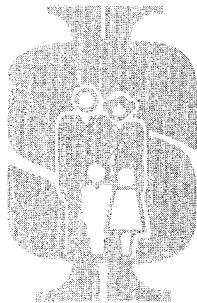


ACTION PAPER

**RESOURCE
REVENUES
AND
STATE SPENDING
ALASKA'S
GOLDEN
OPPORTUNITY**



ALASKA'S GOLDEN OPPORTUNITY

RESOURCE REVENUES AND STATE SPENDING

A REPORT BY
COMMONWEALTH NORTH

Prepared by the Resource Income Committee

December 1980

ALASKA'S GOLDEN OPPORTUNITY

A Commonwealth North Report

First printing....December 1980

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Anchorage, AK 99501

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THE COMMONWEALTH NORTH RESOURCE INCOME COMMITTEE

On October 16, 1979, the Board of Directors of Commonwealth North established the Resource Income Committee to study how best to husband and use the state's projected revenues. Bill Sheffield, President of Sheffield Hotels, was named chairman of a team of fifteen including two former Commissioners of Revenue, two former state legislators and the ex-Director of the Office of Management and Budget of the Anchorage Municipality.

For many months the committee met weekly, heard from key legislators, members of the state administration and representatives of the private sector.

In February 1980, five of the committee testified on the Permanent Fund legislation before the legislature. In March, nearly all of the committee travelled to Juneau to meet with members of both the Senate and House Finance Committees.

In April, as the legislature was finalizing its income tax repeal bill, telegrams were sent to the Governor and every legislator calling for outright tax repeal.

After studying the laws passed by the 1980 legislature as well as the state budget for Fiscal Year 1981, the committee spent weeks hammering out the recommendations included in this report.

Those interviewed by the committee included Governor Jay Hammond, Revenue Commissioner Tom Williams, Senate Finance Chairman John Sackett, Senators George Hohman, Bob Mulcahy, Bill Sumner and Ed Dankworth; House Finance Chairman Russ Meekins, and Representatives Oral Freeman, Ernie Haugen and Hugh Malone; Chairman of the Trustees of the Permanent Fund Elmer Rasmuson and Dean Olsen, trustee of the Alaska Renewable Resources Corporation.

This "Action Paper" includes an examination of a wide range of issues. The result is an analysis of the best ways to invest Alaska's resource revenues for the long-term benefit of the state.

The members of the committee are as follows:

William Sheffield, Chairman
Sheffield Hotels

Robert E. Baer
Totem Realty, Inc.

Bertram B. Beneville
Merrill Lynch Pierce
Fenner & Smith

Edith Bullock
Retired Businesswoman
Former Legislator

David Chatfield
Alaska USA Federal
Credit Union

Harry Donahue
Independent Consultant
Former Director Office of
Management and Budget
Municipality of Anchorage

David Heatwole
Anaconda Copper Company

Max Hodel
Alaska Sales and Service

John Mlakar
Denali Fuel Company

Ron L. Rettig
Alaska Mutual Savings Bank
Former State Senator and
Alaska Commissioner of
Revenue

William Scott
Peat Marwick Mitchell

Judge James Singleton
Appellate Court, State of
Alaska

Paul Wilcox
Paul S. Wilcox Law Firm
Former IBEW Legal Counsel

Renee Murray
Scott Wetzel Services, Inc.

Eric Wohlforth
Wohlforth & Flint
Former Alaska Commissioner
of Revenue

FOREWORD

TRANSCENDING A COLONIAL ECONOMY

Historically, Alaska has always been capital short. Poverty in rural areas sometimes is more bitter than in the villages of India. Sewer, water, electricity and transportation systems are frequently either non-existent or primitive. Our cost of living is the highest in the nation.

Ironically, the most northern state in the union has more in common with the "southern" undeveloped nations of the Third World than it does with the contiguous 48 states. Like the developing nations, Alaska's economy is essentially colonial, characterized by a dual dependence on government expenditure and the export of resources largely in their natural state.

We recommend therefore that our resource revenues be used primarily in a coordinated effort to transcend our colonial economy and hasten the day when Alaska can join its more fortunate sister states in the benefits which a broad-based market economy brings.

To realize this goal, a basic infrastructure must be built. Now, for the first time, with Alaska's resource income, this economic backbone can be put in place. The components should include hydro power projects, a transportation system to reach our people and our natural resources, and ports and harbors to better respond to the opportunities available through international trade and Alaska's resource rich coastal shelf.

While each of the individual recommendations which follow can be defended on its own, they should not be viewed in isolation. Rather they should be seen as component parts of a program of progressive development to a mature and integrated private economy.

CONCLUSIONS

The following points summarize the conclusions of this study:

1. Alaska must free itself from its traditional "colonial economy", an economy characterized by its dependence on the federal government and the export of unprocessed natural resources.
2. Resource revenues must be used skillfully to enhance an integrated market economy sustained by private investment, a healthy local industry and worldwide commerce.
3. To avert a false sense of unlimited wealth, the state should immediately develop and publicize a series of projections illustrating anticipated growth in both state revenues and expenditures.
4. A five- to six-year Capital Improvement Plan, updated on an annual basis, is an urgent priority. This plan will contribute to a more coherent use of state revenues and assist legislative judgement as to annual contributions to the Permanent Fund.
5. In order to strengthen Alaska's private sector, tax burdens must be reduced.
6. Further tax reductions will not only help individual Alaskans but should reduce the size of the bureaucracy and the cost of government.

7. Alaska corporations should be exempted from income taxes on the first \$250,000 of taxable income. This action will help over 90 percent of Alaska's businesses.
8. Municipal taxes, such as sales taxes and real property taxes, should be replaced with state revenue but only if such action is coupled with a lid on local government spending.
9. Corporate income tax and business property tax relief will help the consumer. This action will result in better services, stabilized prices, more employment, and improved facilities for all Alaskans.
10. Transportation fuel taxes for highway, marine and air travel will cost Alaskans an estimated \$28,000,000 in fiscal year 1982. These state taxes are not needed and should be repealed.
11. If the tax repeals recommended above are implemented, some \$278 million will remain with the people each year instead of going to government. Although this will help the people immensely, this sum amounts to less than 4 percent of the projected revenues for FY '82.
12. Companies doing business in Alaska should be encouraged to reinvest their profits in the state. Investment tax credits should be established for this purpose.
13. The windfall profit tax paid by the oil companies should be permitted as an allowable deduction in determining state income taxes to eliminate double taxation.

14. The growth of state and local government operating budgets should be limited by law or by constitutional amendment. The best formula ties government expenditures to the annual fluctuation in personal income of the non-governmental work force.
15. Permanent Fund monies should be invested so that the income from and the value of these dollars keeps pace with inflation. The current Permanent Fund legislation should be amended to allow investments in appreciable assets.
16. In order to finance large, self-liquidating projects, such as ports, harbors, and hydroelectric facilities, an Alaska Investment Fund should be established, along the same lines as the Permanent Fund.
17. Projects built with this Investment Fund will provide the infrastructure needed to move Alaska away from its economic dependence on the rest of the nation. They can be used as collateral for revenue bonds if the state finds itself short of cash in the future.
18. The state government should not jump into the banking business. Loan programs are best administered by existing private lending institutions.
19. State loan programs must be divorced from the temptations of political abuse. Strict accountability through independent audit systems must be established.

SECTION I

THE SIZE OF THE SURPLUS

In order to make wise decisions on the best use of Alaska's revenues, it is imperative that accurate projections are made regarding the state's potential income and predicted expenditures.

According to a November 5, 1980 memorandum by the staff of the legislature's Budget and Audit Committee, there will be \$5,927,600,000 available for appropriation by the legislature for FY '82.

General Fund surplus predictions for the year 2000 range as high as \$184 billion. But the actual surplus (or deficit) will depend on the level of inflation and state spending as well as on the investment policies of the state and the market price of oil and gas.

The state should immediately develop a series of projections illustrating anticipated growth in both government revenues and expenses. These projections should be widely publicized in simple, understandable form.

A false sense of unlimited wealth could badly distort the judgement of the Alaskan people.

Recommendation for Action

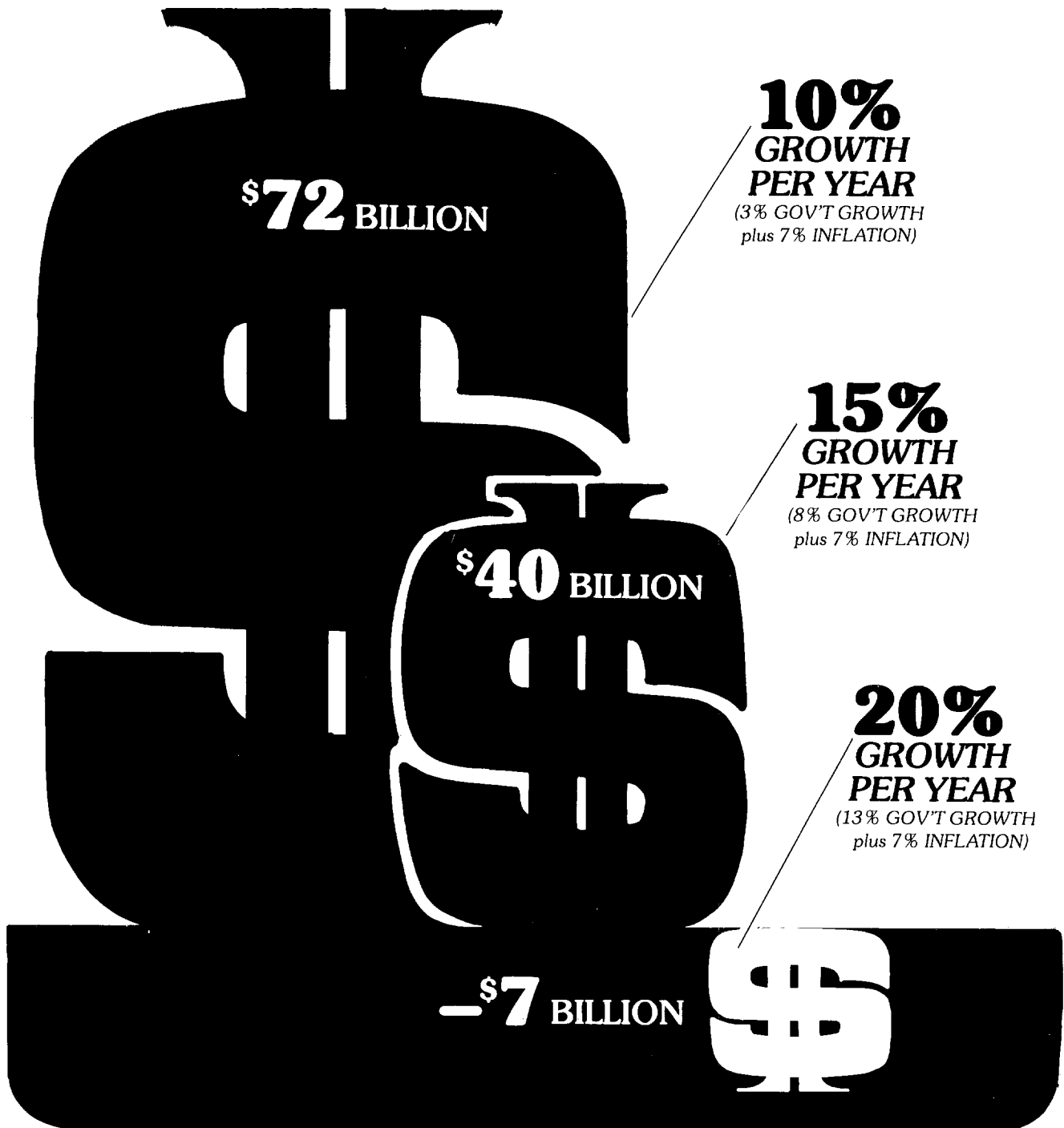
The state should immediately develop a series of projections illustrating anticipated growth in both government revenues and expenses.

Such information is necessary to avert a false sense of unlimited wealth which could badly distort the judgement of the Alaskan people and their leadership and to provide some touchstones for gauging the effect of state spending decisions.

Figure A

1995

Shrinkage of the size of the projected General Fund by 1995 if government growth is not contained.



COMMONWEALTH NORTH CHART

DATA SOURCE: State of Alaska Legislative Working Document Budget Forecasting Model February 20, 1980

Figure A illustrates the devastating impact inflation and government spending could have on Alaska's optimistic revenue projections. The most extreme case charted in the 1980 Legislative Budget Forecast Model was 13 percent real budget growth plus 7 percent inflation, for a total of 20 percent. That rate would place the General Fund \$7 billion in arrears by 1995.

The growth of the operating budget this year alone was 23.9%.

This gloomy prediction based on 20 percent growth, is not unreasonable. The growth in the operating budget alone this year was 23.9 percent.* Capital expenditures jumped 306 percent.

Future income can be projected by several methods advanced by the Department of Revenue and the Budget and Audit Committee. Operating budgets can also be estimated, especially if spending growth is limited by state statute. But, in addition, the state must develop projections for capital improvement budgets. Unless this is done, it will be impossible to manage the state's revenues with a realistic, business-like approach.

Next year, for example, the Governor and the legislature will have about \$5.9 billion of revenue to work with. If \$1.8 billion is placed in the Permanent Fund, as recommended by Representative Oral Freeman, and if the operating budget is in the vicinity of \$2 billion, what will be done with the remaining \$2.1 billion?

*According to the General Operating Budget, expenditures went up 20.7 percent. But when the category "New Legislation" is reviewed, at least \$42 million additional operating expenses can be identified, bringing the total increase to 23.92 percent.

To begin with, the top priority should be large scale capital improvements to upgrade the basic infrastructure of the state.

To implement this, a five- to six-year state Capital Improvement Plan should be prepared and updated on an annual basis. This plan should include municipal improvements that are to be funded, in whole or in part, by state revenues.

When combined with a controlled level of growth in the operating budget, the Capital Improvement Plan will contribute to better-informed decisions regarding the size of contributions to state loan programs and the Permanent Fund.

Recommendation for Action

A five-to six-year state Capital Improvement Plan should be prepared and updated on an annual basis.

Budgets often balloon beyond expectations because maintenance and operating costs are ignored.

Primary consideration should be given to those statewide capital improvements which are the components of the infrastructure necessary to support a multi-faceted economy. Ten and twenty year projections should also be made, similarly updated on an annual basis.

It is imperative that the Capital Improvement Plan include the cost of maintenance and operations of new facilities. Too often future operating budgets balloon beyond expectation because these inevitable on-going costs are ignored.

SECTION II

TAX POLICY

There is no better, clearer or faster way to nurture a market economy than to eliminate personal and corporate taxes. No other single action bears more promise for creating a sustainable broadbased economy to complement the extractive industries. If Alaska is truly dedicated to developing a diversified economy, tax relief is the most direct and expeditious route to take.

**There is no better way to
nurture a market economy
than to eliminate taxes.**

A. PERSONAL INCOME TAX REPEAL

As a result of the action of the September 1980 special legislative session, income tax repeal will enable the people of Alaska to channel additional disposable income into the economy and savings into investments. It is encouraging to consider what will happen when the thought and energy of the current generation of Alaskans are released in this manner.

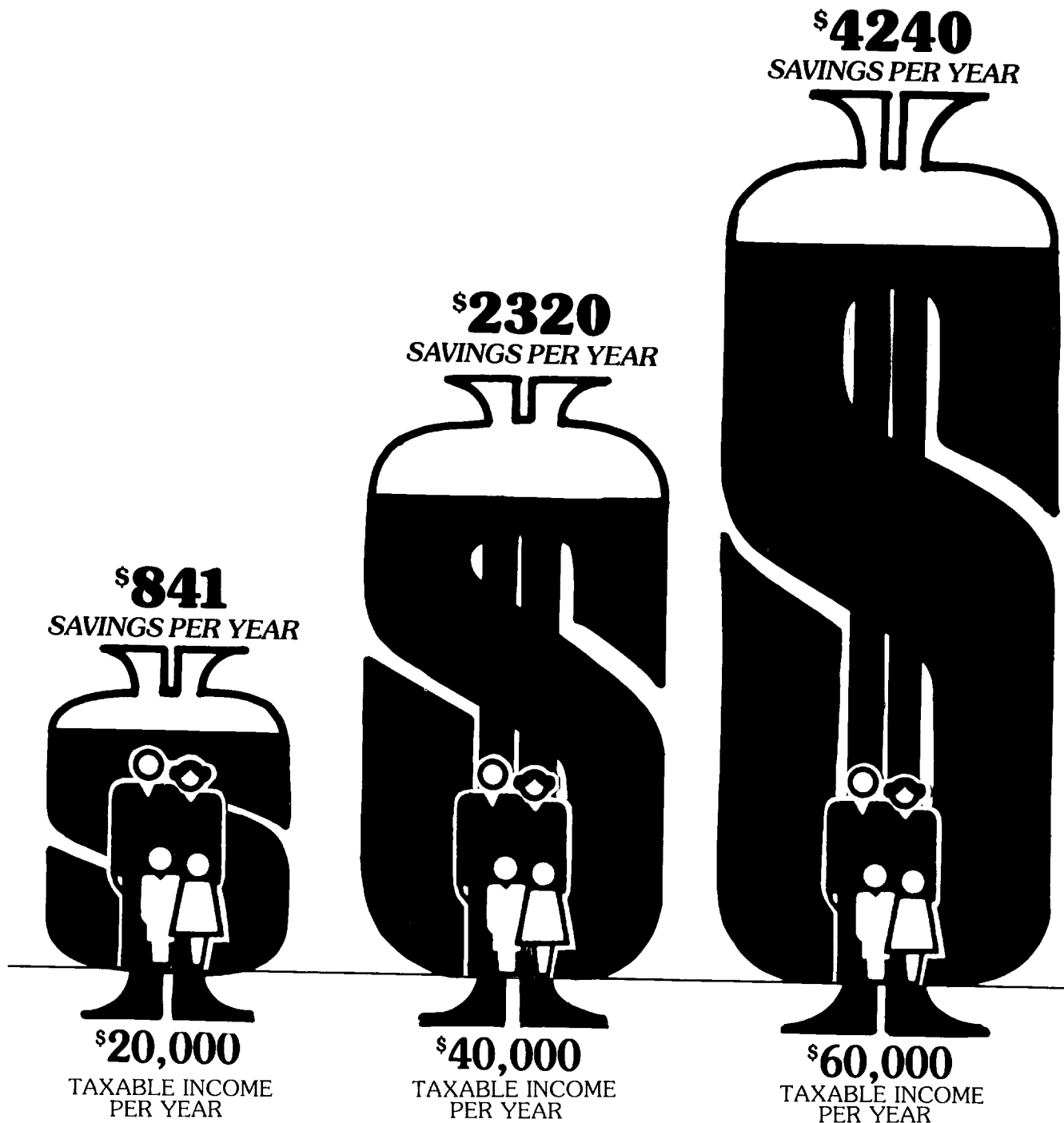
Figure B illustrates the amount of savings personal income tax repeal will accrue to typical Alaskan families before federal income tax.

As the take-home pay of Alaskans increases, additional taxes must be paid to the federal government. But in all cases, real income will increase.

The debate over tax relief in Alaska has raised numerous questions. Some have feared that the repeal of income taxes will create a backlash in the federal government and make it tougher for Alaska to participate in federal programs. In reality, the federal government has no legal basis to discriminate against Alaska; nine other states have no state income taxes.

Figure B

The Advantages of State Income Tax Repeal for Typical Alaska Families



COMMONWEALTH NORTH GRAPH

DATA SOURCE: Based on Alaska state tax tables, for married taxpayers filing jointly who do not itemize.

Others believe we will lose interest in government if we don't pay taxes, but there is no empirical data to support this proposition. It portrays a misconception of where sovereignty lies and a lack of appreciation for the high level of concern and involvement typical of the Alaskan people.

The most efficient way for government to handle money is not to take it from the people in the first place.

Some others wonder if there are better ways to help people receive the benefits of resource revenues. But the most efficient way for government to handle money is not to take it from the people in the first place. Tax repeal not only helps the individual but also reduces the size of the bureaucracy and the cost of government.

B. CORPORATE INCOME TAXES

Last year, non-petroleum businesses in Alaska paid less than \$18,000,000 in corporate income taxes. This sum is not large when measured against the state's revenues, projected to be nearly \$6 billion next year.

For those in the legislature who are sincere about assisting Alaska's business community in a time of recession, reduction or elimination of this tax should be a top priority.

Recommendation for Action

All Alaska businesses should be exempted from state income taxes on the first \$250,000 of taxable income.

A wise formula is to exempt all corporations from income taxes on the first \$250,000 of taxable income. Such an act would virtually eliminate taxes for over ninety percent of all Alaskan businesses, which in time will benefit all Alaskans.

Business tax relief will help stabilize prices in a time of inflation, and increase both employment and inventories. Consumers will benefit through improved services, as businesses become more efficient, hire more people and upgrade their facilities.

C. PROPERTY AND OTHER LOCAL TAX RELIEF

The burden of local property taxes, which hits hard at Alaskans of every income level, must also be lifted. The state would need to reimburse local governments approximately \$100 million annually to replace property taxes, and the positive effect of using surplus funds in this manner would be enormous.

This action must be taken only if it is done concomitantly with the establishment of a lid on local government spending. (See Section III)

The mechanism for property tax relief already exists in the legislation which forgives Alaskans over the age of 65 from paying taxes on their homes. The municipalities compute the projected property taxes and then are reimbursed by the state for these revenues.

Recommendation for Action

Both residential and business property taxes should be eliminated, if coupled with a lid on local government spending.

A number of legislative candidates running for election in the fall of 1980 endorsed property tax repeal, but in general they referred only to residential, not business, property taxes.

Both types of property taxes should be eliminated. To illustrate, the total for the greater Anchorage area predicted by the Municipal staff for 1981 comes to \$59,311,560. Roughly 60 percent of that amount is from residential property and 40 percent from business.

The statewide total is less than double the Anchorage amount.

As presently levied, property taxes are required of all businesses whether they make a profit or not. Business property tax relief, therefore, may be the key to whether a small business survives or goes under.

Visitors sometimes criticize the appearance of some of Alaska's towns and villages. They don't understand that the high cost of doing business here, the narrow margin of profit, and the high percentage of business failures have left little room for maintenance costs and visual appeal.

Many of these problems can be solved if more earnings are left with the people instead of being taken by government.

In June 1978, California's Proposition 13 amended the state constitution, rolling back property taxes and indirectly putting a lid on spending by local governments.

Immediately after the election, predictions of a disastrous aftermath poured forth from Proposition 13's opponents.

An analysis a year later by the U. S. Department of Commerce disclosed a wholly different picture. Although 100,000 jobs in the public sector were eliminated, only 17,000 public employees had to be laid off. The remaining positions were vacated by attrition or retirement. The

In Alaska, property tax relief will especially help the long-term resident who plans to stay in the state.

attrition was accelerated because thousands of public employees switched to attractive new jobs which opened up in the private sector as a result of the injection of private capital made possible by Proposition 13.

The statewide unemployment rate was reduced by a full percentage point, as over a half million new jobs were created in the private sector. Yet, the consumer price index for the state increased only eight percent, a lower rate than the national average.

In Alaska, residential property tax relief would especially help permanent residents, those who own homes and plan to remain in the state.

Figure C shows how much monthly house payments can be reduced on homes of differing values, using the maximum Anchorage mill levy of 12.06.

Reduced monthly house payments will help the young qualify for home loans.

Reduced payments, such as above, will help people (especially the young) to qualify for home loans. Normally, a home buyer is expected to earn four times the estimated monthly house payment. In the case of the \$80,000 home, for example, an Alaskan could qualify with almost \$3,900 less annual salary than currently required.

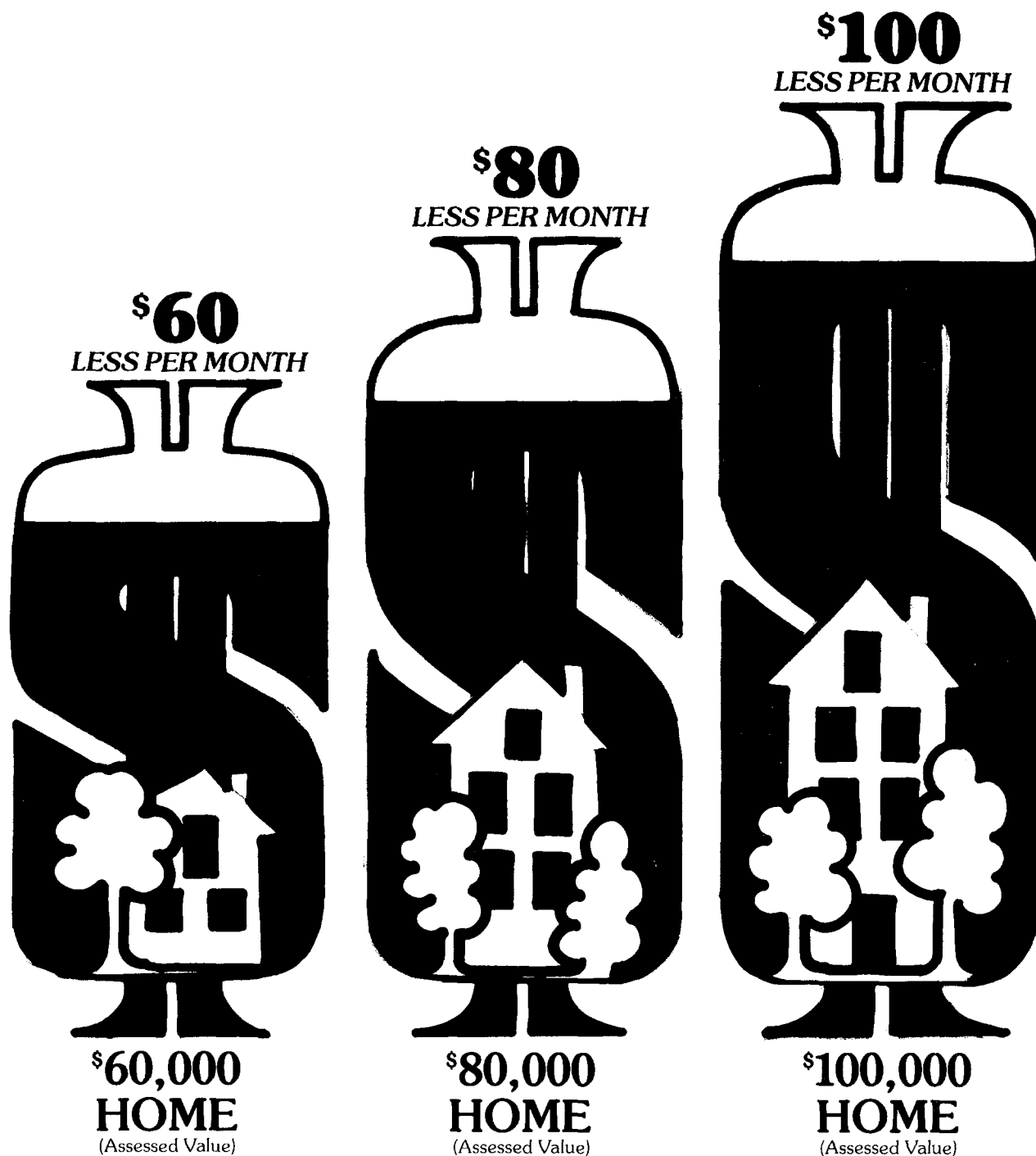
The same rebate system used for property taxes should be applied equitably to those communities using sales taxes. The formula is not complicated and can be used in every Alaskan community currently taxing its citizens for local services.

D. TRANSPORTATION FUEL TAXES

Of the remaining state sales and use taxes, fuel taxes for transportation should be repealed as an obvious

Figure C

The Impact of Repeal of Property Taxes on Monthly House Payments



COMMONWEALTH NORTH GRAPH
DATA SOURCE: Based on 12.06 mil rate.

assistance to consumers, commercial fishermen and business in general.

Estimated revenues for FY '82 include aviation fuel taxes of \$4,300,000, marine fuel taxes of \$3,300,000 and highway fuel taxes of \$20,200,000.

Recommendation for Action

State transportation fuel taxes should be repealed.

This kind of tax repeal is a direct way to lower the cost of living of the average citizen. A gallon of gas at the pump will be reduced as much as 8¢ a gallon.

E. WHAT WILL TAX REPEAL COST?

If the tax relief recommended above is implemented, some \$278,000,000 will remain with the people each year instead of going to government.

Repeal of personal income taxes	\$130,000,000*
Reduction of corporate income taxes	10,000,000
Repeal of municipal property taxes	100,000,000
Repeal of local sales tax	10,000,000
Repeal of transportation fuel taxes	<u>28,000,000</u>
TOTAL	\$278,000,000

*Enacted September 1980.

This money, though an enormous help to individual Alaskans, amounts to only 4 percent of the projected revenues for FY '82 (\$5,927,600,000).

F. INVESTMENT TAX CREDITS

Rather than total repeal of corporate income taxes, Alaska will receive greater benefit from encouraging businesses to reinvest their profits within the state.

Making the step forward to a "post-colonial" industrial base will require enormous amounts of capital investment by the private sector. Projects such as secondary or tertiary processing of petrochemicals require billions of dollars.

Reinvestment of corporate profits can be encouraged through tax credits. A formula should be established so that businesses which use their profits to set up new or improved facilities in the state are compensated through reduced taxes.

Recommendation for Action

Reinvestment of corporate profits within the state should be encouraged through tax credits.

This approach can be designed to encourage the diversification of the industrial community within the state leading to new sources of non-seasonal employment, the broadening of the economic base and a widening of the tax base itself.

G. OIL AND GAS TAXES

As tax reform is implemented by the legislature, a thorough review of the taxes levied on the petroleum industry is in order. The following is a list of the FY '82 revenue projected to be derived by the state from oil and gas production, according to the September 1980 estimates of the Alaska Department of Revenue:

1. Royalties (12.5 - 20% or more) to be paid for the right to produce oil and gas from leases on state lands:
\$2,354,900,000
2. Severance Taxes (12.25%) to be paid for the "severing" of the resource from the ground in the state:
\$1,753,300,000
3. Property Taxes to be paid on industry assets:
\$170,000,000
(Industry also pays over \$75,000,000 to municipalities on these assets as part of the 20 mils required by state law).
4. Income Taxes to be paid in accordance with the Oil and Gas Corporate Income Tax:
\$882,900,000

A vital issue of public policy concerns the encouragement of additional oil and gas development on state lands and, at the same time, ensuring that a fair share of the benefits go to the citizens of Alaska.

The state must provide an environment of stability in its tax policy and break away from its history of changing the rules of the game after private industry has invested heavily.

Recommendation for Action

The windfall profit tax paid by the oil industry should be an allowable deduction.

One immediate change involves the federal windfall profit tax. No provision in the Alaska tax statutes allows for a deduction for windfall profit tax paid. The legislature should rectify this blatant inequity of double taxation.

For FY '82 this action would reduce the \$883 million to be paid by the oil industry as state income tax to approximately \$485 million, and yet Alaska would still receive approximately \$4.5 billion in petroleum revenue compared with \$3.7 billion in FY '81.

Secondly, as a rule of thumb, corporate income taxation should be administered on a uniform, equitable basis.

Nationally, there is a growing awareness of the detrimental impact high taxes can have on the private sector and thereby, the general economy. Alaska has the opportunity to ease this impact by eliminating or reducing many of the taxes currently being paid. Now is the time to act when there is an opportunity to strengthen and broaden the Alaska economy as a whole.

SECTION III

A LID ON GOVERNMENT SPENDING

The elimination of taxes must be accompanied by a lid on both state and local spending. Elected officials must rally the courage and detachment to place tough, binding curbs on budgetary growth.

The Alaskan people endorse the involvement of state government to tend to the impoverished, the handicapped, the disabled, and the involuntarily unemployed. There is, however, a growing backlash to the philosophy that views government as the surrogate for church, community, neighbor, and the family.

If state budget growth averages 20%, by the year 2000 the legislature will be spending \$45 billion per year.

The mere existence of the surplus oil revenues is a nearly irresistible temptation for those who subscribe to the above philosophy to indulge in spending sprees to try to do everything for everyone. If this view dominates state policy, the present good fortune will soon vanish.

Even a cursory examination of the budgetary history of Alaska is enough to heighten one's appreciation of the problem of government growth and to encourage the advancement of remedial proposals.

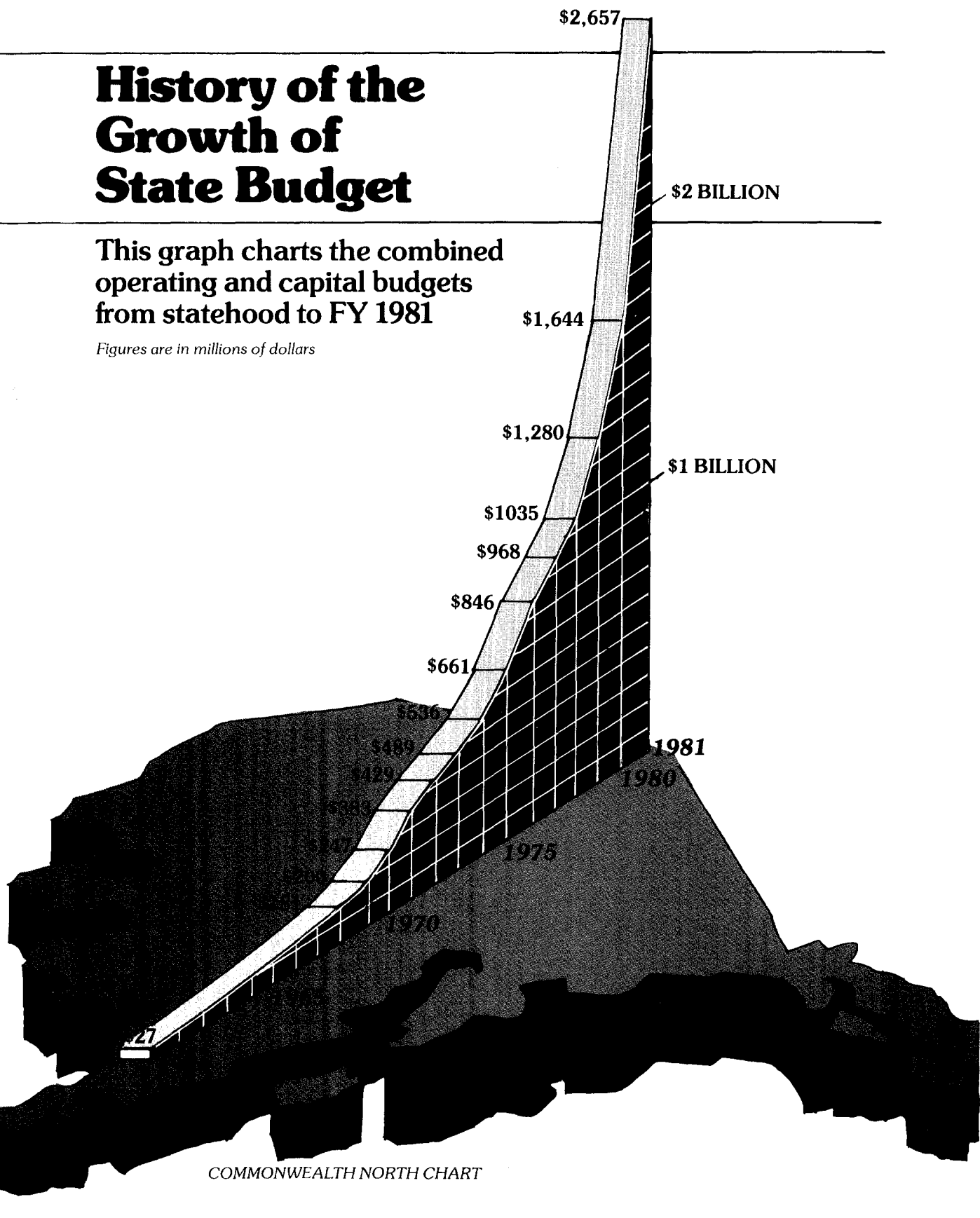
To underline the need for spending limits, consider the possibility of state budget growth at 20 percent (13 percent real growth, plus 7 percent inflation). At that rate, by the year 2000, our legislature will be spending \$45 billion per year.

Figure D

History of the Growth of State Budget

This graph charts the combined operating and capital budgets from statehood to FY 1981

Figures are in millions of dollars



COMMONWEALTH NORTH CHART

It is essential to clamp a lid on both state and local government expenditures

As shown on the graph (Figure D), the State of Alaska had a budget of \$27 million in 1960. The population at the time was approximately 225,000. The per capita cost of the budget was \$120. In 1979, less than 20 years later, the budget had grown to \$1.2 billion with a population of nearly 420,000. In other words, the annual rate of growth averaged over 100 percent. The per capita cost today is roughly \$2,800.

A person who earned \$10,000 a year in 1960 (a good income at that time) would have to earn \$240,000 per year in 1980 to equal the state's growth record.

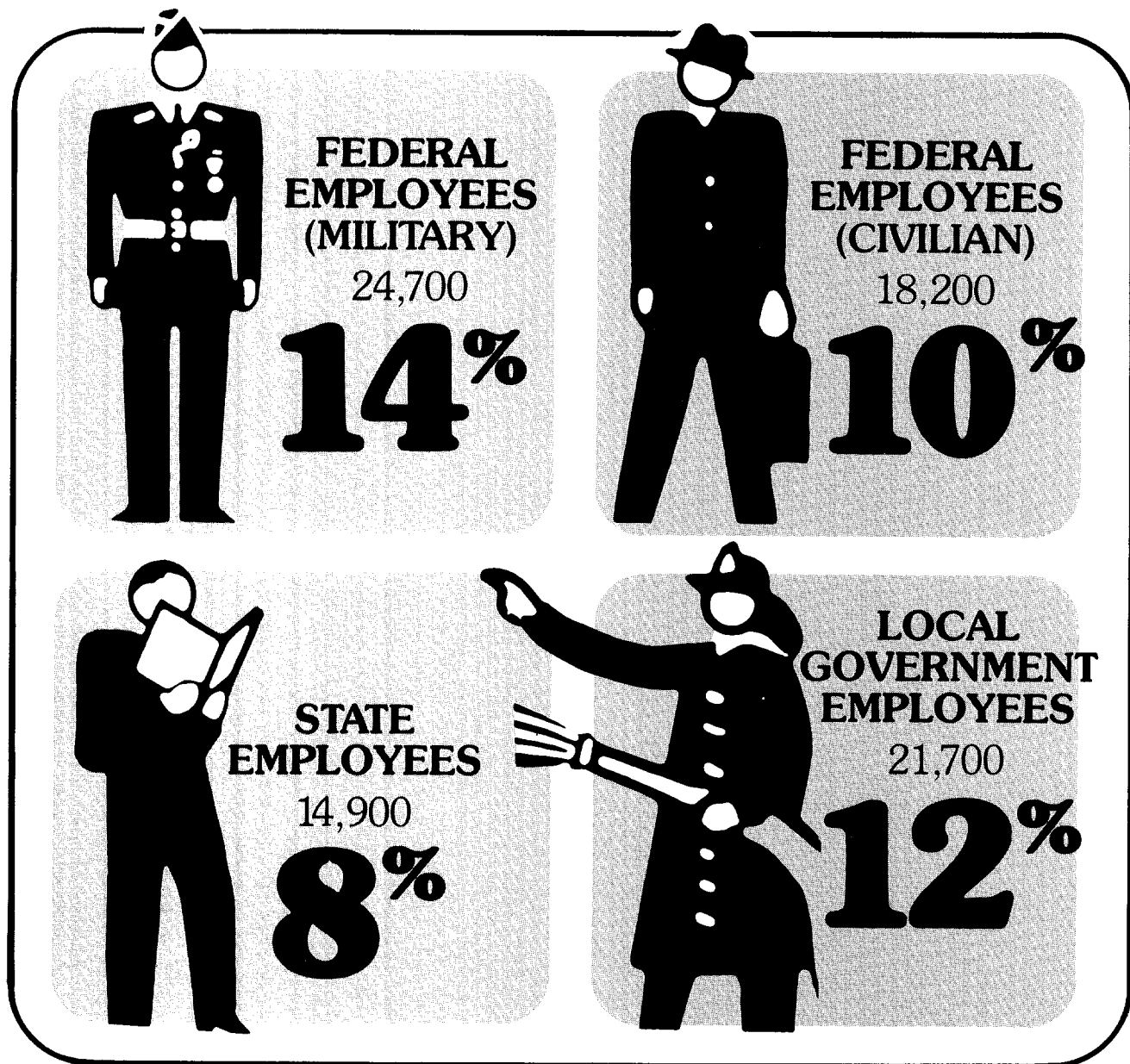
Sixty to 70 percent of government expenses are dedicated to salaries. To control spending, Alaska's elected leaders must check the expanding size of the public payroll. Figure D illustrates the large number of Alaskans employed by government. In addition, at least 15 percent of the work force makes its living from government as consultants, contractors and suppliers.

It would be an unwarranted assumption to suppose that local government, reimbursed by the state for uncollected property or sales taxes, would act with restraint. It is essential to clamp a lid on local expenditures in order to insure that municipal budgets are not inflated for superfluous purposes.

One of the best ways to limit government spending at any level is to tie state and local budgets to the annual fluctuation of personal income per capita of the non-governmental work force. These figures on a statewide and local basis can be obtained annually from the Department of Commerce and Economic Development.

Figure E

Number of Public Employees in Alaska



TOTAL 79,500 or 44%

COMMONWEALTH NORTH CHART

DATA SOURCE: Alaska Department of Labor, Research Division, Juneau

In 1979, personal income for all Alaskans increased 6.6 percent over 1978. On this basis, the state's operating budget, even allowing for the fact that this figure includes the entire work force (government and non-government) should not have exceeded 6.6 percent.

But the growth rate for state operations climbed 23.92 percent, a far cry from the increase justified by the growth in per capita income.

The State Chamber of Commerce is gathering signatures on an initiative to limit spending on the state level. Its formula requires that the operating budget be held constant at its present level, adjusted for annual net percentage changes in per capita personal income and population.

Recommendation for Action

A statute or constitutional amendment is needed to tie state and local budgets to the fluctuation of the personal income of the non-governmental work force.

Instead, the non-governmental work force should be the barometer because, once government salaries are included in the formula, expenditures will be much harder to hold down. But the Chamber approach is far better than no controls at all.

Any formula for limiting government spending must include a clause to free the hands of the Governor and the legislature in case of an emergency. The State Chamber, in its initiative, wisely includes a proviso that after emergency-related expenditures are incurred, appropriations in the following three years must be correspondingly reduced to make up for the increase.

Even more than balancing the budget, putting a lid on government spending is the real solution. Especially when negotiators in the public sector have access to the public treasury, a lid is imperative. Otherwise, the sky is the limit and budgets will soar.

Having placed such a lid on government spending in Alaska, at both the state and local levels, tax repeal can remain in effect for many years to come. The long-term result will be that the Alaskan people themselves, not just the government, will accumulate the capital necessary to build a secure, healthy, and regenerative economy.

The long-term result is that the people of Alaska will accumulate the capital to build a healthy economy.

SECTION IV INVESTMENT POLICY FOR THE PERMANENT FUND

A portion of the Permanent Fund should be invested in assets which produce an increasing level of income.

The Permanent Fund legislation which was signed into law in April of 1980 limits the investment of these funds to the most conservative instruments. It requires that 85 percent of these one-time dollars be invested in fixed income obligations issued by the United States government or by large domestic banks. If this investment philosophy is not changed, the whole concept of the Permanent Fund may fail.

A fitting parallel is the problem facing the aged in America today. A major reason for their plight is the lack of an adequate income being received by these senior citizens. The root cause of this inadequate cash flow is in large part the result of "prudent" investments in fixed income obligations and of fixed income distributions from their retirement plans. These investment decisions were made by well-meaning individuals who were wrong. Rather than providing security for our elderly citizens they have resulted in insecurity because the purchasing power of this fixed cash flow is being ravaged by inflation.

Recommendation for Action

The Permanent Fund legislation should be amended to permit investment in appreciable assets.

We have mandated this same legacy to our children by requiring that Permanent Fund investments be in fixed income obligations. Unlike humans who grow up, grow old, and die, our state will almost always be in a growth phase. If the earnings from the Permanent Fund are to

contribute to the future health, wealth and prosperity of our people, we must provide for increasing income from these assets.

The Fund should be managed in such a way that the purchasing power of these assets will be preserved. To convert an equity asset (raw oil in the ground that can and will appreciate over time) into a fixed income asset with little or no appreciation potential makes little sense.

Some of these funds must be invested in assets that can produce increasing income. One example of this strategy might be major property investments as the University of Washington has done so successfully for decades. Rents are adjusted over the years to offset the inroads of inflation.

Railroad cars and oil tankers could be other examples. Dividends on common stocks have historically increased even during periods of weakness in the market. There are many such examples, most of which have the added attraction of being able to increase in value as well.

It must be remembered that one of the latent dangers of the Permanent Fund is that it can be seen as a panacea for all future needs. In reality, this fund will only be as good as the restraint of government spenders.

If operating and maintenance budgets soar, as happened this year, within a decade government may be clamoring to invade the Fund just to pay for housekeeping and bloated government salaries.

If our children and our children's children, indeed all future Alaskans, are to benefit from the earnings of the Permanent Fund, we must manage it properly. We can and must manage these dollars so that they, too, become a renewable resource.

The Permanent Fund will only be as good as the success of its managers and the restraint of government spenders.

Within a decade the legislature may be clamoring to invade the Permanent Fund just to pay for housekeeping.

SECTION V

NEEDED: AN ALASKA INVESTMENT FUND

If a limit is imposed on the operating budget, the state will possess a substantial amount of disposable income. The state can either add greater amounts to the Permanent Fund or, as an alternative, apply the balance to help the state overcome its historic lag in realizing its potential.

The purpose of the Alaska Investment Fund is to build the basic infrastructure, so lacking in this state.

Whereas the capital budget traditionally addresses the ordinary and vital needs for basic infrastructure, school construction and cultural amenities, there remains an urgent need to establish a fund that will meet the extraordinary infrastructure requirements of a very young and undercapitalized state.

This fund might be called the Alaska Investment Fund, to identify its purpose. The aim will be to channel a portion of the surplus into the financing of large-scale projects of a complex nature that are vital if Alaska is to become something other than a government-dominated "corporate state" some twenty years hence.

Recommendation for Action

A special fund should be established to meet the extraordinary infrastructure requirements of this young and under-capitalized state.

Alaska must develop a commercial and industrial base. It must do so intelligently and prudently with an appropriate regard for the environment.

This base will provide productive employment for its citizens and be a source of additional state revenue when current sources diminish. Otherwise, by the end of this century, Alaska's work force will be nothing more than an army of federal, state, and local government employees, serviced by what purports to be a private sector. That sector will draw its paychecks from the government just as assuredly as if they were signed by governmental paymasters.

On the other hand, if the state undertakes to emplace, with a judicious investment of funds, those facilities that legitimately should be built by government, the result will be enthusiastically received by private investors.

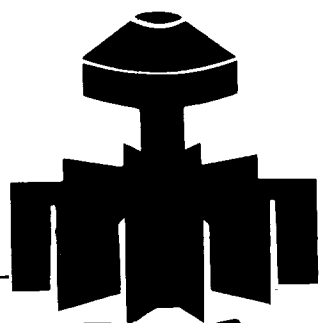
Future currency will not be gold. It will be kilowatts.

For example, if carefully selected port facilities, capable of berthing ships from the far corners of the earth, are constructed at several deep-water, ice-free ports; if rail lines are built to northern and western Alaska, connected to the mainline of the Alaska Railroad; if airports are constructed (or enlarged); if hydroelectric systems are properly located and constructed so as to provide low cost power, and if boat harbors are built in strategic locations to take advantage of our great fisheries, there is little question that private investment will naturally follow.

Some of these projects may be self-liquidating in the long-term, but that need not be a determining criterion. The chief criteria of the projects to be accomplished by this fund are (1) their efficiency in improving the climate for encouraging private investment in Alaska and (2) their complex nature and high cost.

Investment in hydroelectric projects, for example, will accelerate the production of low-cost energy on an environmentally-sound basis. The life

Figure F



Alaska Hydro Electric Sites

currently on the drawing board



COMMONWEALTH NORTH CHART
DATA SOURCE: Alaska Power Authority

expectancy of such projects ranges well beyond 100 years and thereby promises to provide one of Alaska's best weapons against inflation.

Figure F shows hydroelectric sites which are already on the drawing boards.

"Future currency will not be gold. It will be kilowatts," Buckminster Fuller, the inventor-philosopher, told Commonwealth North in December 1979. In that sense, hydroelectric projects are among the most permanent of capital improvements and are excellent "inflation-proof" investments. They will benefit the public through lower, long-term power rates and also reduce costs to the state treasury for expensive state facilities operations.

Alaska would do well to look at the experience of the Province of Alberta, Canada. Oil-rich like Alaska, the Province set up the Alberta Heritage Savings Trust Fund in 1976.

The 1979-80 Heritage Fund annual report shows an ever-increasing investment in Alberta itself. In 1979 the Capital Projects Division and the Alberta Investment Division totalled \$1,662,000,000. The entire Heritage Fund portfolio is \$6,415,000,000.

A caveat must be attached to this proposal for an Alaska Investment Fund. What the state should not do, despite surface validity and short-term advantages, is to construct those facilities which are the proper domain of private industry. Partnerships with industry or equity positions in developments are risky business. For, in the long run, by permitting the camel to get its nose under the tent, one inevitably invites governmental interference and,

Alberta's Heritage Fund shows an ever-increasing investment in Alberta itself.

in fact, control. The record shows that what the government bites off, it swallows.

Such a fund might well be directed by a Commission elected on a state-wide basis, similar to the highly-acclaimed Texas Railroad Commission which has three commissioners serving staggered six-year terms. The Commission could hire an executive of proven credentials from the private sector to manage the fund with an appropriate staff and oversee the contracts under which these projects are constructed.

At least 25 percent of resource revenues should be earmarked for this fund in a similar fashion as those dedicated to the Permanent Fund.

Recommendation for Action

At least 25 percent of resource revenues should be earmarked for the Alaska Investment Fund.

It would be sound public policy to submit the proposed expenditures under this fund for ratification by the electorate.

Alaska can look to the day when the private sector grows as the governmental sector contracts.

If designed correctly, the infrastructure created by the Alaska Investment Fund can assist rural Alaska with lower cost energy, a market for resources which are currently isolated, and employment closer to home. Alaska's rural, urban and Native leadership should work out priorities, values and guidelines which reflect the best interest of all.

Through the mechanism of this fund, Alaska can look to the day when the private sector grows as the governmental sector contracts. Alaska will be given a chance to amass its own capital to realize its great potential in the 21st

century, and thereby, act as a bell-wether for the nation exposing the economic myths of the past twenty years for what they are.

THE "CULTURAL INFRASTRUCTURE"

It is important to stress that the Alaska Investment Fund would not be designed to handle projects for the enhancement of the "cultural infrastructure". These equally important investments, such as libraries, museums, visitor attractions, city beautification and fine arts and civic centers, should remain in the regular capital budget.

In a very tangible way, these projects will assist in the creation of a positive investment climate, enhance the environment of our communities and improve the image of our visitor industry throughout the nation.

Good examples of how this has been done well are the Sitka convention center, the Fairbanks library, and Anchorage's parks and bike trails.

The legislature should be encouraged to fund these kinds of projects which will strengthen the tourist-related infrastructure and attract permanent residents as well.

It is undisputed that people desire pleasant places in which to live. When people are attracted to an area, they bring with them their creativity and money for investment. The result is favorable and prudent development with increased employment opportunities and stability in the economy.

A favorable cultural setting attracts talent, enhances the visitor industry and helps bring stability to the economy.

SECTION VI

STATE LOAN PROGRAMS

When the state becomes the major dispenser of loans, politics and favoritism become dominant.

Concern has been expressed throughout Alaska that the government, in its desire to help the depressed private sector, may become an enormous lending institution. The danger is that when the state becomes the major dispenser of loans, politics and favoritism easily become dominant and sound judgment is impaired.

Except in the case of social loans (i.e. for day care centers, student loans, etc.), the best vehicles for administration purposes are the existing private lending institutions. Underwriting and loan servicing by banks and credit unions should not be duplicated by government. The Alaska financial community already has the expertise to service commercial and housing loans effectively without addition of new state personnel.

Recommendation for Action

Except for "social loans," state loan programs should be administered by existing private lending institutions.

A wide-ranging array of often overlapping state loan agencies has been created by state government. The administration of these programs costs in the area of \$200 million per year, including staff, rent, travel and outside counsel. The following is a list of 38 of the loan programs currently in operation.

1. Agriculture Revolving Loan Fund
2. Alaska Economic Disaster Impact Fund
3. Alaska Gas Pipeline Financing Authority
4. Alaska Housing Finance Corporation
5. Alaska Housing Finance Corporation Housing Development Fund
6. Alaska Industrial Development Authority
7. Alaska Industrial Development Authority Economic Development Fund
8. Alaska Medical Facility Authority
9. Alaska Municipal Bond Bank Authority
10. Alaska Power Authority Power Project Fund
11. Alaska Renewable Resources Corporation
12. Alaska Renewable Resources Corporation Commercial Fish Purchasers Assistance Fund
13. Alaska State Housing Authority Revolving Loan Fund
14. Alternative Technology and Energy Revolving Loan Fund
15. Bulk Fuel Revolving Loan Fund
16. Capital City Revolving Loan Fund
17. Child Care Facility Revolving Loan Fund
18. Commercial Fishing Revolving Loan Fund
19. Disaster Relief Fund
20. Fisheries Enhancement Revolving Loan Fund
21. Fisherman's Mortgage and Note Fund
22. Housing Development Revolving Loan Fund
23. Historical District Revolving Loan Fund
24. Medical Malpractice Liability Revolving Loan Fund

Some state loan programs are operating in direct competition with the private sector.

25. Memorial Scholarship
Revolving Loan Fund
26. Mining Loan Fund
27. Nonconforming Housing
Loan Fund
28. Outdoor, Recreational,
Open Space, and His-
toric Properties
Development Fund
29. Public Law 92-203
Loan Program
(loans to facilitate
creation and organi-
zation of the 12
Native regional
corporations)
30. Relocation Planning
Loans
31. Residential Care
Facility Revolv-
ing Loan Fund
32. Residential Energy
Conservation Fund
33. Scholarship Revolving
Loan Fund
34. Senior Citizens Housing
Development Fund
35. Small Business Revolv-
ing Loan Fund
36. Temperate Social
Activities Revolv-
ing Loan Fund
37. Tourism Revolving
Loan Fund
38. Veterans Revolving
Loan Fund

The state has acted wisely in directing that some of these loan programs be administered by Alaska banks, credit unions and savings and loan associations. However, some of these state agencies are operating in direct competition with the private sector.

When state money is deposited in a private lending institution in a large lump sum with the intention that it be used for real estate and business loans, it is difficult, if not impossible, to direct the

specific use for those funds. Long term loans require long term deposits and this procedure is not feasible. Therefore, the ideal solution is a direct loan purchase plan for new loans. This means that the state only buys the loans from the banks after the projects have been scrutinized, the paperwork is completed, and the loan originated; that is, the funds have been dispensed.

The state should buy loans from the banks after the projects have been scrutinized.

Lending institutions receive an origination fee of one percent plus a servicing fee of less than one half of one percent for handling a loan. They, in turn, are held accountable through strict delinquency guidelines established by the State Departments of Revenue and Commerce.

Emphasis should be placed on loans for the purchase and construction of new homes as well as purchases and improvements of existing homes. In Alaska, the ripple effect from the stimulation of the housing market provides broad economic benefits.

The amount of public discussion regarding state loan programs could falsely give the impression that small business loans can be the cure-all for Alaska's severe economic fluctuations. Certainly they will help, especially if interest rates are favorable. But they are only one part, and perhaps a small part, of the solution.

The point is to create a framework of economic stimulation with the assurance that loan funds will be used in Alaska for the benefit of Alaskans.

Market discipline should govern the in-state lending process. For this reason, it is important that the state loan and financing vehicles for

business purposes achieve sufficient independence from the state to resist political pressures and yet remain responsive to the policy guidelines imposed by their legislative charters.

Loan programs should be developed on a prudent basis with private sector criteria governing loan quality. It is imperative that state lending programs be stabilized and available on a consistent, long-term basis.

The legislature should stop the proliferation of state loan agencies.

Most important of all, the legislature must check the proliferation of loan agencies and personnel currently taking place. Whenever possible those programs should be taken out of the bursting halls of government and channelled through private lending institutions which have proven to be far more competent and accountable.

SECTION VII

INDEPENDENT AUDITS

It is imperative that an independent audit system be established to monitor the administration of the Permanent Fund as well as the state's loan programs and investments.

State loan programs, especially, must be divorced from the temptations of political abuse. Strict accountability must be required so that such loans do not become "grants in disguise". Independent audit systems must be established to oversee their administration.

State loans must not become "grants in disguise".

Recommendation for Action

Independent audit systems should be established to oversee the administration of state loan programs and the Permanent Fund.

While bank loan delinquencies currently run at less than half of one percent, direct state loans are suspected to be failing at an incredible 15 to 20 percent.

In addition to the integrity of these programs and the wisdom with which they are administered, deeper and more fundamental issues should be reviewed. For example, the way surplus funds are invested and the actual impact they are having on the state will influence the shape and health of Alaska.

Delinquencies may be running as high as 15 to 20 % .

Are these funds encouraging a market economy or do they move us closer and closer to statism? Are the loan programs truly assisting renewable resource development, residential construction, mortgages, and small business development?

Are the extractive industries, currently responsible for 93 percent of state revenues, being encouraged by the improvements in the state's transportation and utility infrastructure?

Are the industries which provide our greatest employment in the private sector, such as tourism, fishing and timber, being strengthened?

These questions must be openly asked and answered by an independent auditor and the managers of the funds.

The entire state budget process also needs the scrutiny of the public. Currently the annual budget document is so complex that it masks how millions of dollars are actually being spent.

A citizen's budget review team is needed to study the budget and tell the public what is really going on.

Recommendation for Action

A citizen's budget review team should be established to study the budget and report to the public.

Other states, including Texas and Colorado, already have such teams in place. One group, the Connecticut Public Expenditures Council, is privately funded with a full-time executive director and a professional staff. Along with volunteers from the Hartford-based insurance industry, the staff keep tabs on government expenditures on a near daily basis.

Such an organization would provide an enormous public service for Alaska, especially during the decades just ahead.

SECTION VIII

ALASKA'S GOLDEN OPPORTUNITY

At a time when the nation, indeed much of the world, faces severe shortages of energy and capital, Alaska finds itself favorably blessed. Few generations are given such an opportunity to invest wisely an inheritance of the magnitude of Alaska's anticipated oil revenues. Few "developing countries" have such unlimited prospects for establishing a long-term sound economy in a clean, creative, environment.

The implications of Alaska's situation strike to the very roots of society and raise questions about the relationship of free people to their government.

Government's legitimate role is to provide necessary services that never have and never will be the province of the private sector. But liberty is endangered when government acquires a voracious appetite for preempting and regulating all aspects of human life.

The mystique of government paternalism dies hard, in spite of abysmal failures here and abroad over the past half century.

It would be most unfortunate if we Alaskans squander our golden opportunity. We can demonstrate here the benefits which result from giving our citizens a chance to participate in establishing a strong market economy, backed up by government, not run by it.

Our resource wealth should benefit all Alaskans. Our challenge, then, is to translate this wealth into productive capacity for every citizen, so that each in turn can contribute

As government has grown, the private sector has languished.

Alaska can demonstrate the benefits of a strong market economy, backed by government, not run by it.

to the creation of a better way of life.

Hopefully, the observations and the recommendations in this report will serve as an initial blueprint for the next twenty or thirty years. Perhaps these thoughts and proposals can be used as a yardstick for measuring the quality of the work and the decision-making of those who do, and will, control the public purse.

This can be the initial blueprint for the next 20 or 30 years.

Alaska has the opportunity to show the world how to use and invest its resource income wisely; to provide needed resources for the rest of the nation, the Pacific Rim, and other parts of the world; and to stimulate an advanced culture on America's last frontier. The arts, education, and the amenities that have accompanied all great civilizations of the past can and should flourish here in the 49th state.

If these goals are achieved, it is not boastful to say that Alaska can provide an example for America and beyond.

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COMMONWEALTH NORTH

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