

COMMONWEALTH NORTH

**Permanent Fund Earnings—Phase II
A Cornerstone for Fiscal Certainty**

**1999 COMMONWEALTH NORTH
PERMANENT FUND STUDY GROUP**

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COMMONWEALTH NORTH**Permanent Fund Earnings—Phase II
A Cornerstone for Fiscal Certainty****SUMMARY OF PROPOSALS AND RECOMMENDATIONS**

1. **THE EARNINGS OF THE PERMANENT FUND MUST BE CONSIDERED PART OF THE STATE'S TOTAL FISCAL PACKAGE.** Permanent Fund earnings must be considered part of a total state fiscal package that includes getting the most from money spent for state government. This includes establishing performance measures, maximizing efficiency, eliminating redundancies, scrutinizing the validity and existence of programs, shifting costs to local governments where appropriate, and investing enough to manage commonly owned resources effectively.

Other fiscal tools that need to be employed are: enhancing the returns on other state owned assets, use of the Constitutional Budget Reserve (CBR), use of untapped bonding capacity for capital projects, an income or a sales tax, and more direct user fees for services.
2. **THE PRINCIPAL OF THE PERMANENT FUND SHOULD REMAIN FULLY PROTECTED AGAINST INFLATION.** The principal (the corpus) of the Permanent Fund should be fully protected by preservation of the principal. It can be maintained and protected from inflation by asset allocation and use of an endowment concept.
3. **THE PERMANENT FUND DIVIDEND PROGRAM SHOULD CONTINUE.** The current individual Permanent Fund Dividend Program should continue, using a portion of the Permanent Fund's earnings. The Permanent Fund Dividend should not be capped at any particular level, but 40% of the earnings of the Permanent Fund should be devoted to individual dividends.

4. **THE EARNINGS OF THE PERMANENT FUND SHOULD BE USED TO SUPPORT GOVERNMENT AND FOR THE OTHER USES OUTLINED BELOW.** The biggest single departure from current practice is that Commonwealth North recommends using 30% of Permanent Fund earnings derived from an endowment concept to support state government and for additional purposes as outlined below. This 30% should be funneled through the Constitutional Budget Reserve account.
5. **CREATE A COMMUNITY DIVIDEND PROGRAM.** 20% of the Permanent Fund's earnings should be used to provide a means for local communities to meet their capital needs. The closer that decisions can be brought to the people involved, the more efficient and responsive those decisions will be. Creation of a Community Dividend Program would meet this policy objective.
6. **SUPPORT STATEWIDE CAPITAL NEEDS.** 10% of the Permanent Fund's earnings should be used to fund statewide capital needs and deferred maintenance that provide and maintain infrastructure to support economic sustainability and growth.



Permanent Fund Earnings—Phase II A Cornerstone for Fiscal Certainty

TABLE OF CONTENTS

	<u>PAGE</u>
Study Group co-chairs, members, and participants.....	1
Summary of proposals and recommendations.....	2
Table of contents.....	4
Introductions.....	5
The Study Group's purpose.....	7
The Study Group's process.....	7
Background.....	8
Need for immediate action.....	8
Total fiscal package.....	9
Public uses of the Permanent Fund.....	10
Preservation of principal.....	10
Permanent Fund dividend.....	11
Community Dividend Program.....	11
Statewide capital needs.....	12
General government operating needs.....	12
Support bonding capacity.....	13
Rainy Day account.....	13
Appendix A: Spreadsheet.....	14
Appendix B: Commonwealth North board members and officers.....	15

COMMONWEALTH NORTH**Permanent Fund Earnings—Phase II
A Cornerstone for Fiscal Certainty****INTRODUCTION**

To date, the earnings of the Alaska Permanent Fund have had no clearly defined public purpose beyond the personal dividend program. For the first time since the Permanent Fund's inception, current general fund revenues are insufficient to balance the general fund budget. The balance in the Constitutional Budget Reserve (CBR) is adequate for about three years of supplemental funding government at current levels.

The time has come to face this major fiscal issue.

This study addresses appropriate public purposes and uses of Permanent Fund earnings. So far, the only significant uses of Permanent Fund earnings have been preservation of capital through inflation proofing, and economic stimulus through the individual Permanent Fund Dividend.

Commonwealth North agrees in principle with these established uses, but goes further by taking a broad long-term view as to how they should fit into the total fiscal picture of the state. The biggest single departure from current practice is that Commonwealth North is recommending using Permanent Fund earnings to create revenue stability for Alaska.

Earnings available from the Permanent Fund will be defined as 5% of the five-year trailing average of the total value of the Permanent Fund. Only earnings will be expended. The corpus will remain untouched without a vote of the people, as specified in the Constitution.

In this concept, the Permanent Fund is defined as the total of all subaccounts within the overall Permanent Fund umbrella, with the exception of sufficient earnings reserve account to maintain the 5% earnings distribution. These subaccounts include the current corpus plus unrealized gains, realized gains, and a portion of the earnings reserve account. As of the date of this report, the aggregate of these subaccounts equals about \$26 billion. The value of these accounts will be protected against inflation by financial earnings produced by sound investment policy, asset allocation, and managing the aggregated subaccounts as one integrated portfolio to be maximized for long-term returns.

The current corpus of the Permanent Fund, increased by the addition of unrealized gains, realized gains, and a portion of the earnings reserve account, will continue to be Constitutionally protected. This enlarged corpus will further be increased by Constitutionally mandated resource revenues, and additional annual discretionary deposits

made by the Legislature from the earned surplus in excess of what is required to fund the annual endowment.

In the past, Permanent Fund market returns exceeded the 5% earnings distribution as outlined above. Historic real Permanent Fund earnings of 7.6% have been sufficiently in excess of the 5% distribution to accomplish this goal.

The Legislature has the Constitutional authority already to allocate and spend Permanent Fund earnings. Hence, no vote of the people is required for such expenditures.

In summary, Commonwealth North recommends that Permanent Fund earnings are best used to fund necessary government and sustain economic growth in Alaska. This can be accommodated by using earnings to:

- Protect the value of the fund through preservation of principal.
- Continue the individual Permanent Fund Dividend (PFD) which builds private sector economics through per capita expenditures.
- Institute a Community Dividend Program which will provide a better means for local communities to meet their capital needs. The closer that decisions can be brought to the people involved, the more efficient and responsive those decisions will be.
- Support statewide needs for infrastructure to support economic sustainability and growth.
- Supplement other state revenues to provide for general government operations.
- Provide underwriting support for bonding capacity of the State of Alaska.

Permanent Fund earnings must be considered part of a total state fiscal package that includes, in order of priority:

- Getting the most from money spent for state government. . This includes establishing performance measures, maximizing efficiency, eliminating redundancies, scrutinizing the validity and existence of programs, shifting costs to local governments where appropriate, and investing enough to manage commonly owned resources effectively.
- Enhancing the returns on other state assets as outlined in the October, 1998 Commonwealth North study "Alaska's Asset Portfolio: Managing for Maximum Return".
- Allocation of some Permanent Fund earnings: to pay the costs of government, for a Community Dividend Program, and to bolster the statewide capital budget.

- Prudent use of the Constitutional Budget Reserve (CBR) as a vehicle through which Permanent Fund earnings allocations are funneled to support the general fund budget.
- Use of untapped bonding capacity for capital projects within appropriate debt management guidelines.
- More direct user fees for services.
- Institute income or sales taxes only when all of the above are not sufficient to balance the budget.

The time to act is now. The aforementioned issues are within the Constitutional authority of the Legislature and the Governor to act, and should be immediately implemented.

The Study Group's purpose

In September 1998 this study group's purpose was defined to recommend appropriate uses for Permanent Fund earnings. However, a workable earnings distribution cannot be addressed without looking at the total state fiscal picture. A primary assumption is that economic growth is not only a fundamental purpose of government, but it is also indispensable for Alaska's long-term prosperity.

The Study Group's Process

Upon receiving its direction from the board, a group of 25 men and women met weekly from October 1998 to April 1999.

Meetings included in-person interviews with a wide range of resource people who were well-informed about the history and practice of the Permanent Fund. These people include (in alphabetical order): Commissioner of Revenue Wilson Condon, Dr. Scott Goldsmith of UAA's I.S.E.R., Senator Rick Halford, former Governor Jay Hammond, former Governor Walter Hickel, Roy Huhndorf, Julie Kitka, Steve Rieger, Clem Tillion, Nancy Bear Usera, and Eric Wohlforth.

In addition to this strong resource base, many Commonwealth North members submitted suggestions. Newspaper and magazine articles, and position papers were studied and analyzed. Legislators were consulted. In short, the study group actively solicited input from a widely diverse group of knowledgeable sources.

From this large volume of information, the study group crafted an approach and, in an interactive dialogue with the Commonwealth North board of directors, forged a consensus on key points.

Background

Alaska is faced with a paradox. On the one hand, the projected state budget has a billion dollar annual shortfall that is prompting a search for additional sources of revenue through taxes—either income or sales. On the other hand, the \$25+ billion Permanent Fund is paying out personal dividends that could eliminate the shortfall. Diversion of the dividend from personal to collective use could solve the problem from a purely financial point of view. However, in practical terms, the situation is more complicated.

The Alaskan public has developed a fierce loyalty to the Permanent Fund Dividend (PFD). No public official has yet felt comfortable with the concept that Permanent Fund earnings would be appropriated without a vote of the people. This political reality overshadows any discussion of public purposes for Permanent Fund earnings.

Any recommendation that does not win either tacit or overt public support is likely politically doomed. The fierce loyalty of the public to the Permanent Fund may overshadow any proposal to alter the Permanent Fund in any election, notwithstanding the need to do so. As such, the study group and board of directors have made recommendations that are politically pragmatic and represent sound public policy.

We have been quite specific in recommending allocation of Permanent Fund earnings. What is crafted herein is a recommendation for using the earnings of the Permanent Fund for public purposes beyond simply a personal dividend.

Need for immediate action

Use of Permanent Fund earnings must be addressed immediately:

- a. Waiting until the entire Constitutional Budget Reserve is depleted will severely limit options, reduce income generated by the CBR, and lead to severe short-term cash flow problems in three to four years.
- b. We have an immediate political crisis, not an immediate fiscal crisis. With approximately \$28 billion in liquid reserves, and a \$1 billion annual revenue shortfall (3.6% of liquid reserves), Alaska has the tools to solve its financial problems. However, the political crisis, if unresolved, could lead to a fiscal crisis.
- c. While short and intermediate term cash management issues must be addressed immediately, it is important to not lose sight of long-term asset management and policy goals. It is just as important to maintain and enhance the wealth of Alaska as it is to balance the state's checkbook.

Total fiscal package

Permanent Fund earnings must be considered part of a state fiscal package that includes, in order of priority:

- a. Getting the most from money spent for state government. This includes establishing performance measures, maximizing efficiency, eliminating redundancies, scrutinizing the validity and existence of programs, shifting costs to local governments where appropriate, and investing enough to manage commonly owned resources effectively. Appropriate tools to encourage and reward efficiency are still largely absent from Alaska's laws. Spending cuts must be part of any solution to the state's fiscal gap, but cannot close the gap by themselves. Non-need based programs that are widely seen as wasteful or of little value other than for their beneficiaries should be ended as quickly as possible.
- b. Enhancing the returns on other state assets (as outlined in the October, 1998 Commonwealth North study "Alaska's Asset Portfolio: Managing for Maximum Return"). This additional revenue can become a significant part of the state's financial picture.
- c. Use of the Constitutional Budget Reserve (CBR). Under guidelines established by the Legislature, use available funds in the CBR in conjunction with the use of Permanent Fund earnings and/or taxes for general government purposes.
- d. Use of some Permanent Fund earnings to pay the costs of government is required under any workable solution to the state fiscal gap.
- e. Use of untapped bonding capacity for capital projects within appropriate debt management guidelines.
- f. Even with a significant reduction in state spending, more direct user fees for services, and use of Permanent Fund earnings, there will remain a need to generate additional revenue through a statewide general tax such as a sales tax or personal income tax at some point in the future. Instituting an income or sales tax should be the last resort for additional revenues.

Public uses of the Permanent Fund

Commonwealth North considers the following to be beneficial public priorities of the Permanent Fund:

- a. Preservation of principal. The value of the Permanent Fund must at least stay even with inflation to maintain its purchasing power. This includes the corpus, the earnings reserve account, and unrealized gains.
- b. Remain a vehicle for converting income from non-renewable natural resource wealth into renewable financial wealth.
- c. Build private sector economics through per capita expenditures. The practical implementation of this policy is continuation of the individual Permanent Fund Dividend (PFD).
- d. Provide a means for local communities to meet their capital needs. The closer that decisions can be brought to the people involved, the more efficient and responsive those decisions will be. Creation of a Community Dividend Program would meet this policy objective.
- e. Support state-wide capital needs that provide infrastructure to support economic sustainability and growth.
- f. Supplement other revenues to provide for general government operations.
- g. Provide underwriting support for bonding capacity of the state of Alaska.
- h. Remain a “rainy day” safety net account for unforeseen financial emergencies that are beyond the capacity of the Constitutional Budget Reserve.

Preservation of principal

- a. Inflation proofing is a crucial aspect of the health of the Permanent Fund. Inflation transforms part of Permanent Fund principal each year so that it appears to be income. Spending some or all of this inflation-created “income” would, in effect, constitute a withdrawal from the Fund’s real principal. Returning the inflation-created “income” to the Fund corpus (i.e. inflation-proofing) is necessary to keep the corpus whole. Redefining the principal as the original corpus plus earnings reserve and unrealized gains yields a larger basis for investment allocation and calculation of the 5% earnings. Sound long-term investment policy will be the main engine of earnings as fund managers strive to achieve a return greater than the defined endowment rate of 5%.

- b. Asset allocation should be foundation of the investment process. Commonwealth North urges use of a real total return concept in defining Permanent Fund earnings. Earnings above the anticipated long-term level of inflation can be available for distribution. Most large college endowments and foundations use this concept. The earnings available for all uses would be defined as 5.0% of the average total value of the Permanent Fund for the last five years. While investment returns will vary year-to-year, under this endowment concept historical perspective indicates that in the long run the real earnings of the Permanent Fund will be sufficient to make the 5% payout and also inflation proof the corpus of the Fund.
- c. Creating a more predictable and steady source of income will facilitate better financial planning by the state and local governments.
- d. The total return concept, in conjunction with stable annual distributions, removes the political temptation to realize gains to increase the annual dividend, or to limit realized gains to minimize the dividend.
- e. Preliminary projections indicate that after inflation proofing, and after the Permanent Fund Dividend, the state will have over \$850 million per year to spend on contributions to the CBR, the Community Dividend Program, and the statewide capital budget. (Note: See the attached spreadsheet for reference.)

Permanent Fund Dividend

- a. The Permanent Fund Dividend (PFD) should not be capped as such, but be subject to the discipline of other uses of Permanent Fund earnings under allocations to be established by the Legislature.
- b. We think forty percent (40%) of Permanent Fund earnings (as defined above) should be allocated to the PFD. While this results in a drop in personal PFD from that of recent times, the total amount going to local economies when including the Community Dividend is about the same as recent payouts.
- c. Alaskans will maintain an interest in, and connection with, the performance of the Permanent Fund as their dividend will still be based on the investment performance of the Fund.

Community Dividend Program

- a. A Community Dividend Program (CDP) should be created as a part of the state fiscal package.

- b. We recommend that twenty percent (20%) of Permanent Fund earnings should be allocated to a CDP.
- c. The CDP could be linked to incentives for local participation.
- d. The CDP should not be an added burden to the operating budget. To the extent it supports local capital project initiatives, or replaces other local funding in the state operating budget, it would not be considered additive.
- e. It may be advisable to use an updated and strengthened version of the Municipal Bond Bank to allow communities to leverage their CDP income streams, and allow for a vote of the people before capital projects are approved.

Statewide capital needs

- a. Economic growth is dependent on basic public infrastructure, and its maintenance. Without sufficient capital investment, the economy will suffer and citizens will lead diminished lives.
- b. Alaska has also deferred maintenance of its capital assets beyond what is prudent. Regularly appropriated capital funds can be used to restore the value and quality of such assets.
- c. We believe that ten percent (10%) of Permanent Fund earnings should be allocated to statewide capital needs.
- d. Many local capital needs could be met through the Community Dividend Program, thereby lowering the need for additional capital appropriations at the state level.

General government operating needs

- a. The Legislature should emphasize spending money on essential services, with consideration of clearly defined “trigger points” based on state income levels available to spend, or on the CBR (as mentioned below) which would mandate previously determined cuts in specific programs.
- b. The Legislature should allocate thirty percent (30%) of Permanent Fund earnings for general government operating needs to be funneled through the CBR fund. The crucible of the legislative process, while imperfect and frustrating, is the alternative most open and responsive to ongoing public scrutiny.

- c. The role of the CBR is as a fund administered by the Department of Revenue as a short-term cash management vehicle.
- d. While the CBR is not part of the Permanent Fund, Commonwealth North does not recommend liquidating any portion of the Permanent Fund to add to the CBR. However, the CBR should be used as a vehicle to funnel Permanent Fund earnings to the general government operating budget. In this process, the Legislature must decide what is an appropriate level of funds to remain in this “rainy day” account and alter Permanent Fund earnings accordingly. When some minimum balance in the CBR cannot be maintained, this “trigger point” will mandate reduction of expenditures down to a core of only absolutely essential services.

Support bonding capacity

Since Alaska has almost no general obligation bonds (GO) outstanding, serious consideration must be given to using GO bonds as part of the state fiscal plan.

Traditionally, GO bonds have been used for capital improvements. Maintaining the value of the corpus of the Permanent Fund will provide very real collateral and assurance for bond investors. The Permanent Fund will reduce the cost of borrowing for the State of Alaska.

Rainy Day account

Even with the continuance of the Constitutional Budget Reserve and other smaller savings accounts, a truly huge unforeseen natural or social disaster could require additional resources. The corpus of the Permanent Fund itself would remain an account of last resort for such emergencies.

Appendix A: Spreadsheet

Commonwealth North Use of Permanent Fund Earnings (scenario 2)

	YEAR	2000	2001	2002	2003	2004	2005	2006
oil price (\$/bbl) [from state reference-case scenario, spring 99, linear forecast post 2005]		13.57	14.52	15.28	16.00	16.30	16.64	17.53
ANS oil production (Mbbbl/day) [from reference-case scenario, spring 99]		1.047	1.064	1.035	1.049	1.076	1.031	1.047
general fund revenue (\$M) [from reference-case scenario, spring 99]		1,300.6	1,331.2	1,342.3	1,347.5	1,340.5	1,280.0	1,316.7
general fund expenditures (\$M) [from Governor's budget less 60% of community dividend]		2,419.7	2,467.3	2,483.7	2,497.0	2,510.6	2,524.5	2,538.5
General Fund deficit (\$M)		-1,119.1	-1,136.1	-1,141.4	-1,149.5	-1,170.1	-1,244.5	-1,221.8
Constitutional Budget Reserve balance (start of year) (\$M)		2947.7	2676.8	2389.7	2098.3	1799.5	1480.4	1083.4
CBR balance (end of year) (\$M)		2537.3	2265.2	1988.9	1705.7	1403.2	1026.9	670.1
Permanent Fund corpus balance @7.6% nominal growth (\$M)		28348.3	28977.6	29620.9	30278.5	30950.7	31637.8	32340.2
Income @ 5% of corpus balance (\$M)		1417.4	1448.9	1481.0	1513.9	1547.5	1581.9	1617.0
PF balance (eoy) (\$M)		26930.9	27528.7	28139.9	28764.6	29403.2	30055.9	30723.2
PF dividend (\$/applicant) [population statistics from ISER]		980.40	969.67	1002.23	1013.34	1024.52	1035.95	1047.45
PF earnings for capital programs (\$M) (not included in GF expenditures)		141.7	144.9	148.1	151.4	154.8	158.2	161.7

Assumptions and boundary conditions:

- > Allocation of Permanent Fund earnings: 40% to personal dividend, 30% to CBR, 20% to community dividend, 10% to capital program
- > General fund expenditures from state forecast, no growth except population, reduced 60% of the annual community dividend, dividend added as an expendit
- > Spring 99 reference case oil price projections, linearly forecasted from 2006
- > CBR fund drawn down by \$1B in 99, grows @5.5%.
- > PF corpus defined as earnings reserve, unrealized gains and principal balance; grows at 7.6% annual nominal growth
- > Income defined as 5% of new PF corpus, earnings plowed back each year
- > PF dividend applicants based on ISER population forecast.
- > PF personal dividend based only on 1 year return

2007	2008	2009
18.14	18.75	19.36
1.046	1.046	1.045
1,314.7	1,312.7	1,310.7
2,552.7	2,567.3	2,582.1
-1,238.0	-1,254.6	-1,271.4
706.9	311.6	-103.6
295.4	-98.2	-511.4
33058.1	33792.0	34542.2
1652.9	1689.6	1727.1
31405.2	32102.4	32815.1
1059.05	1070.72	1082.66
165.3	169.0	172.7

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Appendix B: Commonwealth North board members and officers

President—Karen L. Hunt

Acting President—James D. Linxwiler, attorney, law firm of Guess & Rudd

Secretary—Eleanor Andrews, president, The Andrews Group

Treasurer—Joe Griffith, executive manager, finance & planning, Chugach
Electric Association

Richard F. Barnes, president, ENSTAR Natural Gas

James F. Branch, production manager, Exxon USA

Richard Campbell, president, BP Exploration (Alaska) Inc.

Ron Duncan, president, GCI

Mano Frey, executive president, Alaska State AFL-CIO

Glenn Godfrey, chairman, Koniag, Inc., and director, Alaska State Troopers

Edward Lee Gorsuch, chancellor, University of Alaska Anchorage

Walter J. Hickel, former Governor, co-founder of Commonwealth North

D. Max Hodel, founding board member of Commonwealth North

Jonathan Kumin, principal, Kumin Associates

Marc Langland, president, Northrim Bank

Loren H. Lounsbury, founding board member of Commonwealth North

Jeff B. Lowenfels, president, Yukon Pacific Corp.

Kevin Meyers, president, ARCO Alaska, Inc.

Rick Mystrom, Mayor, Municipality of Anchorage

Matthew Nicolai, president, Calista Corporation

Gene O'Hara, administrator, Providence Alaska Medical Center

Morton Plumb, director, Anchorage International Airport

Michael F. Porcaro, president, Porcaro Communications

Susan Ruddy, vice president, Nature Conservancy

Jo-Li Sellin, vice president, National Bank of Alaska

William Sheffield, former Governor, chairman, Alaska Railroad Corporation

William J. Tobin, editor, Voice of the Times, founding board member

Nancy Bear Usera, senior vice president, corporate relations, Alaska USA
Federal Credit Union

Duane Heyman, executive director, Commonwealth North