


**A POSITIVE
COUNTER-CYCLICAL FORCE
IN THE
ALASKA ECONOMY**

The logo consists of a white, rounded rectangular shape with a slightly arched top. Inside this shape, the words "Permanent Fund" and "Earnings" are stacked vertically in a small, black, sans-serif font.

Permanent Fund
Earnings

SUMMARY:

The Permanent Fund represents visionary public policy and, as a savings account, has been well managed. Its earnings should be used as a counter-cyclical force to funnel monies into the grassroots economy through local government in particularly troubled economic times. When times are good, these earnings should be placed in the Fund. The more fundamental crisis, the long-term lack of diversification in the Alaska economy, must also be addressed by the Legislature. To research revenue-generating proposals, the Legislature should establish an Alaska Development Board, the specifics of which are outlined in this report.

A report by
The Commonwealth North
Permanent Fund Committee

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IN ADDITION TO DIVIDENDS, WHAT SHOULD THE EARNINGS OF THE PERMANENT FUND BE USED FOR?

The Alaska Permanent Fund was created by a public referendum in 1976. It was established as an inviolate trust with the principal of the Fund to be invested in perpetuity. The beneficiaries of the trust were to be all present and future generations of Alaskans.

At its origination, nearly everyone agreed upon one purpose for the Fund — to remove a portion of Prudhoe Bay revenues from the appropriations table, making them unavailable for state spending. This has worked. Indeed, 22% of the \$26 billion in oil revenues received by the state since Prudhoe Bay production began has been deposited into the Permanent Fund, saved and invested. At the end of 1987, total assets of the Fund totalled close to \$9 billion.

Although the citizens of Alaska are nearly unanimous in their enthusiasm for the Fund and its management, there is less of a consensus on how to use the Fund's earnings, except for the popular dividend program. These earnings since 1978 total \$4.3 billion, 30 percent of which was distributed as dividends to the Alaska people.

Numerous conflicting proposals have been introduced on how to best use the earnings of the Fund. Most of these proposals have been met with suspicion and cries from some quarters warning against "raiding the Fund." This highly charged environment has led to hesitancy and inaction by Alaska's political leaders, and the central question has gone unanswered: what are we saving this money for?

What are we saving this money for?

During the mid-1980's there was little need for using the "non-dividend" or undistributed earnings. Times were good generally throughout the state. Local and regional economies were booming, fueled by oil activity at Prudhoe Bay and the attendant revenues amassed by state government. After the distribution of dividends to all Alaska residents, the remaining Permanent Fund earnings were simply set aside and from time to time added to the corpus of the Fund by the Legislature with encouragement from the Governor.

However, as 1988 begins, many Alaskans face difficult economic circumstances, and there is a growing sense of urgency and frustration.

“We’ve been saving money for a rainy day,” many say. “Can’t they see it’s raining out there?”

“This recession is not a dip, it’s an abyss,” said an Anchorage property owner and builder. Many of his colleagues have filed bankruptcy, walked away from years of investments, and left Alaska. State and federal regulators have either closed or merged eight financial institutions. Thousands of residents have lost their homes and businesses.

Economists who look beyond the immediate crisis to the long-term economic health of the state express grave concern that North Slope oil production will begin a steady decline within 24 months.

It is against this backdrop that the Board of Directors of Commonwealth North commissioned a committee to study the Permanent Fund and how best its earnings might be utilized to help Alaskans, both in the short-term and in the long-term.

The Committee met weekly for three months. It heard presentations from policy makers and reviewed materials provided by the Permanent Fund staff and other sources.

After weeks of debate, the Committee determined that, in addition to dividends, the earnings have the capacity to play a major positive role in the Alaska economy. The members then prepared the following report.

RECOMMENDATIONS

Recommendation One:

Permanent Fund earnings should be used as a positive, counter-cyclical force in the Alaska economy.

Recommendation Two:

When economic indicators dip dramatically, Permanent Fund earnings should be appropriated directly to municipalities on a per-capita basis. When indicators climb, those earnings should be used to help “inflation proof” the Fund.

Recommendation Three:

The Alaska Legislature should create an Alaska Development Board, empowered to research and recommend to the Legislature major revenue-generating, in-state investments which further expand and diversify the Alaska economy.

Recommendation Four:

Using a portion of the \$516 million in the Permanent Fund’s Earnings Reserve Account, the Legislature should establish an Alaska Development Fund.

Recommendation Five:

The Permanent Fund dividend program is beneficial and should be continued; however, there should be a limit on the size of the dividends.

Recommendation Six:

Use of Permanent Fund earnings to “inflation-proof” the Fund should be encouraged in times of economic growth, but, in depressed economic times, a routine annual appropriation for this purpose should not occur automatically.

Recommendation Seven:

Permanent Fund earnings should be used for state government operations only in dire emergencies.

Recommendation Eight:

Strategies for using Permanent Fund earnings, including those in this report, should be written in statute, not incorporated into the state Constitution at this time.

RECOMMENDATION ONE:

Permanent Fund earnings should be used as a positive, counter-cyclical force in the Alaska economy.

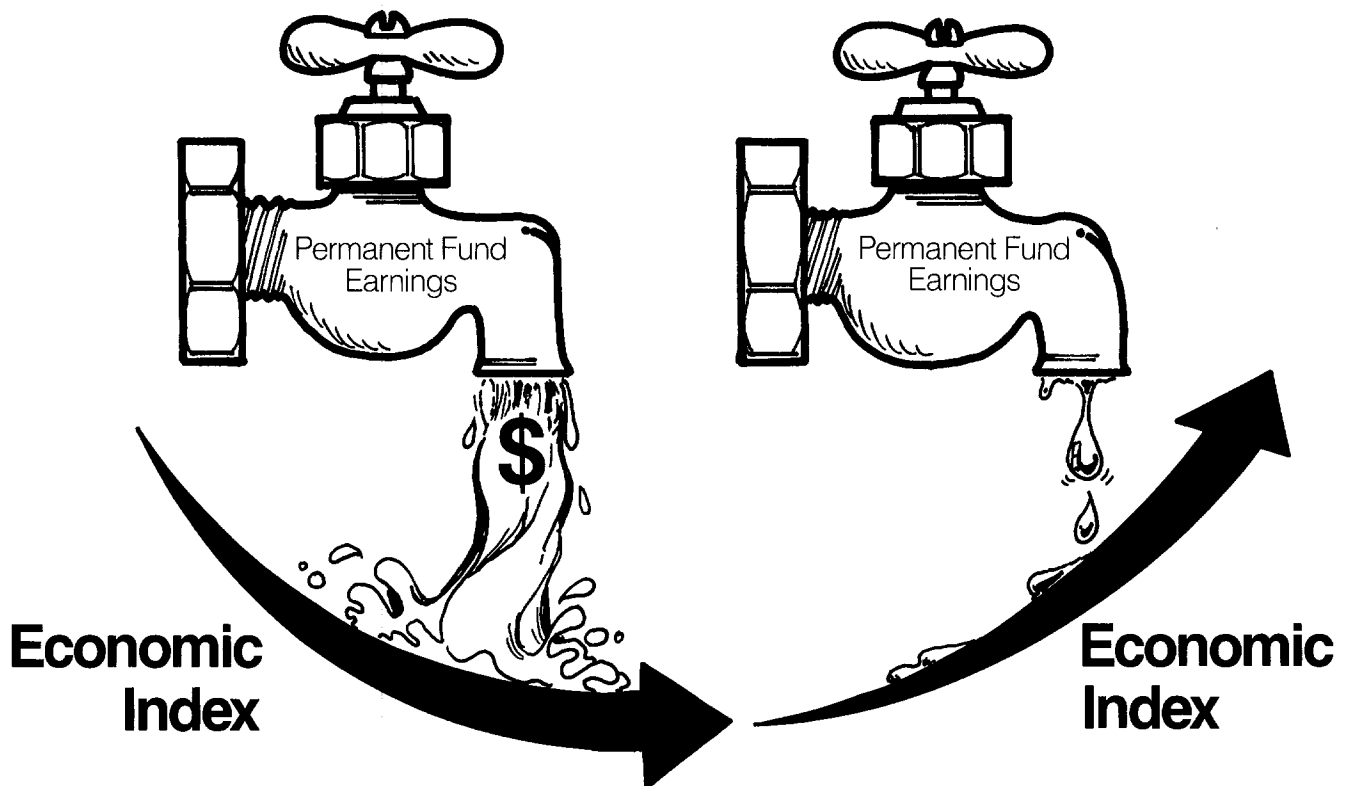
Earnings from the Permanent Fund can and should help level the peaks and valleys of Alaska's traditional boom and bust economic cycles. Appropriations of the earnings should be an important aspect of the state's overall fiscal policies, with additional money injected into the economy during hard times and money withdrawn from the economy during times of rapid growth.

At the national level the Federal Reserve Board has achieved success in controlling inflation and in combatting recession. The Board makes its decisions based on a number of leading and trailing economic indicators. The instruments it uses in pursuing its objectives are monetary in nature, i.e., interest rates and other mechanisms which affect the quantity of money in circulation.

Although Alaska has no comparable monetary tools, Alaska's Permanent Fund earnings could play an equally important and significant role through fiscal (appropriation) policy. This approach should and can be handled carefully so that the earnings are used wisely and distributed fairly throughout the state.

Establishing an economic "spigot"

To begin with, the Legislature should establish a broad-based economic index, written in law, which will determine when Permanent Fund earnings should be injected into the economy and when they should be withdrawn.



This index should include available Alaska economic indicators such as

- Consumer spending
- Savings and investments
- Public and private sector employment
- Wage and salary rates
- Housing starts
- Retail and wholesale sales
- Value of contract construction
- Personal income
- Gross state product
- State revenues

This index will enable the Alaska Legislature and the Governor to determine objectively the performance of the economy and its outlook and become the basis for formulating the state's fiscal policy.

If the index begins to drop, the administrative department, legislative committee, or board of advisors the Legislature designates would recommend appropriation of a portion of the earnings. If the index rises, such spending would be reduced or terminated and the earnings retained instead. In this way, the Permanent Fund would operate as a counter-cyclical force designed to minimize the volatility of economic contractions and expansions.

RECOMMENDATION TWO:

When economic indicators dip dramatically, Permanent Fund earnings should be appropriated directly to municipalities on a per-capita basis. When indicators climb, those earnings should be used to help "inflation-proof" the Fund.

Because of the unique nature of the Permanent Fund, drawn from one-time resource revenues and held in trust for all, it is recommended that the flow of money from the earnings (apart from the dividends) be directed to local governments on a consistent per-capita basis. In this way each local entity can make its own judgments as to what its citizens most need, whether jobs, street repair, tax relief, etc. This dispersion will strengthen local decision-making authority and responsibility.

In the unorganized borough, service areas or regional education districts should be the recipients of these funds so that the per-capita disbursement reaches all Alaskans.

The Legislature may wish to establish certain parameters for local governments to use in order to ensure that this special distribution of the Permanent Fund earnings is spent in the most economically beneficial manner. For example, services obtained with these funds should be contracted out to private firms wherever possible. This approach will support the private sector while permitting more rapid expansion and reduction of services without enlarging local bureaucracies.

Use of an impersonal barometer such as the index suggested above and a per-capita formula will help to negate the regional and personal politics which too often dominate the legislative spending process.

RECOMMENDATION THREE:

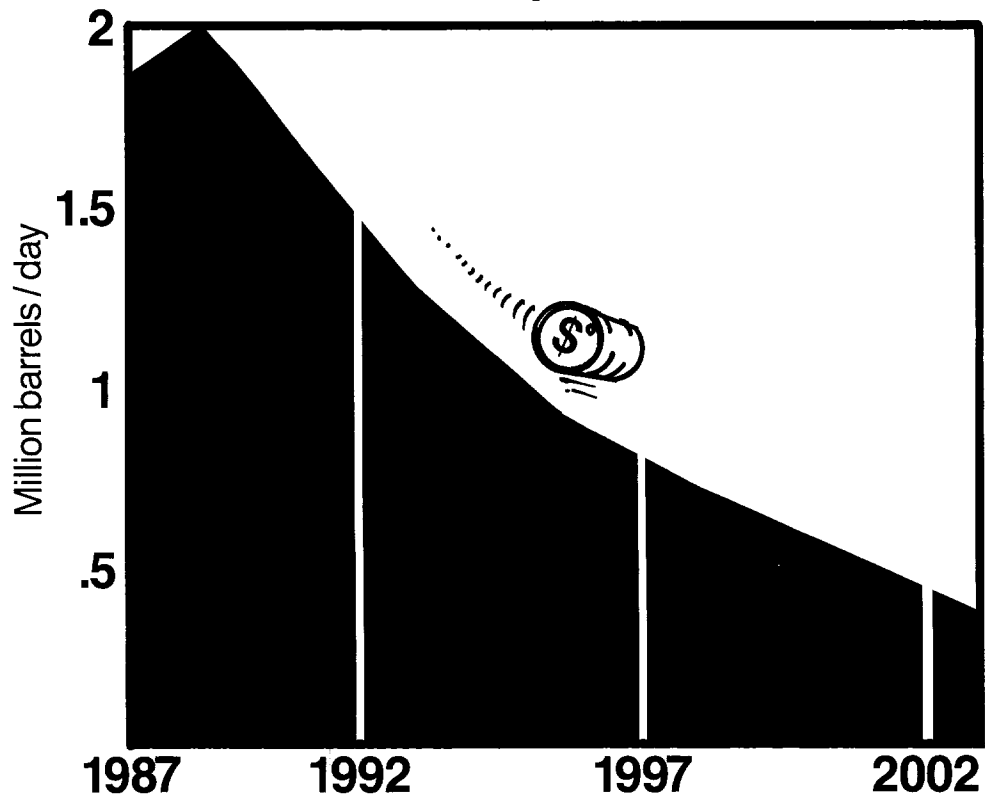
The Alaska Legislature should create an Alaska Development Board, empowered to research and recommend to the Legislature major revenue-generating, in-state investments which further expand and diversify the Alaska economy.

As mentioned earlier, Prudhoe Bay production will begin a rapid decline within the next 24 months. According to the Alaska Division of Oil and Gas, that decline will reduce the trans-Alaska pipeline throughput from today's 2 million barrels a day to 500,000 a day by the year 2002.

In other words, in just 14 years, production from the resource development activity which now accounts for 82% of state revenue will be just one-quarter of what it is today.

Unless other major sources of revenue are developed, Alaska has a calamity in the making. No other Alaska resource comes close to the potential of North Slope oil for generating revenues. In FY 82 these revenues peaked at \$4.1 billion, but by FY 87 they had dropped to \$1.7 billion. If oil prices stay in the \$16-\$18 range, Prudhoe Bay revenues in 2002 will be just \$425 million (in nominal dollars).

**Estimated Production of
Alaska North Slope Crude Oil**



Statistics: Alaska Department of Natural Resources

The Alaska Development Board

The crying need, the missing element in Alaska's overall state spending and investment strategy, is an aggressive program to diversify the economy and replenish the sources of jobs and revenues now provided on the North Slope.

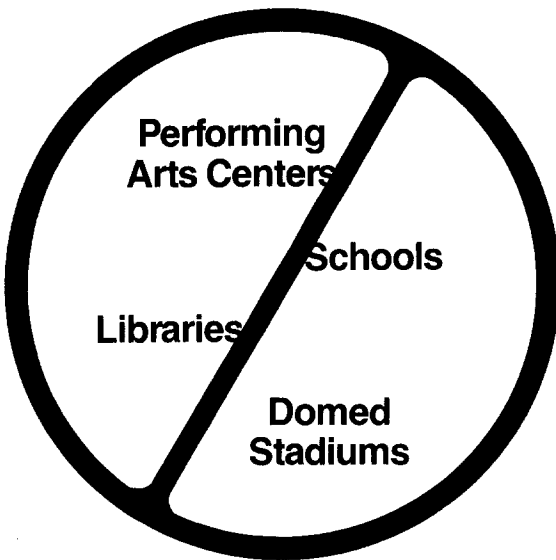
To begin to accomplish this end in a thoughtful but activist manner, the Legislature should create an Alaska Development Board similar in structure to the Permanent Fund board of trustees. The task of this new board would be to research, study feasibility, and recommend to the Legislature and the Governor major revenue-generating, in-state capital investments which can help diversify the economy into the next century.

Projects that would qualify would have to have an assured source of repayment; i. e., they must have the capacity to generate substantial revenues through tariffs, rents, and user fees. Examples include docks, railways, causeways, electrical generation units, water systems, and wastewater plants.

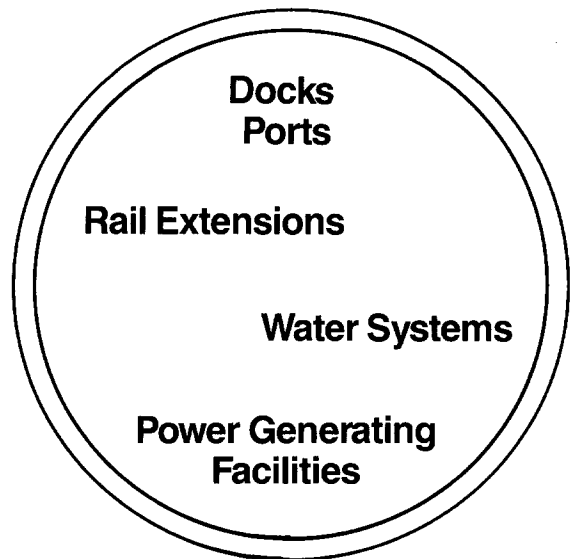
The infrastructure needed to attract one or more U.S. Navy vessels to homeport in Alaska is an excellent example. The Navy traditionally rents such facilities over a many year period.

Only revenue-generating projects would be considered.

It is vital that a distinction be drawn between capital projects, such as quality-of-life facilities (of which Anchorage's Project 80's is a prime example) and the kinds of revenue-generating projects that can pay their own operating and maintenance costs and return the original start-up investments to the state. It is only the latter which would be considered by the Alaska Development Board.

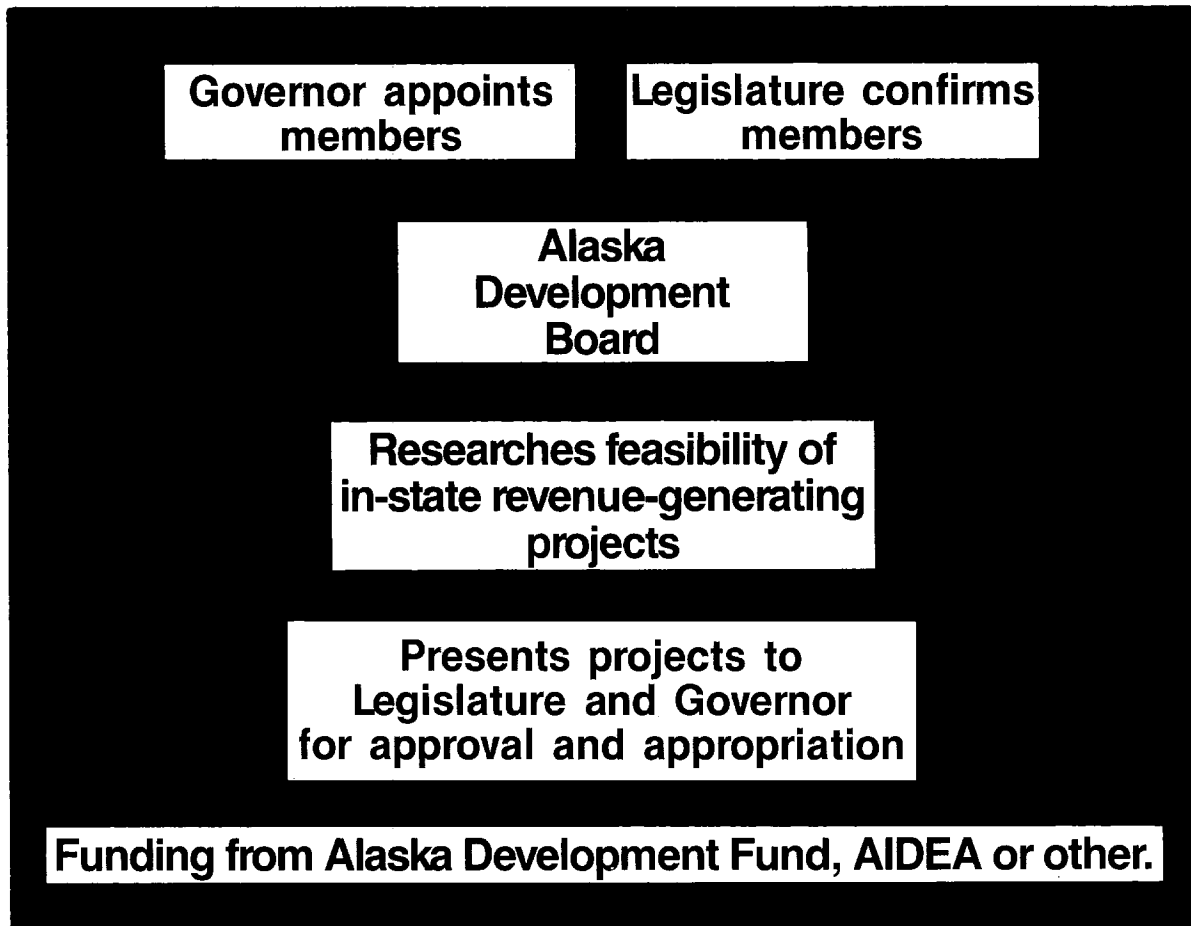


Capital projects which require on-going taxes or revenues to operate.



Revenue-generating projects which pay back investments and cover own O/M costs.

The Alaska Development Board



Membership of the Board

The members of the Board should be appointed by the Governor and approved by the Legislature. They should be given an arm's length relationship and a mandate to take a statewide viewpoint, just as the Permanent Fund Trustees divorce themselves from the special interest entanglements of the political process. Individuals must be named to this board on the basis of professional qualifications, emphasizing experience in designing, financing, guiding, and operating major projects of the magnitude which can strengthen Alaska's economic future.

RECOMMENDATION FOUR:

Using a portion of the \$516 million in the Permanent Fund's Earnings Reserve Account, the Legislature should establish an Alaska Development Fund.

Funding for the projects recommended by the Development Board and approved by the Legislature can be derived from several sources, including revenue bonds through the Alaska Industrial Development and Export Authority (AIDEA). This approach was used to finance the construction of the road to the vast Red Dog lead and zinc reserve northeast of Kotzebue.

In addition, the Legislature should set aside a one-time deposit of a portion of the undistributed earnings from the Fund. This large pool of dollars, known as the Earnings Reserve Account, currently contains \$516 million. Another possible source to establish an Alaska Development Fund is the windfall monies from oil litigation such as the Dinkum-Sands settlement (\$329 million). The reserves in the Alaska Development Fund would be saved and invested by the Permanent Fund Trustees until they are appropriated by the Legislature to facilitate projects recommended by the Development Board.

The Legislature has the final say.

It is important to emphasize that the Alaska Development Board would not have the power to allocate monies from the Alaska Development Fund. That prerogative would remain with the Legislature (with the concurrence of the Governor) which is charged by the Constitution with the task of appropriating funds.

RECOMMENDATION FIVE:

The Permanent Fund dividend program is beneficial and should be continued; however there should be a limit on the size of the dividends.

One of the very positive benefits of the Permanent Fund dividend has been the link it has created between the citizens of the state and the government. Just as personal income taxes in other states keep citizens alert to the spending decisions of their elected representatives, so the Permanent Fund dividend program has made Alaskans sensitive and attuned to how resource revenues are used.

Since the program's inception, a total of \$1.48 billion has been distributed and the benefits to the state's economy are recognized by nearly all Alaskans. The size of the dividend distribution, however, should be capped at an amount such as 40% of the annual earnings, as recommended last year by the State Senate, or at \$1,000 per person per annum.

RECOMMENDATION SIX:

Use of Permanent Fund earnings to “inflation-proof” the Fund should be encouraged in times of economic growth but, in depressed economic times, a routine annual appropriation for this purpose should not occur automatically.

A portion of the Permanent Fund’s earnings has been used annually to strengthen the Fund and help it to grow and combat inflation.

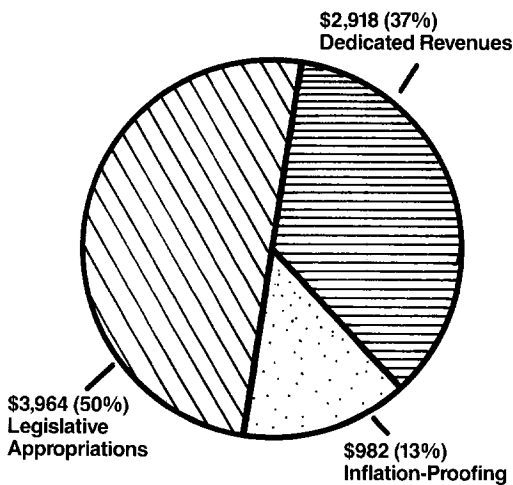
The Legislature has also demonstrated fiscal wisdom by appropriating large additional sums to the principal of the Permanent Fund during years of affluence. In fact, an impressive \$3.964 billion of the Fund resulted from such actions. This policy has been a wise one, especially in times of great wealth.

But “inflation-proofing” in a seriously depressed economy does not fulfill the original intent of the Fund which was to benefit all generations of Alaskans, including those currently trying to survive and make ends meet. In times of a shrinking economy, “inflation-proofing,” if continued apace, will choke out all other uses of the earnings when, instead, a portion of those earnings should be injected into the economy through Alaska’s communities as recommended herein.

And, as suggested in Recommendation One, it should be written into law that, in times of growth and expansion in the state’s economy, the Fund should be strengthened by the Legislature through redeposit of the earnings.

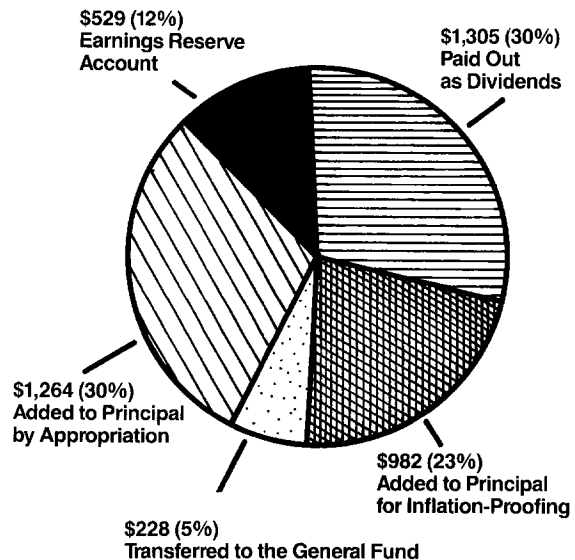
SOURCE OF PERMANENT FUND

Contributions to Principal Since Inception
Total at June 30, 1987: \$7.86 Billion
(in millions)



USE OF EARNINGS

Distribution of Earnings 1978 – 1987
Total Net Earnings: \$4.3 Billion
(in millions)



Such action will help combat the erosion of the Fund due to inflation, avoid overheating of the economy and at the same time reduce public spending.

But the Legislature should not make annual anti-inflation appropriations regardless of the real world circumstances being faced by Alaska's citizens.

RECOMMENDATION SEVEN:

Permanent Fund earnings should be used for state government operations only in dire emergencies.

Alaskans are keenly aware that state government grew rapidly at the advent of Alaska's oil wealth, far outdistancing all other states as to number of employees per capita, wage levels and benefits.

The waste in state government must be dealt with and the excesses curbed.* None of the earnings from the Permanent Fund should be allocated to state government operations in the foreseeable future, absent a major calamity or emergency.

To date, the earnings have been almost entirely used for inflation-proofing the Fund or dividends distributed equally to all Alaska residents. The recommendation in this paper that earnings be used as a counter-cyclical force in the economy calls for a per-capita distribution, maintaining the philosophy that this Fund is held in trust by all residents of the state and therefore any distribution should be made on an equal basis.

It should be remembered that approximately 85% of all royalties and revenues derived from North Slope oil activities are funneled directly into the General Fund out of which the Legislature appropriates monies for government operations. It is the firm conviction of this committee that earnings from the remaining 15% set aside in the Permanent Fund should be added to the General Fund only in case of a major calamity or emergency.

* Note: For strategies to reduce state government spending without precipitating a "crash landing", see the December 1986 Commonwealth North report, *Alaska's Budget Crisis, Facing the Facts — Closing the Gaps*.

RECOMMENDATION EIGHT:

Strategies for using Permanent Fund earnings, including those in this report, should be written in statute, not incorporated into the state Constitution at this time.

Public policies for using Permanent Fund earnings should be written in statute and thus remain flexible so that the Governor and the Legislature can respond to changing circumstances. World oil prices, the main determinant in state revenues, are too volatile to incorporate spending policies into the Constitution.

A number of fixed formulas were reviewed and studied carefully, including the 40-30-30 amendment proposed by the State Senate last session. All of them contain a number of excellent concepts. They should not, however, be incorporated in the Constitution.

Likewise, Commonwealth North's 1982 recommendation to create a Capital Investment Fund through a Constitutional amendment should be replaced by the approach outlined in this report.

If the recommendations in this report are adopted by the Legislature and function successfully, then there will be no need to lock them into the Constitution. Public support will keep them intact. If they are poorly managed, or fail to be successful for other reasons, they can and should be changed by a future Legislature without having to go through the Constitutional amendment process.

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As well as providing a forum for national and international speakers, working committees study critical issues facing the state and the nation and prepare well-researched action papers, such as this one.

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