conserving, protecting, and enhancing the quality of the human and natural environment in and near the Cowichan Valley Regional District, British Columbia, Canada."<sup>512</sup> To do this CCLT: "Works with other groups and with government; Educates people in our communities; Provides assistance and guidance to landowners; Promotes a cooperative approach to conservation; Protects critical land; and Holds conservation covenants."<sup>513</sup>

## ***2. Lessons from CLTs for Fair Exchange***

CLTs are private non-profit undertakings. Similar to cooperatives or charitable non-profits, they are private entities financed by their organizers', private donors or foundations. Unlike most of the examples described above, they generally have no direct

<sup>509</sup> Institute for Community Economics web site [www.iceclt.org/clt](http://www.iceclt.org/clt) (found on 3/28/05)

<sup>510</sup> Institute for Community Economics web site [www.iceclt.org/clt/cltmodel.html](http://www.iceclt.org/clt/cltmodel.html) (found on 3/28/05)

<sup>511</sup> Institute for Community Economics web site [www.iceclt.org/clt/cltmodel.html](http://www.iceclt.org/clt/cltmodel.html) (found on 3/28/05)

<sup>512</sup> Cowichan Community Land Trust Society web site ,<http://www.island.net/~cclt/whatwedo.htm> (found 3/28/05)

<sup>513</sup> Cowichan Community Land Trust Society web site ,<http://www.island.net/~cclt/whatwedo.htm> (found 3/28/05)

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connection to a government. Their benefit to Fair Exchange programs is their experience in creating long term structures that balance diverse interests in shared property.

Their governance structure achieves an important balance between the needs of individuals and community needs. Fair Exchange programs will need to develop long term structures that balance between the needs of individuals, business, community and government.

#### **H. Relationship of Precedents to Fair Exchange Models**

The historical precedents are viewed in at least a three aspects when considered as potential Fair Exchange precedents. These are: 1) acquisition, 2) distribution, and 3) governance. Acquisition is the means used by the community to obtain ownership interests in the businesses it aids. Distribution is the mechanism used to allocate assets to citizens, jointly or severally. Governance describes how, if at all, a board of directors representing the citizens asserts its ownership prerogatives. The above examples were provided as working models of some Fair Exchange features in following categories.

Acquisition examples include: TVA, Lockheed, Conrail, Alaska Permanent Fund, Alberta Heritage Fund, Chrysler and the Airline Stabilization Act. The last four of which provide the best examples of a fair exchange acquisition.

Distribution examples include: the Homestead Act, Alaska Permanent Fund, Canadian LSIFs and community land trusts. The author favors some combination of the Alaska and LSIF models for distribution.

Governance in Fair Exchange trusts will likely require use of features of the Airline Stabilization Act, the Alaska Permanent Fund, the Labor Sponsored Investment Funds, community land trusts and possibly the TVA.

Negotiation of a Fair Exchange agreement will require a standard system for quantifying those community benefits that cannot easily be monetized.

### **IV. Fair Exchange Models**

The models that follow are not complete pieces of legislation. They are frameworks developed in response to requests from interested legislators. In a number of places the author provides a "NOTE" suggesting some alternatives that are not detailed, but generally refer back to one of the examples described in the sections above.

#### **A. International Trade Rules**

The following federal legislation would also make sense as a requirement in international agreements, or at least as an exemption from rules that prevent communities from giving preference to local businesses. This paper was funded by a source focused solely on the

U.S. However, COG seeks experts on international trade agreements to help locate and develop Fair Exchange model international agreements.

### **B. Federal legislation to level the playing field between states and communities**

Federal legislation designed to level the playing field between communities, and raise the floor in negotiations with businesses, would require that any community desiring federal transportation fund (*or anything else Congress could agree upon that every local government needs*) payments must:

Section 1. Enact and enforce legislation requiring than in exchange for any government investment in a private business, the citizens shall receive equity in exchange or obtain a community benefit contract backed by securities (in the form of stock, warrants or property liens) equivalent to the value of the government investment. A portion of the interest or dividends from these securities shall be used to supply the residents of the taxing entity with a stream of income or other direct benefit(s); a portion of the income shall be used to inflation proof the fund; and a portion may be used for any public purpose approved by the community trust which may include contribution to the local government. The principal shall be held or reinvested by a community trust to provide for the “long-term benefit of the community and all its citizens” as defined in the community trust agreement. (NOTE: This language should be broad enough to allow experiments with a variety of the positive examples described in Sections II and III above.)

Section 2. The following, when all the decision parameters in the Notes below were filled in, could be a safe harbor model for communities to use if Section 1 above were enacted.

### **C. Federal “safe harbor” model for local laws**

“Whenever a Government invests in a private Benefited Business Entity (Company) by providing it with special benefits not given to all taxpayers in the ordinary course (hereinafter “Government Investment”), the business shall provide a quid pro quo at fair market value to the Commonwealth.”

“*Benefited Business Entity*” means a for-profit enterprise in whatever form it is organized (hereinafter referred to as “Company” but not limited to enterprises organized in the corporate form).

“*Government Investment*” means any tax deduction, abatement, grant, government subsidized or guaranteed loan, license (e.g. banking and broadcasting), lease, concession, or contract, preparing and/or providing parcels of land, government contracts, and favorable utility rates, use of non-renewable resources, etc. or any other thing of value for which less than a market price is paid to the Community;

*"Quid pro quo"* means an amount equivalent to the Government Investment in corporate common stock or preferred stock or stock warrants convertible into such common stock if the Company is a stock company, or its equivalent in cash; or partnership rights (if the Company is a partnership) or membership rights (if the Company is an LLC), or similar ownership rights in any other business form (hereinafter collectively referred to generally as "Company Stock") in the Company. Said Company Stock shall have the greatest voting and dividend rights of any other class of Company Stock owned by the Company.

*"Commonweal"* means: (NOTE: Defining and structuring the "Commonweal" or "Community Trust" is the most challenging aspect of developing a Fair Exchange law.

*Here the community must decide upon a private, public or quasi-public entity that meets specific tests of bona fide interest in protecting the long-term economic, social, ecological and/or cultural interests of the local citizens. The community may wish to use a model such statements of principals or objectives as the Canadian Alliance LSIFs' Statement of Alliance Principles, the language defining the Alaska Permanent Fund, the Alberta Heritage Fund or the TVA (all described previously in this article) or some combination or variation of these.*

*This is also the place where the community must designate its "well-informed-citizen-surrogate" whether that be a set of trustees appointed by one or more elected leaders as in Alaska; a labor state or provincial labor federation, as in the Alliance LSIFs; a major cooperative federation, or a multi-party body such as the Conrail USRA structure or leave that function to the local government as they did in Alberta.)*

The Commonweal or Community Trust shall provide benefits to all citizens individually and to the community generally as follows. (Note: Here again choices (hopefully informed by some of the history described above) must be made including:

- a) on individual benefits: 1) dividends, savings or equity accounts for individual citizens with 2) the ability for individuals to withdraw and use the funds (for any purpose or for limited purposes such as the current limits for IRAs or education funds); and 3) the ability (or not) to vote for some of the trust's leadership; and
- b) on community benefits whether to follow: 1) the social investment model of the LSIFs; 2) the endowment fund model of the Alaska fund; 3) a mixed model – hopefully with more deliberation and planning than Alberta; or 4) to try something based on the TVA model.)

Community Benefit Agreement language such as that used in the State Statutory Model below might be appropriate as a safe harbor as well.

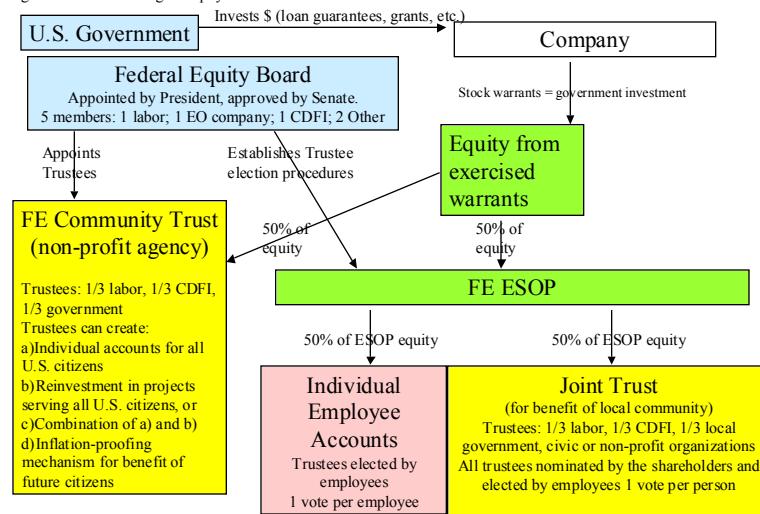
**D. Model for investment of federal funds in businesses: the Fair Exchange Investment and Taxpayer Protection Act (Fair Exchange Act) of 2005 Draft, (“Fair Exchange Act”)**

In summary, the sample Fair Exchange Act language below provides the following.

- 1) It creates a government board to negotiate and extract equity in exchange for government subsidies to business, with a 5-member Federal Equity Exchange Board (“Equity Board”) appointed by the President and approved by the Senate.
- 2) The Board must include at least one representative from organized labor, one from a community development financial institution, and one from a majority employee owned company.
- 3) The fund equity is allocated equally between and managed by two bodies, the Fair Exchange ESOP (Fair Exchange ESOP), and the Fair Exchange Community Trust (Community Trust).
  - a. One half of the Fair Exchange ESOP assets are allocated to individual accounts for the Company’s employees and they elect the Fair Exchange ESOP Trustee.
  - b. The other half of the Fair Exchange ESOP’s stock goes to the Fair Exchange ESOP Joint Trust. The Fair Exchange ESOP Joint Trust holds its stock in a single account to be used for the benefit of current and future employees and the community. It is patient capital that sustains the enterprise and community but does not belong to any individual. Its trustees are elected 1/3 each by shareholders, employees and community representatives. The community representatives are nominated by shareholders and elected by company employees.

The Fair Exchange Community Trust (Community Trust) is a non-profit entity whose board is appointed by the Equity Board. It decides how to allocate its half of the stock between individual and community needs and future security within certain parameters. It is the body charged with being the LSIF- type board or Alaska Permanent Fund- type trustees.) Figure 8 (below) is a diagram of the trusts created under the Fair Exchange Act, the trustee appointments and uses of funds.

Figure 8 – Fair Exchange Taxpayer Investment Protection Act of 2005



## Fair Exchange Act Article I – Preamble

Whereas, this Government has made loans, loan guarantees and provided other investments to private businesses since early in our history, including most railroad companies, most airlines, Chrysler, Lockheed, the savings and loan industry; and others, and

Whereas, there is no reason to believe such investments will not be sought again and again from Congress; and

Whereas, due to the increase in foreign competition in many sectors of the U.S. economy, it is reasonable to anticipate that many more businesses will seek investment from the US government in the form of grants, loans and loan guarantees, to handle the damages and risks of this new situation; and

Whereas many of the firms seeking assistance own or operate assets both within and outside the United States; and

Whereas there has been a trend of U.S. companies outsourcing much of their work outside the U.S., and

Whereas, many individual taxpayers are also harmed by loss of employment due to the circumstances that cause companies to seek government grants, loans and/or loan guarantees, tax abatements, favorable licenses, etc. (hereinafter referred to as "Government Investment"), and

Whereas, corporations, unlike individuals, may be legal persons, but do not hold citizenship in any country; and

Whereas, the primary purpose of the government is to protect and defend the rights of its citizens to life, liberty, property and the pursuit of happiness.

*(NOTE: Much of the following language is based on the Air Transportation Safety and Stabilization Act (ATSSA discussed above in the section on the airline bailout.)*

### **Fair Exchange Act Article II – Creating the Federal Equity Exchange Board**

IT IS HEREBY RESOLVED that the Congress of the United States shall require in exchange for any grants, loans or loan guarantees made for or on behalf of any for-profit business entity (hereinafter "the Business") by the United States Government or any of its agencies (hereinafter "the Government"), the Federal Equity Exchange Board (hereinafter "Equity Board") shall obtain contracts under which the Government, the Business' employees and all current U.S. taxpayers shall participate in gain of the participating Business and/or its security holders through use of common or preferred stock and instruments such as warrants and stock options or other appropriate equity instruments.

A) The Equity Board's purpose is to utilize the lending capacity of the federal government to accomplish and balance three goals:

- 1) Broadly distribute "meaningful ownership" among U.S. citizens in the same way that the Homestead Act of the 1862 made many citizens landowners and that ESOPs make employees owners;
- 2) While lending and making loan guarantees to stabilize US businesses and the U.S. economy;
- 3) Create a non-wage stream of income or savings for all U.S. citizens; and
- 4) Make investment decisions and exercise any securities voting rights on behalf of the greatest good of the greatest number of U.S. citizens considering their need for strong sustainable communities, jobs, income, health, safety, education, a clean environment, and retirement security.

B) The Equity Board shall include five members appointed by the President with the advice and consent of the Senate. However, there must be at least one each from a community development financial institution, one from a national labor federation and one from a majority employee owned business. In carrying out the goals stated in Section 1 (above), the Equity Board may create revolving loan funds to further enable employee or community ownership programs with repaid loan funds.

C) "Meaningful ownership" shall be interpreted by the Equity Board, but shall include both voting and property rights.

### **Fair Exchange Act Article III - Powers and Functions of the Equity Board, FESSOP and Fair Exchange Community Trust**

A) The Equity Board shall obtain contracts under which the Government, the Business' employees and all current U.S. taxpayers shall participate in gain of the participating Business and/or its security holders through use of common or preferred stock and

instruments such as warrants and stock options or other appropriate equity instruments as follows:

- 1) In exchange for any direct grant of funds to the Business, the Business shall provide stock (or its equivalent in a non-stock business) meeting all the requirements of IRC Sec.409 (a) (with the exceptions noted in paragraph 2 below) and shall contribute qualifying employer securities, as defined in IRC Sec.4975 (e)(7) and (8), with fair market value, as defined in ERISA 29 USC Sec. 1108(e) equivalent to the value of the grant made, which shall be divided equally between:
  - a) a Fair Exchange ESOP, defined in Section A (2) below (hereinafter "Fair Exchange Fair Exchange ESOP") and
  - b) a Fair Exchange Community Trust (hereinafter "Community Trust"), defined in Section A (4) below.
- 2) The Business shall create a qualified Fair Exchange ESOP that shall be:
  - a) An employee stock ownership plan meeting the all the requirements of IRC Sec.409 (a) (with the exceptions noted in paragraph 2(b) below) and shall contribute qualifying employer securities, as defined in IRC Sec.4975 (e)(7) and (8), with fair market value, as defined in ERISA 29 USC Sec. 1108(e) equivalent to 50% of the value of the grant made.
  - b) A qualified Fair Exchange ESOP shall include the following features in addition to the requirements noted in paragraph 2(a) above, and (where these conflict with IRC Sec. 409(a), the requirements of this paragraph shall take precedence). These requirements include:
    - i. The majority of the Trustees of the Fair Exchange ESOP shall be elected on a one vote per person basis by the Fair Exchange ESOP participants, pursuant to procedures and regulations established by the Equity Board.
    - ii. Allocations to the individual accounts of individual participants in a Fair Exchange ESOP shall be made from one half of the contributed stock;
    - iii. The other half of the stock contributed to the Fair Exchange ESOP shall be allocated to the "Fair Exchange ESOP Joint Trust". The Fair Exchange ESOP Joint Trust shall hold its interest in the Fair Exchange ESOP stock for the benefit of current and future employees and the local community. Its Trustees shall be elected as follows: 1/3 by shareholders; 1/3 by the employees on a one vote per person basis; and 1/3 shall be comprised of representatives of local governmental, civic or non-profit organizations (located in communities where the Business has facilities) nominated by the shareholders and approved by vote of the employees on a one vote per person basis.

- 3) The Equity Board shall create a qualified Fair Exchange Community Trust (Community Trust) to which the Business will give the remaining 50% of the stock or equivalent required in Section a(1)(b) above.
- 4) A Community Trust shall be a non-profit agency with a board appointed by the Equity Board. Its board shall include an equal number of representatives from labor, community development financial institutions and government. The Community Trust is empowered to:
  - a. Create individual accounts to annually allocate the equity or its income equally to each person who that year qualifies as a citizen of the U.S.; or
  - b. Create a community reinvestment plan to use the equity or its income for projects that serve all the citizens of the U.S.; or
  - c. Create some combination of the individual accounts and community reinvestment plan described above;
  - d. Use its best efforts to create an inflation-proofing mechanism to provide a stream of income for future citizens as well as current citizens.

#### **E. State Statutory Language Example**

There is not a single model for Fair Exchange. Currently it is a concept in need of pilot projects. Thus, this single state model is not intended to be the primary state or local model. It is simply one example of applying the information garnered from this article to create a model fitting a particular legislator's purposes.

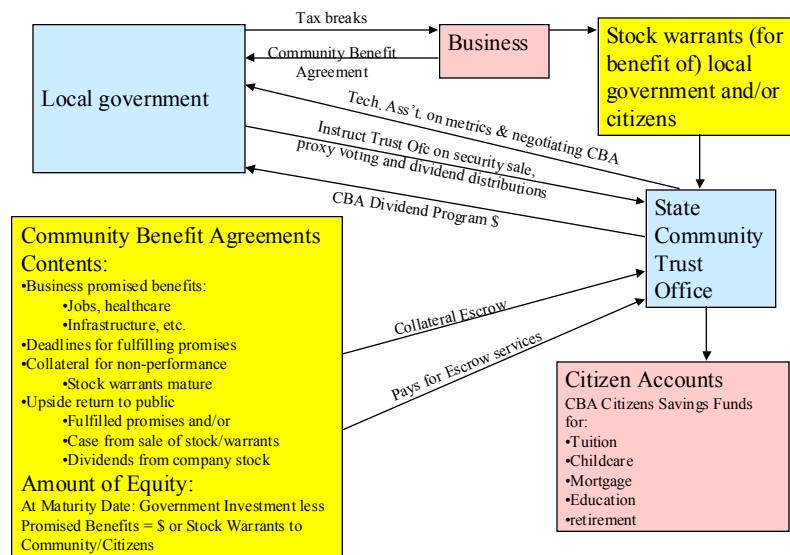
The following proposal was drafted at the request of a legislative staff person. She requested a non-mandatory Fair Exchange mechanism that would enable smaller communities, lacking deep financial resources or sophistication, to negotiate community benefit agreements and manage community trusts. A large city would probably want to create and control its own trust. A state law concerning investment of state funds might look more similar to the proposed Fair Exchange Act model for federal funds.

Making a system for socially useful and economically fair transactions out of our current system of government subsidies to business is a complex process. It needs for well-considered and crafted legal and administrative structures. Successful Fair Exchange laws will require a strong and focused technical assistance capacity.

Distressed communities and states are probably not well suited to a mandatory fair exchange policy, because of the level of risk in their deals, and the scarcity of potential investors. However, even in those locations, a non-mandatory fair exchange policy might be useful. There may be deals where the private investor is willing, or the public entity has the ability to make a larger investment with a fair exchange contract in place. In those cases it may be useful to have legislation providing the format for a community benefit agreement, and providing a state agency able to provide technical assistance or oversight that is beyond the resources of small communities (discussed further in Section V(A) below.)

In summary, the sample language below: 1) creates a trustee in the state treasurer's office who can hold stock, warrants, other securities or escrow funds negotiated in a Community Benefit Agreement, and paid for our of the trusts it manages; 2) defines a Securitized Community Benefit Agreement as a contract between a community, a business receiving special government benefits and a community trust organization in which the business promises to provide very specific benefits to the community in exchange for its investment in the Company; 3) requires the parties to agree on metrics to measure performance of these promises and firm dates by which performance is required; 4) provides that to the extent full performance is not timely performed, a corollary percent of the security becomes permanently vested in the community trust.(See Figure 9.)

Figure 9 – State (Trust Office) Fair Exchange Model



#### Example:

Whereas, this State Government and local governments within the State have made loans, loan guarantees and provided other investments to private businesses in the past and are likely to in the future, and

Whereas many of the firms seeking assistance own or operate assets both within and outside the State; and

Whereas there has been a trend of U.S. companies outsourcing much of their work outside the U.S., and

Whereas, many individual taxpayers are also harmed by loss of employment due to the circumstances that cause companies to seek government grants, loans and/or loan guarantees, tax abatements, favorable licenses, etc. (hereinafter referred to as "government largesse"), and

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Whereas, corporations, unlike individuals, may be legal persons, but are not citizens; and

Whereas, the primary purpose of the government is to protect and defend the rights of its citizens to life, liberty, property and the pursuit of happiness:

NOW THEREFORE, the State of \_\_\_\_\_ hereby creates a structure enabling the State and local governments to enter into community benefit agreements with businesses. It provides a State trustee to hold collateral or escrow from companies for communities derived from community benefit agreements. Nothing herein shall prevent a local government from creating its own community trust to hold and manage such assets, nor require that the State trustee hold such assets. The trust structure is intended to provide cost savings and enhance expertise by pooling trustee services for interested communities. The trustee services will be paid on a fee for service basis by the trusts utilizing it. The trustee disperses the funds at the direction of the community government for any of the permitted purposes.

- a. The State of \_\_\_\_\_ hereby creates a statewide community trust office in the State Department of Treasury, “\_\_\_\_\_ Community Trust Office” (“Trust Office”), which shall administer assets obtained as security for Community Benefit Agreements (CBAs).
- b. Any “Community,” defined in Sec.(c) below, may enter into a “Securitized Community Benefit Agreement” (“Securitized CBA”), defined in Sec.(c) below, with a “Business”, defined in Sec.(c) below. Any Securitized CBA which meets the requirements of this statute may, upon community request, be administered by the Trust Office in cooperation with the local Community as provided in this statute.
- c. When a “Community” (*NOTE: as defined in whatever section of \_\_\_\_\_ Code defines all boards of directors for governments in \_\_\_\_\_ from the state on down to the township and school authority – citation to be added*) invests in a private business (hereinafter “Business”) by providing it with special benefits not given to all taxpayers in the ordinary course (hereinafter “Government Investment”), such as a tax abatement, a gift of land or any other thing of value for which less than a market price is paid to the Community; the Community may enter into a securitized Community Benefit Agreement (Securitized CBA) defined as:

“A contract between a Community granting Government Investment and the Business (“Company”) may include a “Securitized CBA Security” to insure that the Community shall receive fair value in exchange for the ‘Government Investment’.

- d. The Trust Office shall hold the Securitized CBA Security in trust for the Community in accordance with the terms of the Securitized CBA.
- e. Every Security Agreement shall have one Maturity Date or series of Maturity Dates. The Securitized CBA may state specific non-Securitized CBA “Promised Benefits” (Company Promised Benefits) to be provided to the Community by the Company by no later than the Maturity Date(s) specified in the Securitized CBA;
- f. The Securitized CBA shall include metrics (meeting the requirements of Trust Office regulations *to be promulgated*) to quantify the Government Investments and any

- Company Promised Benefits enumerated in the Securitized CBA to enable both parties to measure partial and complete Company Promised Benefits performance;
- g. Upon the Maturity Date the Securitized CBA Security shall mature. For any portion of Company Promised Benefits not performed by the Maturity Date, that portion of the Securitized CBA Security shall become the inalienable property of the Trust Office for the benefit of the Community.
  - h. Unless another type of Securitized CBA Security (meeting requirements of Trust Office regulations *to be promulgated*) is mutually agreed upon by the parties, the Securitized CBA Security shall be corporate common stock (if the Company is a stock company), partnership (if the Company is a partnership) or membership rights (if the Company is an LLC), or similar ownership rights in any other business form (hereinafter collectively referred to generally as " Securitized CBA Stock" in the Company with the greatest voting and dividend rights or preferred stock convertible into such common stock or its equivalent in cash.
  - i. The Securitized CBA shall provide that no later than the closing date of the Government Investment transaction, the Company issue Securitized CBA Security warrants in the name of the Trust Office for the benefit of the Community. Said warrants shall mature on the Maturity Date(s) in the total amount of the Government Investment less the value of the Company Promised Benefits (as measured by the agreed upon metric described in Sec. (f) above) as of the relevant Maturity Date.
  - j. The matured warrants shall then be retained or sold by the Trust Office as directed by the Community government. A Community may direct the Trust Office to use the dividends and/or proceeds from sale of the Securitized CBA Stock for any of the following within the Community's jurisdiction (as instructed by the Community governing Board of Directors): utility subsidy to every Community ratepayer; public parks, public schools, public safety, fire protection, environmental clean-up, arts & culture or savings funds for every citizen which may be withdrawn without penalty for tuition, child care, home purchase, local business investment, retirement or health care.

Any voting Securitized CBA Stock retained by Trust Office pursuant to Community instructions shall be voted as instructed by the Community governing board.

#### **F. Fair Exchange adds self-enforcement feature to community benefit agreements**

Note that the state model, with the community benefit agreement (above), unlike the other models, does not require that the business give up any equity permanently as an upside for risk. This model is designed for those situations where the community is more interested in getting other benefits such as jobs with health insurance, than it is in getting an equity investment. The new feature this state Fair Exchange model adds to community benefit agreements is self-enforcement. Unlike a typical contract or a state clawback law<sup>514</sup>, that would have to be enforced in a court, the equity collateral or escrow is in the

<sup>514</sup> Greg LeRoy, *No More Candy Store: State and Cities Making Job Subsidies Accountable*, Institute on Taxation and Economic Policy (1997) pp. 43-54.

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hands of the community trust when the subsidy deal closes. Non-compliance by the business triggers maturity of the warrants, and the community trust owns stock or retrieves the escrow. Such escrows are fairly standard in substantial business contracts.

## V. ISSUES CONFRONTING POTENTIAL FAIR EXCHANGE LEGISLATION

### A. Mandatory vs. Optional

Plant location competition between local governments argues for mandatory federal legislation.

One of the most difficult obstacles to implementing a Fair Exchange proposal is the competition between communities when companies are seeking locations for new facilities and jobs<sup>515</sup>. There are many examples of companies asking communities to make bids for a plant, and significant examples where the community paid for much more than it received<sup>516</sup>. Many local leaders and politicians see the logic of the Fair Exchange idea. Yet they believe it would be politically impossible to create any such obstacles to potential new jobs in their communities. This way of thinking has led to ever-larger public incentives/ investments in private businesses, without protection.

The fact that the U.S. government required, received and made a profit on its Chrysler stock warrants is not widely known<sup>517</sup>. Even more obscure is the knowledge that every loan and loan guarantee given by the Airline Stabilization Board required and received stock warrants<sup>518</sup>. There are clear federal precedents. Furthermore, in a report by the (GAO)<sup>519</sup> one of the key recommendations is that if the government made such an investment again it should get potential “upside” benefits again. With the change of a few words, the language of the ASTSSA could be amended to require equity in any situation where the federal government makes a similar loan or loan guarantee or other such investment. It need not be limited to airlines.<sup>520</sup> The FEITPA 2005 model above is based on existing ASTSSA and ESOP laws.

A solution to the competition problem between states and local government could be accomplished with federal legislation that required, as a condition of receiving federal transportation or other development funds, that any special government benefits to

<sup>515</sup>Greg LeRoy, No More Candy Store: State and Cities Making Job Subsidies Accountable, Institute on Taxation and Economic Policy (1997)

<sup>516</sup> Greg LeRoy, *No More Candy Store: State and Cities Making Job Subsidies Accountable*, Institute on Taxation and Economic Policy (1997) pp.4-5.

<sup>517</sup> See above section in this article on 1979 Chrysler Corporation Loan Guarantee Act

<sup>518</sup> Testimony of Michael Kestenbaum, Executive Director of the Air Transportation Stabilization Board before the Subcommittee on Aviation United States House of Representatives, June 3, 2004 p. 2.

<sup>519</sup> Comptroller General of the United States, *Report to Congress: Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD 84-34, March 29, 1984, pp. 17 - 18.

<sup>520</sup> Compare the language in the “Model for investment of federal funds in businesses: The Fair Exchange Investment and Taxpayer Protection Act of 2005 with ATSSA115 Stat. 230, 49 U.S.C. 40101 Sections 102 (b) and (d).

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private businesses would have to be subject to a fair exchange community benefit agreement created under a local or state fair exchange law, enforceable by the local government and possibly the U.S. Department of Labor or IRS. Such laws would need to permit enforcement by “affected parties” or a federal agency in order to avoid evasion of the law through sweetheart deals between local politicians and businesses. The ‘Federal legislation to level the playing field between states and communities’ in the above “Fair Exchange Models” section is designed to address this problem.

### **B. Getting initial legislation passed argues for optional and local**

LSIF is private and voluntary .No individual has to put his money into it. The government makes no direct contributions with tax funds, except to provide tax exemptions for contributions by individuals.

The State Statutory Language Example above is optional, local legislation. The legislative aide who requested it believes that the easiest way to get actual Fair Exchange laws enacted is to start small, with optional ones, and strengthen them over time, as they become better known and accepted.

Communities and states that are most likely to be successful early adopters of FE, are those fast-growing, attractive communities that have sufficient demand and thus market leverage to reject subsidy seekers, such as the communities to which Manhattan based businesses have been moving since 9/11, like Stamford, CT or Jersey City, or states with increasing populations, such as California.

Due to competition between communities for job location, communities with less market leverage (such as the rust belt states) may seek or wait for federal legislation to level the playing field between them and the other venues with which they compete.

### **C. Form of Fair Exchange**

Many communities negotiating with businesses over development funds are more interested in immediate benefits such as jobs, than they are in ownership of stock, which may be volatile or not readily marketable. Use of stock warrants as collateral to ensure performance of other types of promises enables FE to be incorporated in a broad array of community benefit agreements. That problem is addressed in the above “State Statutory Language Example.”

### **D. Types of government largesse for which to require FE**

Certain forms of special government benefits to companies are obvious candidates for Fair Exchange rules, such as tax abatements, royalties for use of natural resources, grazing rights, pollution permits, grants of cash or land and loan guarantees to create jobs. Items where Fair Exchange requirements might generate less of the necessary public good are loan subsidies to create low-income housing, etc. In the housing example, the government might be trading needed new housing stock for equity. Yet even in the

housing programs there may be room for more Fair Exchange. There are housing subsidy programs in which the developers are only required to make the units available at a subsidized rate for a specified period. One should consider whether, at the point when the subsidies end, whether the government or a community land trust should have a first right of refusal to buy those assets to retain their subsidized character, and to be credited in the purchase with some of the financial benefit gained by the developer.

#### **E. Composition of the Community Trust to administer the Fair Exchange assets**

As the historical examples above show it is tough to find the right combination to protect the interests of the government, individual citizens as employees, job seekers, investors and neighbors to the development. The examples in the above "Fair Exchange Models" section are an attempt to synthesize some of the best qualities of the Alaska Permanent Fund, the Alberta Heritage Fund and the Labor Sponsored Investment Funds. In each instance the government body creating the Fair Exchange system needs to balance its goals on several parameters: 1) economic development/ social investment (as in the LSIF Alliance Principles) versus maximizing return on invested capital (as the Alaska Fund does); 2) payment of normal government expenses to lower taxes, as in Alberta, versus investment in highly screened local sustainable productive business assets such as the Alliance LSIFs, versus maximizing income for individual citizens (as in Alaska); 3) considering what effect the new program may have on increasing or decreasing citizens' responsibility towards the community compared to their personal interests.

Once those decisions have been made it may be easier to determine who represents the citizens. These may include government appointees or well-informed-citizen-surrogate representatives from specific interest groups (unions, community organizations). The board thus created usually chooses the investment/business professionals for the trust. Yet the government body creating the program should maintain oversight to ensure the Trust serves the public/citizens' interests, including both financial and social oversight. Alaska solves that problem by requiring its APF Trustees to report to the legislature and to have their budget approved by the legislature. In Alberta, the government serves all these functions. At the TVA, the board is appointed by the U.S. President, can be removed by Congress, and reports to the government, but is otherwise fairly free to run its business. The LSIFs are formed by the labor federations and choose the financial sources or experts for their funds. The only government control is in making tax deductions available or not.

#### **F. Will Fair Exchange keep private business from doing business with government? And if so, is that bad?**

It is possible that if there were widespread Fair Exchange legislation, companies would be less willing to take money from governments, because they would not want to provide the equity quid pro quo. This could be a positive development. Communities could preserve or use their development funds for projects that provided a more obvious long-lasting benefit to the community. The behavior of Northwest Airlines in initially seeking

ATSSSA funds, and then dropping its application when they understood the equity kicker, is very instructive. The purpose of most government development incentive funds is to provide financing truly needed by a company and generally unavailable from the private sector.

#### **G. What about companies that have securities the Trust does not want to hold?**

Does every business entity have securities the Community Trust wants to or can hold, such as closely held company stock, partnership or limited liability company memberships (LLC interests)? If the company is worth giving subsidies to, it should have stock warrants with some value. Remember, the Chrysler stock warrants were considered almost worthless when the U.S. government took them, yet they ended up providing over \$350 million in profit.

Of course if the stock were marketable securities, the trustees could sell the stock or warrants and use the proceeds to diversify. If there was no such public market, the trust might ask for an escrow account, instead of equity to collateralize its loan or to insure performance of promises. The trust could make disbursements upon completion of specific negotiated contract goals. Escrows are commonly used in business contracts, and may be more palatable than stock warrants or options, especially to closely held businesses that do want to risk sharing ownership.

#### **H. Defining and measuring “Community Benefit”: What is a Community Benefit Agreement? Why are they needed? How can Fair Exchange make them easier to enforce?**

There is substantial literature documenting the problem of competition between communities to provide subsidies to attract company investments.<sup>521</sup> The parties to such negotiations are not fairly matched. The investor, seeking the subsidy, operates in an environment of ever more mobile capital. He works with location consultants who have more consolidated information about the subsidies available from various communities, which is public information. Communities have no way of knowing what investors may really be looking for and they have no knowledge of when the next big deal may arise for their community.<sup>522</sup>

<sup>521</sup> Greg LeRoy, *No More Candy Store: State and Cities Making Job Subsidies Accountable*, Institute on Taxation and Economic Policy (1997); and Kenneth P. Thomas, The Sources and Processes of Tax and Subsidy Competition, presented at “Reining in the Competition for Investment” conference at University of Minnesota (February 2004) found at [www.hhh.umn.edu/img/assets/6158/thomas\\_paper.pdf](http://www.hhh.umn.edu/img/assets/6158/thomas_paper.pdf) (4/3/2005)

<sup>522</sup> Kenneth P. Thomas, The Sources and Processes of Tax and Subsidy Competition, presented at “Reining in the Competition for Investment” conference at University of Minnesota (February 2004) found at [www.hhh.umn.edu/img/assets/6158/thomas\\_paper.pdf](http://www.hhh.umn.edu/img/assets/6158/thomas_paper.pdf) (4/3/2005) p. 1-2

Community organizations have taken the lead in pushing back unfair subsidies by insisting on greater transparency, or repayment of subsidies if businesses renege on promises (“clawback laws”).<sup>523</sup>

Community Benefit Agreements (CBA’s) are an innovation created by the Los Angeles Alliance for a New Economy (LAANE). A CBA is a contract between a business or developer, a government body and a community organization (often working with labor unions) in which the business agrees to provide specific benefits, such as: a certain number of jobs paying designated fair wages including health insurance or other such benefits; building and maintenance of specific buildings or infrastructure; agreement to require tenant businesses in a new development to hire a certain percentage of its employees from the local community, etc. In exchange for these benefits, the community organization agrees to support the developer’s proposal (that needs some type of government approval); the government gives the developer the necessary approval and usually tax subsidies, free land or other financial incentives.<sup>524</sup>

In its section on Monitoring and Enforcement, the LAANE book on CBA’s points out that a heavy emphasis on monitoring and enforcement in negotiation of CBAs may make them more difficult to achieve.<sup>525</sup> A state Fair Exchange law, such as the State Statutory Language Example above, could use stock warrants or cash escrow to make the CBA self-enforcing. Such escrow arrangements are quite standard in commercial contracts, and may seem more palatable to developers. Otherwise, a standard contract generally requires enforcement through litigation or arbitration. But if the government or community trust received stock warrants or an escrow that automatically matured upon default by the developer, enforcement would be easier and the agreements much stronger.

Coordination of government policies is the only logical way to blunt the dynamic of competition for investment; the only truly successful (sic example) of this is the European Union, where favorable basic law (the Treaty of Rome) and a centralized monitoring and enforcement capacity have enabled the E.U. to exert some control over the investment-attraction activities of Member States, and local governments within its territory.<sup>526</sup>

Federal Fair Exchange laws could serve to blunt this dynamic, if localities were required to implement and enforce Fair Exchange laws in order to obtain some federal funds, as in the “Federal legislation to level the playing field between states and communities” section above.

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<sup>523</sup> Greg LeRoy, *No More Candy Store: State and Cities Making Job Subsidies Accountable*, Institute on Taxation and Economic Policy (1997) pp. 43-54.

<sup>524</sup> Julian Gross, Greg LeRoy and Madeline Janis-Aparicio, *Community Benefit Agreements: Making Development Projects Accountable*, Good Jobs First and California Subsidy Project (2002) pp. 1 – 2.

<sup>525</sup> Julian Gross, Greg LeRoy and Madeline Janis-Aparicio, *Community Benefit Agreements: Making Development Projects Accountable*, Good Jobs First and California Subsidy Project (2002) p. 48.

<sup>526</sup> Kenneth P. Thomas, The Sources and Processes of Tax and Subsidy Competition, presented at “Reining in the Competition for Investment” conference at University of Minnesota (February 2004) found at [www.hhh.umn.edu/img/assets/6158/thomas\\_paper.pdf](http://www.hhh.umn.edu/img/assets/6158/thomas_paper.pdf) (4/3/2005) p.2

## **I. Defining and Measuring Community Benefit**

In the above sections on LSIF and the Alberta Heritage Fund, we encountered the problem of measuring community benefits. Melissa Moye pointed out the disparate cost-benefit analysis paradigms used by different sets of researchers,<sup>527</sup> and the methods used by Regional Data Corporation to determine the economic impact of Ontario LSIFs by comparison to an extrapolated “but for” reality.<sup>528</sup> The Alberta Heritage Fund has either had difficulty quantifying the benefits that went into its investments in Crown Corporations, development projects and tax reductions; or it was never pressed to do so; or there was negligible benefit; although major projects employing a substantial number of people were created. Alberta converted its Fund to be invested as a more traditional endowment to resolve this vagueness and show more concrete results.

This author has found no literature outlining a standard for quantifying community benefits.

However, if a community seeks to enter into a CBA (such as those outlined in the State Statutory Language Example above) the agreement must have a way to quantify the results so that both parties will know if and when any automatic enforcement mechanisms will be triggered. The subsidy and the contract generally lasts for a set term of years, and calls for a certain number of jobs of a certain quality to be created. Often it falls down on the issue of longevity of the jobs.

To date, the author has found no agreed upon methodology and not much by way of examples using measures common to business transactions, such as calculating the present value of the income stream from a promised job over a projected number of years of employment. The technical assistance project envisioned by Capital Ownership Group will work on this problem and develop some objective measures. Many state and local governments lack the expertise to negotiate appropriate equity agreements, so any Fair Exchange legislation must address the expertise gap.

## **J. Some suggestions for community benefit measurements**

Here are some examples of how the parties might quantify the value of various community benefits using fairly standard business concepts.

1. The value of each job created would be measured by the real wages, benefits and taxes paid on behalf of each employee in one of the newly created jobs for the

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<sup>527</sup> Melissa Moye, “Review of Studies Assessing the Impact of Labor-Sponsored Investment Funds in Canada,” Work & Technology Institute, (no date, after 1995) found at <http://www.uswa.org/uswa/program/content/438.php> (3/27/05) pp.5 –7.

<sup>528</sup> Regional Data Corporation, “Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds”, May, 2004

entire term of the subsidy. This would include any employees replacing those who terminate employment on the basis that it is a single job slot. If the employer left before providing all those person/years of wages and benefits, the amount of the contract default would be clear. Since the subsidy usually accrues over time and the employment costs do as well, there would be no need to calculate the present value of either.

2. If one party provides cash, land or other valuable property at closing, while the other party makes its contribution over time, it is proper to discount the contribution over time to the present value at closing.
3. Infrastructure improvements and proposed environmental mitigation should be valued by getting an independent bid or valuation for the work as though the municipality were to build it itself.
4. The multiplier effect of job creation is an assumption made by an economist. The parties can consult economics professors to get proposals for standard assumptions and negotiate an agreed upon multiplier, such as the University of Toronto model used in the Ontario LSIF study.<sup>529</sup>
5. Similarly, the parties may have to agree upon a discount to make the transaction more attractive to the investor (especially in early legislation that is non-mandatory and not required under federal or state legislation). For example, instead of the community receiving 100% in fair value in exchange for its contribution, a Fair Exchange law might provide that 85% was sufficient.

The community needs to be careful to count in the agreement the value of everything it invests. Tax abatements or subsidies are fairly easy to calculate in cash. The contract should also include the value of any physical improvements or special services provided to the company by the community, such as worker training, staff time seeking grants from other government or private bodies and locating other resources.

#### **K. Community Trust Network – may solve problems of Community Trust fiduciary soundness and make most efficient use of management resources**

##### ***1. Fiduciary Issues and Voting Clout***

Under a Fair Exchange law, a community trust would begin to own shares in local companies. If the community trust sees itself as an endowment, or seeks stability, trustees will have fiduciary concerns about holding too much of certain securities and not enough of others. Diversification of assets is a typical fiduciary strategy. For, example, that is why the Alaska fund is required to be invested as an endowment is a broad range of investments. However, that same diversification dilutes the ability of the trust to exert its interests in corporate governance as a substantial shareholder in an investee company.

<sup>529</sup> Regional Data Corporation, “Analysis of Fiscal Costs and Fiscal and Economic Impact of Ontario Labour-Sponsored Investment Funds”, pp. 11 –13, May, 2004

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## ***2. Community Trust Network with Voting Trust Agreements is a Solution***

If Fair Exchange legislation were widespread, (i.e. if it were a requirement for local communities to obtain some of their federal funds), then there would be many local community trusts obtaining equity interests in a diverse array of companies, even though each community might have only a few local companies' stock in its portfolio. (See Figures 10A and 10B.)

Portfolio diversification could be achieved, while still preserving voting clout for the local community trusts, if a community trust network were formed. The network would be like a mutual fund. Communities would trade shares, acquired under their Fair Exchange laws, into a pool of such stock held by the network trust mutual fund. In return they would receive an equivalent dollar value of network trust mutual fund shares. However, the local community trust would enter into a voting trust agreement with the network trust mutual fund, as part of this swap. The voting trust agreement would enable the community trust to direct the voting in the shares of local companies it contributed to the mutual fund.

For example, the hypothetical Detroit Community Trust could diversify its portfolio (as should a good fiduciary), trading some or all of its \$5 million dollars worth of MMM stock to a national mutual fund of Community Trusts (Community Trusts) for \$5 million worth of shares in the mutual fund made up of stock obtained by all the other Community Trusts. The mutual fund and the Community Trusts could have voting trust agreements allowing the Detroit Community Trust to continue to vote the proxies on all the MMM shares it traded to the mutual fund.

Efficiency and high quality management would be another advantage to creating the network and its mutual fund. The larger pooled funds could employ high quality professional staff to help communities negotiate FE agreements, administer and invest funds, coordinate proxy voting and voting trusts for the community trusts and wield more clout in proxy voting.

If thousands of communities had these community trusts, over time, a significant amount of corporate stock would be subject to community voting trust agreements. These, if voted in conjunction with public and union pension funds, other socially responsible investment funds, and others concerned with corporate responsibility to communities, could have a significant impact on corporate behavior.

Figure 10a – Community Trust Network and Mutual Fund

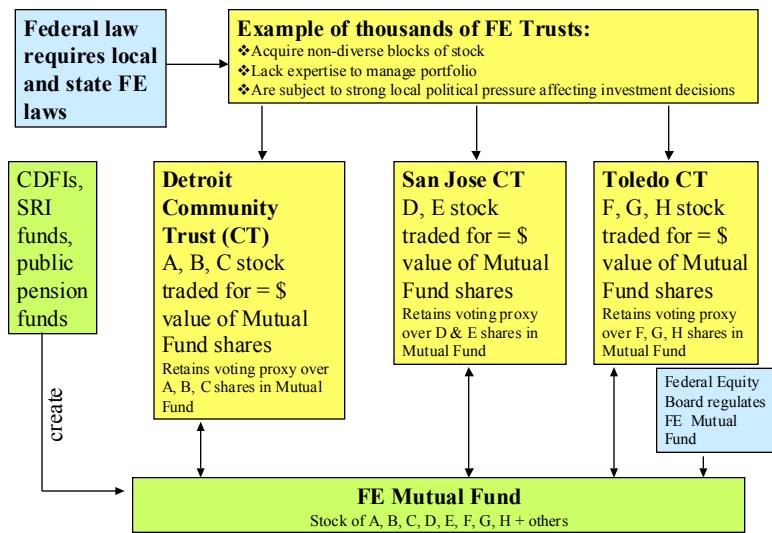
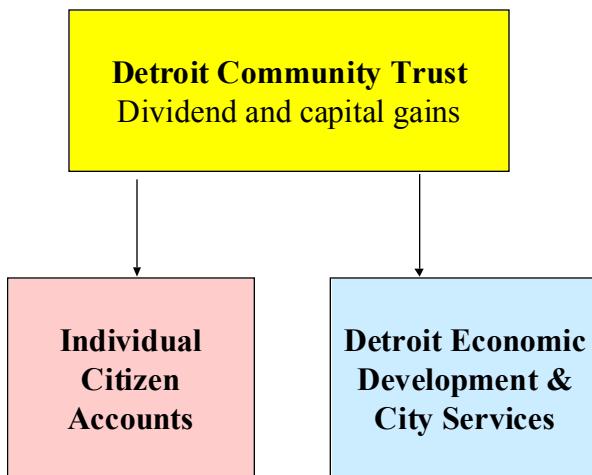


Figure 10b – Detroit Community Trust (Example)



## VI. How governments, intellectuals, community and non-profit organizations could use Fair Exchange

National, state and local governments and global trade organizations could use FE to obtain revenue without increasing taxes; raise the floor for local jurisdictions competing  
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for plant location; and create mutual fund networks of community trusts, described above, to create both diversified investments and consolidate voting blocs to influence corporate behavior.

Governments could use FE to save money when companies refuse subsidies rather than give up equity; and recreate new community trust institutions with the resources to implement locally focused economic development.

Local governments and community organizations could negotiate community benefit agreements that include stock warrants as collateral for promised jobs or other benefits promised to communities in exchange for subsidies.

Community development financial institutions and micro-lenders could serve as honest brokers to manage FE funds, especially in countries where a corruption is a major issue. They could be recipients of a portion of the FE proceeds to loan out as local micro loans. They could create and administer individual account plans that allocated funds to all individual citizens.

Socially responsible investment professionals and funds, that currently manage stock portfolios for socially responsible consumers or organizations, could provide the expertise required to create and manage the community trust and mutual fund mechanisms enabling the community trusts to build diversified funds and stock voting agreements.

Sympathetic think tanks and intellectuals could reorient use of the President's term "Ownership Society" from his January 2005 State of the Union address, by showing that FE is the fairest and most business like method of organizing transactions between governments and businesses and providing citizens a truly useful equity stake.

Fair Exchange provides a powerful argument to counter the call for private equity accounts as part of social security, while adopting the President's emphasis on the importance of broad equity ownership to advocate for Fair Exchange. Scholars could develop the details and supporting research to show how (if true) young people and all citizens in the US would be better off keeping the existing Social Security system instead of making individual investments. This author agrees with the major critiques of the President's social security plan, including: 1) that it would require major government debt increases; 2) it encourages individuals to borrow funds to buy stock, which is margin buying, a practice frowned on by most financial advisors for average working people; and 3) the risk of unaffordable loss in retirement benefits.

However, there is good reason to advocate in favor of providing every citizen with a non-wage additional stream of equity income. A combination of global wage competition and technological advance may well be decreasing the number of jobs available as the population increases, at least in the U.S. According to the Economic Policy Institute (EPI) in its *State of Working America 2004 –2005*, "From 2000-2003, long-term unemployment increased 198%. For those with a Bachelor's degree or more, the increase

was 299%".<sup>530</sup> EPI says that in the previous seven post World War II recession recoveries, all lost jobs were recovered within the first 20 months of the recovery, except in the 1990's recession it took 30 months to reach this break even-point, and in the current recovery, "39 months after the peak, we are still 1.2 million jobs short".<sup>531</sup>

Fair Exchange provides a much better source for a second stream of income unconnected to wages. The current Social Security system could remain untouched and intact, while citizens got FE equity accounts, as all Alaskan citizens now have under the Alaska Permanent Fund. Then most citizens would have some equity ownership, without the government debt or the individual retirement risk provided by the President's plan.

The Capital Ownership Group (COG) would like to provide technical assistance to governments at all levels to craft FE models to fit their circumstances. This would include working with attorneys, bankers, accountants, other professionals and community representatives to devise model FE legislation, community benefit agreements, FE collateral stock warrants, metrics for community benefit agreements, and other necessary FE technology. COG would expand the research begun in this article, create and collect information on FE examples. It would create a clearinghouse for materials, research, training and/or technical assistance for all the parties contemplating, developing and managing FE programs, and creating community benefit agreements using FE concepts.

#### **A. Range of Issues, Venues, and Jurisdictions in which FE might be used**

##### ***1. Voluntary and Local***

Without passing any new laws, FE concepts can be incorporated in voluntary agreements between willing companies, governments and community organizations, by entering into a contract with FE provisions. Currently, some communities require job quality standards from companies receiving development subsidies.<sup>532</sup> In other communities, such standards are attained by means of a community benefit agreement<sup>533</sup> between a company, a government board of directors and a community organization.

##### ***2. FCC Licenses: Taxpayers should get part of the profits generated when private companies use public airwaves***

Free distribution of the airwaves may be the most glaring of current unfair exchanges. The government has given away or sold licenses at very low prices to media companies.

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<sup>530</sup> Lawrence Mishel, Jared Bernstein, Sylvia Allegretto, "Facts & Figures – Jobs" *The State of Working America 2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>531</sup> Press release (p.2) for Lawrence Mishel, Jared Bernstein, Sylvia Allegretto, *The State of Working America 2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>532</sup> A. Purinton, *The Policy Shift to Good Job, Good Jobs First*, November 2003, pp. 1-5.

<sup>533</sup> Julian Gross, Madeline Janis-Aparicio, *Community Benefit Agreement: Making Development Projects Accountable*, Good Jobs First and California Public Subsidies Project (2002).

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The companies make enormous profits, and do not provide free access for election purposes. Our political system has become corrupted by money because candidates must raise huge war chests to pay for advertising on the public's airwaves. This need not be so. Federal legislation could require FE in all transactions with the federal government as described in the proposed FEITPA 2005 legislative model above, based on the ATSSSA law. It could extend beyond loans, loan guarantees and tax abatements to use of collective resources such as the airwaves.

Why should a communications company pay the government nothing for use of a portion of the radio spectrum for radio, television, cell phones and wireless Internet connections, when they make millions annually using that public resource? The Media Access Project estimates that the U.S. radio spectrum is worth \$771 billion.<sup>534</sup> FCC licenses should require for-profit companies to pay royalty fees based on the income derived from the use of this public asset, just as the oil companies pay royalties to the Alaska Permanent Fund. Some of these royalties could be paid at least partially in stock of the broadcaster to the relevant community trust providing citizens with equity and dividend return on a percentage of the profits made off those licenses, and eventually some shareholder clout. These fees could go a long way toward providing resources for good public, election and children's television and much needed improvements in schools, health care and infrastructure without increasing taxes on average citizens.

### **B. Federal Financing of Pilot FE Projects**

The federal government could begin by funding some local/state pilot projects to find the most effective, efficient and practical FE models. It could also create a TVA for the Gulf Coast hurricane damage reconstruction, including all the well-conceived mechanisms used by the New Deal to get the funds to the people who need them, provide jobs at a decent wage to the displaced people to do the reconstructing and prevent corrupt use of the funds.

### **C. How Fair Exchange can help communities survive the global “race to the bottom” and improve global corporate responsibility**

From 2000 to 2004, the EPI shows that Indian software jobs producing exports to the U.S. **increased 120%**, while, between 2000 and 2002, U.S. software occupations

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<sup>534</sup>“The Citizen’s Guide to the Airwaves”, Media Access Project (MAP), New America Foundation (2003) and on their web site the MAP states, “The electromagnetic spectrum represents one of our greatest public resources. Unlike grazing land or old growth forests, however, use of spectrum can be virtually inexhaustible. ...the FCC issues exclusive licenses to use spectrum. Until recently, the FCC gave away (sic) limited number of licenses for free on condition that the licensee serve their local community. Since 1993, the FCC has sold the right to use spectrum at auction.” New technology is changing the need for exclusively allocated spectrum, and new policies are decreasing the public interest obligations of broadcasters. J.H. Snider, “The Decline of Broadcasters’ Public Interest Obligations – a Policy Backgrounder”, New America Foundation (3/26/2004)

**decreased by 154%.**<sup>535</sup> As increasing numbers of ever-higher skilled jobs leave the U.S. for lower wage, lower benefit countries, communities in the U.S. and, ultimately in all countries, will need to change their relationships with the corporations they aid and subsidize. As the corporations they help continue to move to ever-cheaper wages, communities and citizens must begin to get market level compensation for their investments in those private companies. Otherwise, the communities will be left holding the short end of the stick.

A distinct advantage of the Fair Exchange approach is that it does not pit higher wage countries against lower-wage countries. It does not prevent companies from moving to produce in lower-wage countries when competition requires it. Rather it requires that the community that invested in the company making such a move receive the same benefit as the rest of the company shareholders from that move. Thus, Fair Exchange does not penalize developing economies. Developing countries are also hurt by capital mobility. The recent lifting of U.S. textile quotas is a good example. Factories in many developing countries are threatened with closure as China is poised to absorb a huge segment of the textile market.<sup>536</sup> If Fair Exchange rules were applied universally, it would aid poor countries that have invested in businesses infrastructure by bringing their citizens or communities a portion of the profits they help to generate.

The quality of life in the U.S. in recent years has already decreased in many ways due to global competition, with the economic growth going to corporate profit and not replacing the lost U.S. manufacturing jobs with similarly high paid, full-time jobs with benefits.<sup>537</sup> The pay and benefits in the new jobs being created is considerably less than in those being lost.<sup>538</sup> A smaller percentage of the workforce has regular full-time employment.<sup>539</sup>

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<sup>535</sup> Lawrence Mishel, Jared Bernstein, Sylvia Allegretto, "Facts & Figures – Wages" p.2, *The State of Working America2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>536</sup> Cecil Yancy Jr. "End of Textile Quotas to Further Hurt Industry" *SouthEast Farm Press*, October 6, 2004, "When the World Trade Organization (WTO) lifted quotas on 29 categories of manufactured goods in 2002, China's share of the U.S. market in those products went from 9 percent to 65 percent...In an ironic twist, many of the same developing countries who once clamored for repeal of the quotas have now signed the Istanbul Declaration. When their voices were loudest in support of repeal of the quotas, the developing countries did not anticipate Chinese dominance and China was not yet a member of the WTO."

<sup>537</sup> "...Since the recession began in the first quarter of 2001, 85% of the growth of corporate income has accrued to profits, and 15% to compensation. In contrast, compensation comprised 79% of the income growth in the corporate sector in eight prior business cycles, with profits contributing 21% of the growth." News Release from EPI announcing the book - Lawrence Mishel, Jared Bernstein, Sylvia Allegretto, *The State of Working America2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>538</sup> Comparing industries that are adding jobs faster than average (expanding industries) with those that are losing jobs faster than average (contracting industries), "Contracting industries paid \$61,983 in annual compensation, including all wages and benefits, while expanding industries paid \$35,546 in compensation...or 42% less." News Release from EPI announcing the book - Lawrence Mishel, Jared Bernstein, Sylvia Allegretto, *The State of Working America2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>539</sup> "The underemployment rate (including part-time workers who want to work full-time and discouraged workers who've given up looking for jobs) increased 9.6% as of June 2004." "The employment gain during the latest recovery was only 0.2%. On average, employment increased by 9.5% in the previous nine

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Even full-time employees are likely to have less comprehensive health care benefits than 15 years ago (if they have any), pay a higher co-pay for whatever they get, and are unlikely to have a defined benefit pension plan.<sup>540</sup> The economy has grown without significant increases in employment or wages.<sup>541</sup> Private sector unions are smaller and losing members and benefits every year<sup>542</sup>. All of this is attributable to pressure from the global marketplace. Simultaneously, virtually all state governments are financially strapped and cutting already trimmed down budgets for education, health care, transportation and other essential services.

At this writing the entire airline industry is going through a transition, fueled by the low-cost carriers that provide less in wages and benefits for their workers than the more established airlines. In order to survive, the older companies have been slashing their labor and benefit costs as best they can. At this writing United and other major airlines are in bankruptcy court unloading their mammoth pension liabilities on the public.<sup>543</sup> The extra cost to the public does not end with the extra pension benefits. Every uninsured person who is treated in a hospital is paid for through the ever-increasing insurance premiums paid by the companies and individuals who still have health insurance. Those increased costs, in turn, make the remaining companies that provide health insurance and retirement plans, less competitive with those that do not. For example at General Motors (GM) health care alone account(s) for \$1,400 in the cost of every vehicle built in the United States. GM's Japanese competition spends less than \$400 per vehicle for health care, leaving General Motors with a penalty of \$1,000 a vehicle or \$4 billion annually.<sup>544</sup>

According to David Cole, Chairman of the Center for Automotive Research (CAR).

economic recoveries." Lawrence Mishel, Jared Bernstein, Sylvia Allegretto, "Facts and Figures: Jobs", *The State of Working America2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>540</sup> "Health insurance coverage eroded for all wage groups in the 2000-02 period. Over the longer period, 1979-2002, health insurance coverage declined sizably, and comparably, across the wage spectrum. Less than half the workforce is covered by employer-provided pensions. Pension coverage fell from 48.3% in 2000 to just 45.5% in 2002." "Facts and Figures: Wages", *The State of Working America2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>541</sup> "After almost three years of recovery, ...unemployment is essentially unchanged, job growth has stalled and real wages have started to fall behind inflation. Today's picture is a stark contrast to the full employment period before the recession, when the tight labor market ensured that the benefits of growth were broadly shared....This is a worse position, in terms of recouping lost jobs, than any business cycle since the 1930's." News Release from EPI announcing the book - Lawrence Mishel, Jared Bernstein, Sylvia Allegretto, *The State of Working America2004/2005*, Economic Policy Institute, Cornell University Press, January 2005 found at [http://www.epinet.org/content.cfm/books\\_swa2004](http://www.epinet.org/content.cfm/books_swa2004) (4/7/2005)

<sup>542</sup> In 2003, 15.8 million U.S. workers belonged to unions 12.9 percent of the U.S. workforce. (Bureau of Labor Statistics). Fifty years ago, 16.8 million workers belonged to unions—but they made up 33 percent of the U.S. workforce.(Bureau of Labor Statistics) found at [http://www.aflcio.org/aboutaflcio/ourfuture/facts\\_densityunion.cfm](http://www.aflcio.org/aboutaflcio/ourfuture/facts_densityunion.cfm) (04/07/2005).

<sup>543</sup> BNA Pension & Benefits Reporter Vol.32, No.5, Feb.1, 2005 p.263 –64.

<sup>544</sup> James E. Harbour, "Why GM's profits really hit the wall: while legacy costs are real all-new cars may pose a real problem" *Detroit News*, March 27, 2005 found at <http://www.detroitnews.com/2005/editorial/0503/27/A15-129850.htm> (4/7/05)

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Domestic manufacturers...pay \$2,000 to \$2,500 per car in current work health-care and retiree legacy costs – costs that are unsupportable in a world with capacity of 80 million units and demand of 60 million.<sup>545</sup>

This is a key reason why they are losing market share to younger foreign companies.) This vicious cycle is called the “race to the bottom”.

Fair Exchange will not stop this race, but it does provide one effective means for communities to reap some of the rewards of the global economic restructuring for which they are now paying the bills.

#### **D. Strategies addressing the imbalance between community and commerce**

To create a humane and sustainable global community that properly balances the needs of communities and the important economic engine of business, several strategies must be pursued simultaneously. They include: enforceable agreements on environmental sustainability, human, civil and labor rights, elevating the sovereign rights of communities in relationship to businesses; reorganization of the international financial institutions and debt, internalizing in the costs of products and services (through corporate accountability measures) all the costs of production now externalized onto the public; and providing a source of non-wage income through broad ownership to offset the loss of work caused by technology.

#### **E. Fair Exchange is only one of these strategies**

Fair Exchange is not a solution to all those problems and it does not address all the above-mentioned strategies. However, it is one of several important strategies, which, when pursued together, can bring proper balance back into the relationship between businesses and communities.

## **VII. CONCLUSIONS**

Fair Exchange provides a businesslike approach for communities to be treated as investors when they invest in private companies. Fair Exchange can be used to retain and rebuild the community assets that have increasingly been privatized, and to provide a much-needed second stream of income for all citizens. It can be used to build the asset base all citizens need to truly be stakeholders in the community. It can be a first step towards reclaiming the commons for the community.

This article describes large-scale successful and unsuccessful legal and historical precedents for Fair Exchange, comparing their virtues and drawbacks on issues of equity acquisition and distribution, community impact on corporate governance, and their local

<sup>545</sup> Tom Henderson, “What Drives Detroit” *FACSNET Business & Economics* April 7, 2005, found at [http://www.facsnet.org/tools/biz\\_econ/detroit\\_auto.php](http://www.facsnet.org/tools/biz_econ/detroit_auto.php) (4/7/05)

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social and economic impact. The article provides model local, state and federal legislation, which could also be used in global trade agreements. It discusses the complex problem of quantifying non-financial (but very real) community benefits for the existing precedents, community benefit agreements, and proposed fair exchange models. It proposes basic metrics for some community benefits.

It describes the creation of a Community Trust network including a mutual fund and voting trust agreements to enable thousands of local community trusts to pool resources, diversify their investment portfolios, and increase their impact on corporate governance in conjunction with pension and socially responsible investment funds.

For each issue raised in the section on “Issues confronting potential FE legislation” this article proposes potential alternative solutions. We will only know which ones work after experimentation by a number of communities.

The sections on “How governments, intellectuals, community and non-profit organizations can use Fair Exchange” and “Range of Issues, Venues and Jurisdictions for Fair Exchange” discusses potential Fair Exchange agreements governing use of the airwaves; its significance in the policy debate about how to organize a real “ownership society” without undermining social security; and its significance in confronting the transfer of jobs from developed to developing countries or from developing countries to China.

This article was written during 2004–2005 when direct government ownership and management of business operations was an extremely unpopular idea, and elimination or privatization of public services was the trend. As 2005 draws to a close, the political climate in the U.S. may be changing as the consequences of privatization and tax cuts begin to take their toll on public well being. The combined social costs of tax cuts, the Iraq war and reconstruction of the massive hurricane damage may change the political climate regarding government spending, which will make the New Deal programs like the TVA more appealing and politically viable. A key feature that made the New Deal work was stringent oversight and controls to prevent corruption and patronage. The model legislation provided herein provides a system of checks and balances intended to limit corruption. However, any major Fair Exchange program should have a strong external oversight mechanism to prevent corruption and patronage.

For more information on current projects, or to inquire about beginning a Fair Exchange project contact the Capital Ownership Group at [cog@kent.edu](mailto:cog@kent.edu) or 313-331-7821.

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#### **Appendix A: Stock Warrants Issued by Each Airline<sup>546</sup>**

Carrier	Website	Amount borrowed in millions \$	Stock warrants issued	Comments
America West	<a href="http://www.americawest.com/default.asp">http://www.americawest.com/default.asp</a> (then go About AWA, Investor Relations, Press Releases and pick year you want to look at)	380	Am West website press release: issued to ATSB warrants for the purchase of 18.75 million shares of Class B common stock at an exercise price of \$3.00 per share. Exercise period of 10 years. Additional 3.8 million warrants with same terms will be issued to other participants in the loan.	In conditional letter from ATSB - Government needs to receive warrants that represent 33% of AWA's common stock on a fully diluted basis ... MSN article says 5%
American Trans Air	<a href="http://www.ata.com/sitemap.html">http://www.ata.com/sitemap.html</a>	148.5	11% of ATA stock – according to MSN report	No information available re: warrants on ATA website or ATSB press release
Aloha Airlines	<a href="http://www.alohaairlines.com/fly/index.htm">http://www.alohaairlines.com/fly/index.htm</a> (No loan information on their website)	40.5		
Frontier Airlines	<a href="http://frontierairlines.com/">http://frontierairlines.com/</a>	63	Issued warrants to purchase of 3,833,946 shares of our common stock at \$6.00 per share to the ATSB (and two other guarantors). The warrants had an estimated fair value of \$9,282,538 when issued and expire 7	Already repaid loan (02-14-03); not due until 2007.

<sup>546</sup> Table 3, showing the stock warrants issued by each airline was compiled from data taken ATSB website and the airlines' websites.

			years after issuance. Subsequently re-priced from \$6.00 to \$5.92 per share ...	
US Airways	<a href="http://usairways.com/">http://usairways.com/</a>	900	Warrants representing 10% of reorganized equity ...	
World Airways	<a href="http://worldair.com/">http://worldair.com/</a>	27	Issued to ATSB warrants to purchase an aggregate of 2,378,233 shares of Common Stock ... (see pg. 34 of Ann Rep – stock staggered over years and <u>prices</u> )	

**Comment [dgo1]:** Last Complete draft printed 3:00 a.m. 4/28/05DGO finished 1<sup>st</sup> rewrite and spell-checked text and part of footnotes 4/11/05 2:00 a.m. DGO added Crocus scandal section 4/26/05 6:30 pm 4/14/05 DGO Read and edited Introduction thru – entire article as of 4/28/05 3:00 a.m. 4/29/05 LM finished text edits and table of contents