

Inflation-proofing, the POMV draw, and the Earnings Reserve: Understanding the Interconnections

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Permanent Fund Value (APFC projections for June 30, 2020)

Total Fund Value (\$67.8 B) =
Principal (\$53.8 B) +
Earnings Reserve (\$14.0 B)

Principal (\$53.8 B) =
Contributions (\$46.9 B) +
Unrealized gains (\$6.9 B)



Alaska Constitution, Article IX, Section 15 (Passed 1976.)

“At least twenty-five per cent 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 investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.”



Attorney General Opinions

Greg Renkes (2003):

“We believe that the corporation’s policy that only realized earnings are available for expenditure is correct.”

Svobodny (2009):

“The ER account, however, should retain the unrealized gains and losses attributable to the investments of the ER account. The entire balance of the ER is subject to appropriation, and thus available for expenditure.”



APFC Board Resolution 18-04

3. Automatic Inflation Proofing.

“The Board believes that the inflation-proofing transfer should become a guaranteed annual event rather than a discretionary transfer that is subject to appropriation.”



What if the ER cannot pay the POMV?

- **POMV can only be paid from ER.**
- **If we remove \$3 B per year from ER and realized earnings are less than \$3B, then ER declines.**
- **ER can go to zero! So POMV (or PFD) could not be paid!**



A real policy issue.

2019: Legislature voted to transfer \$8B from ER to corpus. Governor used veto to reduce to \$4 B.

Under \$4B transfer: June 2020 ER = \$14 B

Under \$8B transfer: June 2020 ER = \$10B



How big a problem? Theoretical or real?

Three Monte Carlo studies (Bridgewater, Callan, ISER) indicate:

--Even starting at large ER (>\$13 B) and no inflation proofing, probability is surprising large (15% to 20%.)

--Automatic inflation-proofing seriously increases the risk (because it reduces the ER.)

Guettabi, 2018

(ISER publication 1664, pp. 24-27)

Assumptions:

1. ER starts at \$13 B
2. 5% POMV (no inflation proofing)

Result: Probability that ER goes to zero at least once by 2030 = 20%

Callan 10-year stress test (APFC Board, December 3, 2019)

ADN reported:

- 15%** chance that at least one payment will incomplete with current balance (\$16.6 B.)
- Greg Allen, Callan CEO: “A big ERA balance is helpful, in my opinion.”
- Suggested a \$12 B minimum for ER.



Bridgewater 10-year Stress Test # 1 (December 2017 APFC Board meeting)

Assumptions:

1. \$13 B to start
2. POMV is 5.25% for 2 years, then 5%
3. Inflation proofing assumes 2.25% inflation
4. The POMV distribution is made before inflation proofing
5. POMV distributions only come from ER.

Results: Percent of 10-year runs in which

- A. At least 1 POMV distribution is missed: **44%**
- B. At least 3 POMV distributions are missed: **16%**



The questionable work-around.

Have the APFC Board realize gains in order to refill the ER.



Policy

- I. More specific (and transparent) modelling is required. Multiple models are good.**
- II. The executive branch should include modelling of ER and POMV in budget planning.**
- III. The legislature should hear and consider modelling of ER and POMV in its consideration of transfers to corpus.**



More resilient policy

Use statutory or constitutional changes to create an endowment management strategy for the Permanent Fund.

Note: Most university endowments do not use fixed POMV strategy. They have a target, but they adjust to market conditions.

“You need to protect PF from legislators”

- I. Sources of PF principal, 1978-2019.**
 - Oil: \$17 B**
 - Inflation proofing appropriations: \$17 B**
 - Other appropriations: \$7 B**
- II. 2004-2013: Legislature added \$11B to CBR, SBR.**
- III. Legislature did not appropriate inflation-proofing in 2016, 2017, 2018.**



Should we aspire to put government finances on autopilot?

1. **OK, it's easy to write a simple formula.**
2. **But it's hard to made the formula do what you want.**
3. **And it's hard to predict how the future will impact your formula.**
4. **And what do you do when your formulae collide?**

(Given our social math phobia, how many voters or legislators will understand what the formula does?)



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