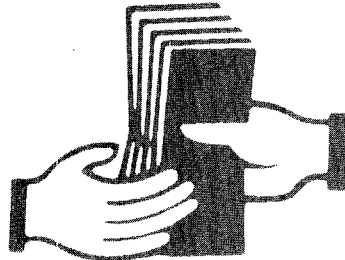


ACTION PAPER

THE PROMISE AND THE PITFALLS OF ALASKA'S STATE LOAN PROGRAMS



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AND THE
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OF
ALASKA'S STATE
LOAN PROGRAMS**

A Report by
Commonwealth North

Prepared by the Banking and Loan Committee

May 1981

THE PROMISE AND THE PITFALLS
OF ALASKA'S STATE LOAN PROGRAMS

A Commonwealth North Report

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THE COMMONWEALTH NORTH BANKING AND LOAN COMMITTEE

On December 11, 1980, Commonwealth North published an extensive report on government spending, prepared by the Resource Income Committee. The authors warned against the state "jumping into the banking business" and recommended that most state loan programs be administered by private lending institutions.

Four days later, the Board of Directors launched a follow-up study on this issue. Co-chairman William A. Egan, long an observer of the central bank of North Dakota, suggested that its experience be reviewed. Co-chairman Walter J. Hickel urged that ways be devised to make state loan programs strictly accountable and avoid the abuse of political favoritism, an obvious danger in a time of revenue surplus.

The charge for the Committee was defined as follows:

To study the North Dakota experience with its central bank; to review the multitude of Alaska state lending agencies; to involve the input and opinions of the private financial community of Alaska; to make detailed recommendations as to if and how the legislature should consolidate state programs and avoid direct competition with the private sector.

Board member David Chatfield, who participated in the year-long Resource Income study, was named chairman of the working group, which was called the Banking and Loan Committee.

The Committee met weekly for four months. Sub-committees formed to examine all of the state loan programs currently on the books. These programs were divided into renewable resource programs, housing programs, business programs and social programs. For the most part, these sub-committees also met weekly.

Where necessary the sub-committee chairmen invited resource people from the community to assist in the extensive work required to review so many diverse and complicated programs.

To study the North Dakota Bank, a special sub-committee was formed. Telephone interviews and correspondence were

followed by a trip by Committee Chairman Chatfield to Bismarck, N.D., headquarters of the bank. Meetings were held with both Herb Thorndahl, President of the bank and Harry Argue, Executive Director of the North Dakota Bankers Association. The results of those meetings, and a study of the material provided, is included in the following report.

The members of the Committee are as follows: John Norman, Joan Sheppard, Bob Baer, Kris Lethin, Fred Ferrara, Dick Miller, Stan Howitt, Bob Lowe, Edith Bullock and Jim Faiks.

Thanks are in order to the following for their assistance in the research for this study: Walt Alexander, Michael Lynch, Steve Shropshire, Margo Armistead, Earl Miller, Bob Kubick, Patricia Corbett, Al Strawn, and Ski Olsonoski.

The Committee also wishes to acknowledge the cooperation and assistance rendered by state employees involved in the administration of the various loan programs in providing information and analysis of program status.

CONCLUSIONS

1. The proliferation of state loan agencies must be checked lest the private sector be swamped in the wake of the ship of state.
2. The legislature is strongly urged to launch an independent audit and examination of all state loan programs to determine and disclose their true financial performance and current status.
3. Twelve of the state loan programs exist in name only and should be removed from the books.
4. The great majority of the state loan programs should be consolidated into three loan authorities.
5. State loan activity should be confined to a secondary market support function, with no direct public contact.
6. The Alaska Renewable Resource Corporation (ARRC) and the Commercial Fishing and Agricultural Bank (CFAB) should be abolished or have their operations severely curtailed.
7. Inequities created by current state loan programs should be corrected by allowing re-financing of the existing indebtedness on residential and commercial real estate through state loan programs as restructured in this report.

8. Alaska should not establish a central bank. State loan programs, properly restructured, can fulfill the more beneficial functions performed by the Bank of North Dakota without undermining Alaska financial institutions by competing directly for deposits and loans.
9. The state must outgrow its "crisis mentality" and institute a long-term approach to state loan programs, thereby bringing stability to the financial market of Alaska.

FOREWORD

Alaska's strong financial balance sheet, the result of North Slope oil production and rising world oil prices, has impelled state government to attempt to use revenue dollars for the enhancement of the life and economy of state residents.

While billions of dollars have been placed in Alaska's "nest egg", the Permanent Fund, a barrage of new legislation has been submitted to provide loans and grants to Alaskans for a wide variety of pursuits and purposes.

This effort takes many forms, trying to address both the unique problems of rural Alaska as well as the needs of citizens who live and work in an urban setting. There are dangers in assuming that any one approach can apply to all parts of the state. Rural Alaskans want to improve their communities and services, find jobs locally and yet retain their cultural and traditional ways of living.

Urban Alaskans seek ways to improve their cities, rejuvenate sagging economies and yet are leary of the competitive disadvantages which can result from selective state loan programs.

While this report is being published, another Commonwealth North study nears completion. It will address perhaps Alaska's highest priority; the creation of an economic infrastructure which can help both rural and urban citizens.

In studying the state's loan policies, this Committee discovered well-founded concerns centered around the practice of artificially influencing the economy. Loans made at below market rates for selected individuals or purposes distort and interfere with a free market, creating inequities among citizens and encouraging pursuits for other than prudent reasons.

In addition to the implications of state interference with economics there is also the very real problem of state participation in economic activities. By allowing and fostering direct loans to citizens, the state unfairly competes with and undermines the private lending institutions, including banks, credit unions and savings and loan associations. In other cases the state enters into "joint ventures" with selected business enterprises, resulting in direct competition with private firms.

Several programs, however, have succeeded in investing in Alaska without competing with the private sector. These programs have channeled state money, or state-backed money, into the economy, and have done so by utilizing private lending institutions. Lenders originate and service the loans, and in some cases participate in them while selling the loans to the state. This behind-the-scenes financial investment is referred to as secondary market activity.

The above approach is seen as a preferred model for all state loan programs, except those with strictly social purposes.

The concern of many that unrestricted state loan activity can swamp the private financial sector is illustrated by the fact that present balances in state loan programs equal more than \$1.8 billion, or nearly the total of loans in all Alaska banks.

This concern is heightened by the fact that new appropriations for state loan activities introduced in the legislature thus far this year amount to an additional \$3.3 billion, more than the total assets of all financial institutions in the state.

This trend is particularly disturbing when a look at other states with surplus revenues reveals an almost complete absence of state loans to citizens. Louisiana residents amended their constitution to prohibit virtually all state lending. Wyoming has but one direct loan program, a seldom-used remnant of the Great Depression.

Montana has eliminated almost every loan program, one of which was "a terrible experience. All but one loan went bankrupt," officials say. All of these states do provide, through the bonding mechanism, a secondary lending function. But years of experience have discouraged other forms of lending.

Whereas many of Alaska's problems originate outside of the state and are often out of the control of its citizens, the issues addressed in this paper have solutions that Alaskans can administer.

It is hoped that the recommendations presented are adopted by Alaska's legislative leaders. These conclusions are the result of careful review of the state's loan programs and months of debate on the best course to take to benefit all Alaskans.

CONCLUSION 1:

The proliferation of state loan agencies must be checked lest the private sector be swamped in the wake of the ship of state.

Concern has been expressed throughout Alaska that the government, in its desire to help the private sector, may become an enormous lending institution. Indeed, the state is currently by far the largest Alaska lender and, as we have shown, new loan appropriations bills now before the legislature equal more than the total assets of all Alaska financial institutions.

Favorable loan terms, artificially low rates, and relative ease of loan acquisition through marginal underwriting sometimes prevalent in state loan programs encourages the private sector to acquire "cheap" funds. This lures many individuals into the expansion of businesses or property purchases merely to obtain the loans and often at the cost of burdensome debt service. These expansions may not be economically viable and in some instances will lead to business difficulties or perhaps outright failure.

In addition, some state-sponsored organizations seem not the least bit reluctant to use their government-supplied, low-cost capital advantage in direct, open competition with private financial institutions for loans, deposits and personnel.

If this public policy direction continues, Alaska is in danger of becoming a "company town," with state government as the proprietor of the company store.

CONCLUSION 2:

The legislature is strongly urged to launch an independent audit and examination of all state loan programs to determine and disclose their true financial performance and current status.

Despite the best efforts of some, no one in government has a handle on the 38 state loan programs. These programs are administered by 22 different state divisions and agencies resulting in considerable overlap and duplication of effort representing substantial redundancy and waste.

Without benefit of an independent audit and examination of state loan programs, it is difficult to determine their total staffing and administrative costs with any degree of accuracy. (In fact, it is difficult to be certain that all loan problems have even been located and identified for review). It appears, however, that the annual cost of staff, supervision, facilities, travel and other overhead amounts to an annual expenditure of state dollars somewhere between \$50 and \$200 million.

State employees administering the various loan programs were found to be, by and large, cooperative and thorough in providing information concerning their activities. Though they generally act in good faith, they are understandably interested in showing their programs in the best possible light.

In addition, there is a lack of uniformity and consistency in financial reporting among the various agencies. Several different methods of calculating delinquency and loss are utilized.

In the absence of a complete, independent audit and examination, it is impossible to determine the extent of use of extension

agreements and other devices which can artificially improve delinquency and loss statistics.

Such a comprehensive review should be completed by independent auditors at the earliest possible date.

CONCLUSION 3:

Twelve of the state loan programs exist in name only and should be removed from the books.

1. Alaska State Housing Authority Revolving Loan Fund

This program has not been funded for many years. The temptation now will be to fund all programs regardless of their worth. It should be officially scrapped.

2. Housing Development Revolving Loan Fund

This program is presently inactive and has not been funded in several years.

3. Alaska Economic Disaster Impact Fund

This program has not been funded and is not operating. When disasters strike, needed funds should be allocated from the Governor's contingency fund.

4. Residential Care Facility Revolving Loan Fund

This program is presently inactive and has not been funded in several years.

5. Temperate Social Activities Revolving Loan Fund

This program is presently inactive and has not been funded in several years.

6. Tourism Revolving Loan Fund

This program has already been given new guidelines and shifted to AIDA.

7. Child Care Facility Revolving Loan Fund

This program should be terminated as it is now written. Child care facilities can obtain financing through private lending institutions or AIDA.

8. The Fishermen's Mortgage and Note Fund

Due to inactivity and overlapping with other programs, this program should be discontinued.

9. Public Law 92-302 (Native Corporation Loan Program)

Currently there are no loans outstanding in this program. No loans may be made after 1977 and the program is inoperative after 1982.

10. Veterans Revolving Loan Fund

The housing portion of this program has already been shifted to AHFC and other portions of this program have been eliminated.

11. Relocation Planning Loans

No loans have been made by the state agencies under the provisions of this program and no appropriations have been made.

12. AHFC Development Fund

Although this program functioned until 1980, it is no longer necessary because of legislative changes.

CONCLUSION 4:

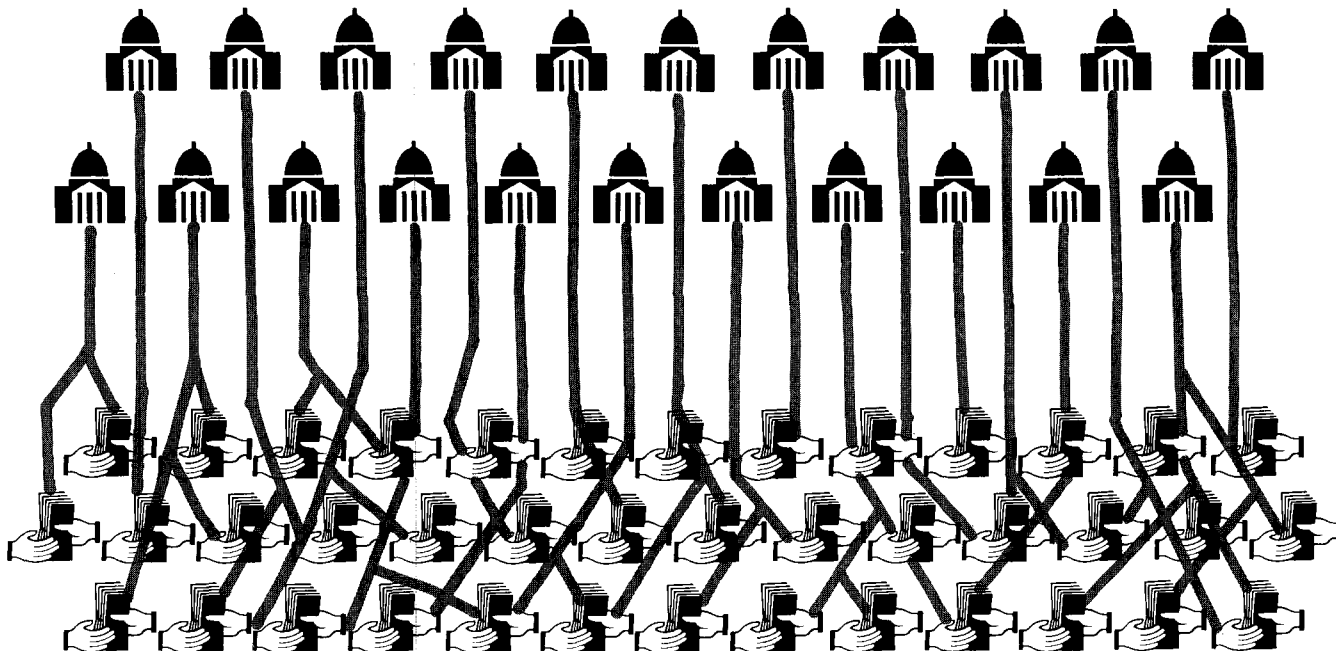
The great majority of the state loan programs should be consolidated into three loan authorities.

The current jumble of 38 loan programs administered by 22 different divisions of state government should be combined into three loan authorities. These new entities will help rid the state programs of their redundancy and wasted overhead, as well as provide a clear line of accountability. The new authorities encompass the general areas of housing, business and social needs.

The following are recommendations of what they should be called and how they would operate:

CURRENT ORGANIZATION OF STATE LOAN PROGRAMS

22 Divisions



38 Loan Programs

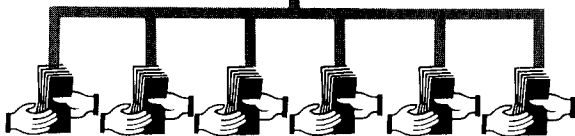
A. The Alaska Housing Loan Authority

The idea of this agency is not to re-invent the wheel, but to utilize the already-proven methods of home financing by the Alaska Housing Finance Corporation (AHFC). These methods should be expanded and adapted to all types of housing currently being addressed by state loan programs.

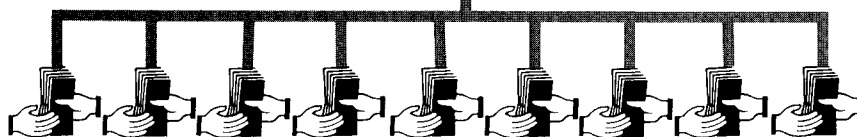
In other words, the AHFC secondary market approach should also be utilized for senior citizen housing, veterans home loans, mobile homes and non-conforming home loans, so that private lending institutions will want to originate and service the loans.

RECOMMENDED RE-ORGANIZATION

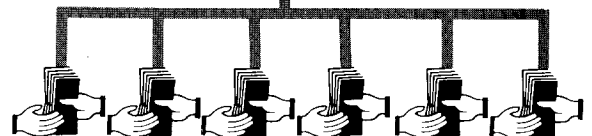
THE ALASKA HOUSING LOAN AUTHORITY



THE ALASKA BUSINESS LOAN AUTHORITY



THE ALASKA SOCIAL LOAN AUTHORITY



The Committee studied each of the housing loan programs and the types of loans that are currently available. The programs listed below contain aspects which are considered necessary and worthy of continuation, if they are combined to eliminate redundancy and waste:

- Alaska Housing Finance Corporation
- Senior Citizens Housing Development Fund
- Mobile Home Loan Program (currently under AHFC)
- Residential Energy Conservation Fund
- Non-Conforming Housing Loan Fund

B. The Alaska Business Loan Authority

As with the housing authority, this agency should utilize the methods and procedures of an existing agency; the Alaska Industrial Development Authority (AIDA). Though it is a new agency and only now establishing its credibility, AIDA has, thus far, built on several healthy premises. It makes no direct loans, requires participation and servicing by private lending institutions, and sells bonds to finance the loan packages it handles.

In some cases, especially with small business loans, because of IRS limitations on tax exempt bond funding, the Alaska Business Loan Authority would not sell bonds to finance the projects which qualify, but would require direct state appropriations. AIDA does, however, have authority to issue taxable bonds which would provide all types of financing.

The AIDA model should be continued, requiring participation on the part of the lending institutions which service the loans and restricting the agency from direct loan activity.

In the past, the state has treated the renewable resource industries as a special case, requiring numerous programs. It is observed, however, that when these industries are profit-making ventures, they should be treated in the same manner as all others.

There are currently seven separate agencies providing loans to fishing and agricultural interests. One result is that banks which have specialized in fishing loans are losing their trained personnel to high paying government jobs and the banks are becoming less active in their fisheries departments. If this continues, the viability of private lenders having qualified personnel on staff for agricultural and fishing project underwriting will be seriously jeopardized. If the various agencies making similar loans are combined, fewer personnel will be needed and more expertise requirements can be shifted to the lenders.

Finally, in examining the various business loan programs, there is a wide disparity and inconsistency in interest rates without any apparent justification for the unequal treatment. For example, a fishing or agricultural loan may be made at a 6% annual rate of interest while the AIDA portion of a business loan may be at 12%.

For this reason, a complete review of the interest rates and terms of business loan programs is necessary.

The programs listed below contain aspects which are considered necessary and worthy of continuation, if they are combined to eliminate redundancy and waste:

- Alaska Industrial Development Authority
- Small Business Revolving Loan Fund
- Mining Revolving Loan Fund
- Agricultural Revolving Loan Fund

- Commercial Fishing Revolving Loan Fund
- Alaska Medical Facility Authority
- Tourism Revolving Loan Fund

In addition, the following two programs are industry-research oriented and should be included as a separate division:

- Alternate Technology and Energy Revolving Loan Fund
- Fisheries Enhancement Revolving Loan Fund

C. The Alaska Social Loan Authority

The programs under this proposed authority serve a wide-range of social purposes with an underlying basic assumption that there is no profit motive involved. These programs were enacted by past legislatures to meet emergency or unique situations which could not be met in the private sector.

However, upon examination some of the programs in this category may actually be making business-oriented loans that are not primarily for social purposes. For example, a program such as the Historical District Revolving Loan Fund to preserve historical sites appears to be making some loans that could just as well be made under AIDA since a business interest is present.

Also, some of the programs need to be reviewed to ascertain if new standards or criteria should be established to prevent the loans from becoming grants due to delinquencies, or benefiting specific business enterprises over their competition.

This authority should have a board of trustees which includes the Commissioners of Health and Social Services, Education, Natural Resources, and Community and Regional Affairs.

The current programs which would come under its mandate are:

- Medical Malpractice Liability
Revolving Loan Fund
- Scholarship Revolving Loan Fund
- Historic District Loan Fund
- Outdoor Recreation Open Space
Revolving Loan Fund
- Bulk Fuel Revolving Loan Fund
- Disaster Relief Fund

D. Miscellaneous Loan Programs

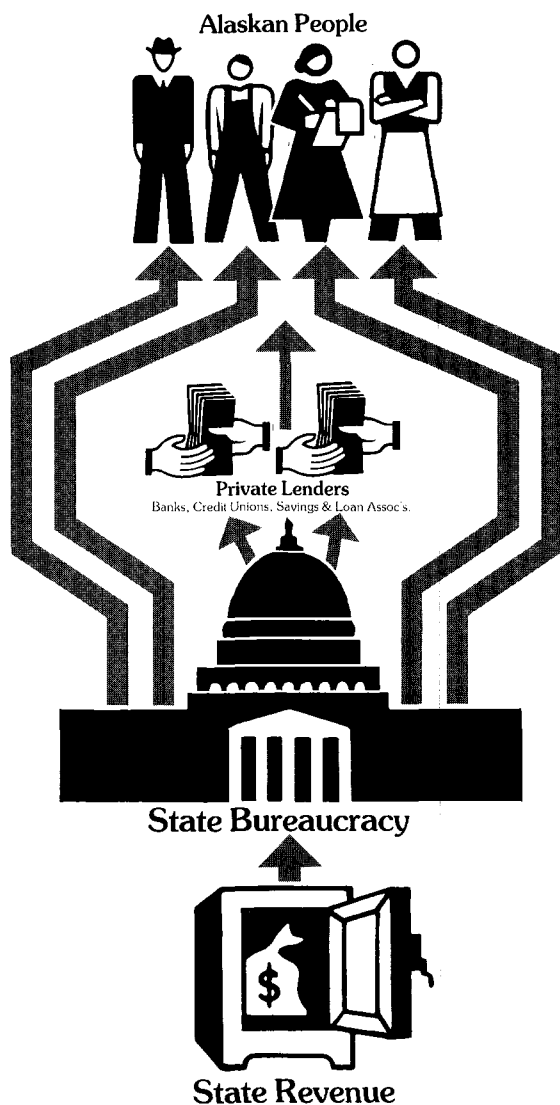
Five loan programs exist that do not naturally fit into the three authorities described above. Two of these are inactive, and their usefulness will depend on the outcome of the capital move and gas pipeline issues:

- Capital City Revolving Loan Fund
- Alaska Gas Pipeline Financing
Authority

The remaining three programs should be administered as they are:

- Alaska Municipal Bond Bank Authority
- Alaska Power Authority Power Project
Fund
- Memorial Scholarship Revolving Loan
Fund

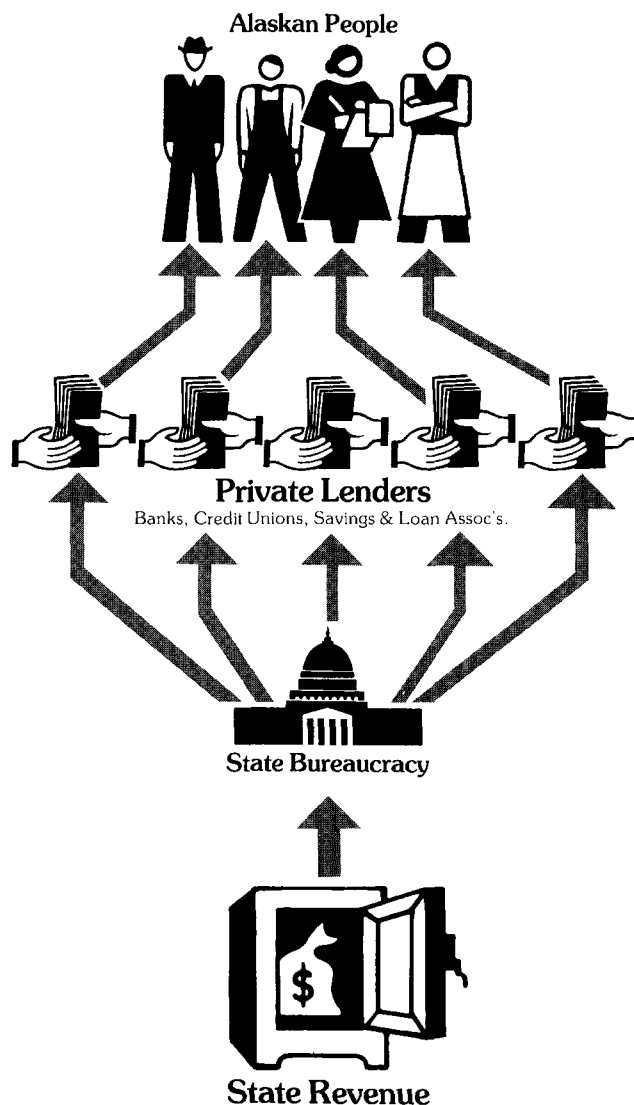
DIRECT LENDING



Weaknesses

1. Bureaucracy expands
2. The state competes directly with the private lenders
3. Delinquency rates go up, sometimes to as high as 20%.
4. Political pressure can determine who gets loans.
5. The money "owned" by all Alaskans is wasted on high overhead and can easily be lost through bad loans.

SECONDARY LENDING



Strengths

1. Bureaucracy is held to a minimum.
2. Private lending institutions originate and service the loans.
3. Strict guidelines require the lenders to keep delinquency rates below 2%.
4. The process is removed from political pressure.
5. The public funds invested within the state become a "renewable resource."

CONCLUSION 5:

State loan activity should be confined to a secondary market support function, with no direct public contact.

The most efficient and accountable administration of state loan programs is accomplished through private lenders. Comparison of the performance of existing direct state loan activities versus state secondary market (investment purchase) activities clearly confirms that secondary market programs offer the most prudent use of state revenues for loan programs.

With private lending institutions accepting applications and underwriting loans, and the state providing the money for the purchase of loans, more money is put into the economy. The quality of loans purchased for investment by the state is controlled both by the use of proven criteria in lender underwriting during loan origination, and by strict delinquency guidelines applied to these loan portfolios by state agencies overseeing the programs.

This method is highly efficient for implementing state loan programs. Lending institutions are paid nominal fees for originating loans (normally 1%) and 3/8 of 1% for servicing them. This secondary market approach enables the state agencies to operate with minimum staff and resources, while still supplying proper supervision to the loan programs.

CONCLUSION 6:

ARRC and CFAB should be abolished or have their operations severely curtailed.

Two existing and active loan programs, Alaska Renewable Resources Corporation (ARRC) and Commercial Fishing and Agricultural Bank (CFAB) have questionable objectives, limited accountability, and dangerous implications. They should be abolished or their operations severely curtailed.

1. Alaska Renewable Resources Corporation (ARRC)

ARRC's legislated objective is to provide financial assistance for projects which will promote the development, research, and marketing of the state's renewable resources. Its source of funding is perpetual and, through a tangled flow of cash, it receives 5% of the rent and royalties received from all state mineral production, one-half of which is available for lending activities.

ARRC loans and makes equity investments in Alaskan businesses which are incapable of receiving conventional funds at reasonable rates and in which it will have limited ownership and management control. ARRC has loaned and made investments in fishing ventures, agricultural projects and forest products.

Through business failure it has acquired total ownership of at least one business and potential ownership looms for several others totalling more than \$1 million in delinquent loans.

ARRC should be abolished for the following reasons:

- (1) The method of funding this agency guarantees its continuance regardless of performance.
- (2) ARRC's high risk venture capital and research functions make it immune to conventional accountability criteria.
- (3) The potential for complete business take-overs can lead to direct competition between state-owned businesses and the private sector.
- (4) State-owned or partially owned businesses have an unfair advantage over and undermine the private sector.
- (5) Forced emphasis on impractical renewable resource ventures may well be counterproductive and result in poor return on invested funds.
- (6) Renewable resource loans can be provided by the appropriate loan authority proposed in this report.

2. Commercial Fishing and Agricultural Bank (CFAB)

CFAB is a cooperative bank owned principally by the state of Alaska and, through its affiliation with the National Bank of Cooperatives, makes fishing and agricultural loans. The legislative definition of the bank is confusing: "CFAB is a public corporation and government instrumentality in the Department of Commerce and Economic Development but

has a legal existence independent of and separate from the state."

CFAB functions as an active and aggressive direct lender, making loans to the fishing and agricultural industry.

CFAB has an unfair advantage for the following reasons:

- (1) It was capitalized by a \$30 million 9-1/2% state loan, making it Alaska's third largest bank in terms of capital.
- (2) It is exempt from all state and municipal taxes.
- (3) Its employees receive state salary and full benefits plus additional unreported bonuses.
- (4) It is not regulated by the state or federal government as are all other financial institutions.
- (5) It is in direct competition with private financial institutions and since it is state-financed, offers higher employee compensation, lower loan rates, and is free from regulation. It has a decided and unfair advantage.

It is recommended that CFAB either be abolished or be required to discontinue making direct loans so that it operates only as a secondary lender.

CONCLUSION 7:

Inequities created by current state loan programs should be corrected by allowing re-financing of residential and commercial real estate through state loan programs as restructured in this report.

Qualified individuals and businesses should have a program to refinance existing real estate mortgages that were made at high interest rates during periods of unusual rate fluctuations. To deny this is to grant an unfair advantage to new borrowers.

Refinancing of existing indebtedness should be limited to those loans that were made at rates in excess of 1/2% above the rate for comparable loans under current state programs.

To avoid creating a "bandwagon effect" of loans being obtained with intent to extract equity under this program, only loans existing prior to January 1, 1981 should qualify for refinancing, and only to the extent of their existing indebtedness.

CONCLUSION 8:

Alaska should not establish a central bank. State loan programs, properly restructured, can fulfill the more beneficial functions performed by the Bank of North Dakota without undermining Alaska financial institutions by competing directly for deposits and loans.

The Bank of North Dakota was established by the state legislature in 1919 with capital provided by the state. The purposes for organization of the bank were to encourage and promote agriculture, commerce, and industry.

Operating from its single location in Bismarck, North Dakota, the bank accepts time and checking accounts from individuals and corporations, including correspondent accounts from the other 173 North Dakota banks.

The bank is active in V.A. and F.H.A. home loans, student loans, farm loans to 50% of value, and bank stock loans to residents of North Dakota. Except for these, the bank is prohibited from making private and commercial loans.

As of December 31, 1979, total assets of the bank were \$624,701,209, with deposits of \$408,297,084, representing 11% of total bank deposits in North Dakota. Deposits of the next largest bank in the state were \$117,222,000. Thus, by size, the Bank of North Dakota dwarfs the private financial institutions of the state.

The bank has accomplished its stated lending objectives, and has assisted the private financial system by serving as a central bank for check clearings, loan participations, and as a secondary market for the purchase of loans originated and serviced

by private lenders. To a limited extent, the bank accepts direct deposits from the public and state government agencies and thus is in direct competition with private industry.

Interviewed at his office in Bismarck, the Executive Director of the North Dakota Bankers Association, Harry Argue, suggested that his members feel that the state-owned bank should not have been chartered. He was somewhat critical of the bank's direct dealings with the general public. He was supportive of its secondary market and other activities on behalf of private financial institutions.

The President of the Bank of North Dakota, Herb Thorndal, stressed the bank's secondary market activities and support services for the private financial community, which constitutes the bulk of its current activity. He emphasized that the bank has very limited contact with the general public. He agreed that many of its more important financial activities could be accomplished under a different structure, for example, as a state division rather than a bank.

In summation, Alaska state loan programs, properly restructured, can fulfill the more beneficial functions performed by the North Dakota Bank without undermining the deposit structure of Alaska financial institutions and without competing directly with private institutions for deposits, loans, or personnel.

CONCLUSION 9:

The state must outgrow its "crisis mentality" and institute a long-term approach to state loan programs, thereby bringing stability to the financial market of Alaska.

Through a variety of beneficial programs the state has injected money back into the economy for the financing of homes and businesses. Even though steps have been taken each year to fill the gaps in home financing, the lack of continuity has at times created panic buying.

This panic buying not only creates severe market distortions, but creates major problems for those Alaskans involved in the housing industry.

State programs should provide long term stability to the financial market of Alaska. The recommendations contained in this report, when enacted, will bring efficiency and stability to an extremely important segment of the state's economy. These improvements should be viewed as semi-permanent, long-term solutions to the challenges presented by state loan activities.

Future adjustments or "tinkering" with these programs should only be permitted for good reason and after careful study. This will contribute a much-needed element of permanence, stability and predictability to state loan programs and, therefore, to the economy on a whole.

SUMMARY

In summary, if the legislature adopts the recommendations of this report, it will:

- (1) drop the twelve redundant agencies from the books;
- (2) scrap ARRC and CFAB or severely limit their activities before they encroach further on private sector functions;
- (3) combine the remaining loan programs into three lean and accountable loan authorities,
- (4) confine state government lending to secondary market activities,
- (5) launch an independent audit and examination of all state loan programs.

The above accomplishments will contribute to a strong and healthy future for Alaska, providing the right balance of public and private sectors for the betterment of all its citizens.



"If the state, inspite of good intentions, continues to encourage direct lending, many observers fear the private sector may be swamped by government."

COMMONWEALTH NORTH

Commonwealth North is a non-profit corporation, organized and existing under the laws of the State of Alaska. Non-partisan in nature, its purpose is to inject enlightened vitality into the world of commerce and public policy.

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