THE TRUSTEE PAPERS
Volume No. 3

The Role of the Permanent Fund in Alaska's Fiscal and Economic Future

A Collection of Public Policy Perspectives

Published August 1989

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August 14, 1989

Dear Fellow Alaskans:

On behalf of the Board of Trustees of the Alaska Permanent Fund Corporation, I am pleased to present **The Trustee Papers, Volume No. 3.**

The majority of the papers collected herein were originally submitted to the Joint House and Senate State Affairs Committees earlier this year at the public hearings conducted on the Permanent Fund. One result of those hearings was enactment of legislation establishing the Commission on the Future of the Permanent Fund.

The Trustees submit these papers to the Commission and the citizens of this state to encourage the public debate on the proper role of the Permanent Fund in Alaska's economic and fiscal future. In our view, these papers offer some clear thinking on many of the issues which are inevitably raised in this debate, and they also offer a diverse and worthwhile collection of reasoned arguments regarding specific uses of Fund income.

Although the Alaska Permanent Fund Corporation neither supports nor opposes any proposed changes to the current use of Fund earnings (except as they may relate to the proper exercise of the Trustees' fiduciary responsibilities as required under the prudent investor rule), we offer these thoughts for your consideration.

With tens of billions of dollars of Fund income at stake, it is well worth our time for all of us to try to understand not only the short-term but also the long-term consequences of any actions we may take regarding the Permanent Fund.

Sincerely,

John T. Kelsey

John T. Kelsey
Chairman, Board of Trustees

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Note: *The Trustee Papers, Volume No. 1,* printed in March 1982, is a collection of papers prepared for the Board of Trustees as part of a series of seminars conducted that year to address such issues as the appropriate criteria for public investment, the pros and cons of investing the Permanent Fund instate, and alternative methods of distributing Permanent Fund benefits.

The Trustee Papers, Volume No. 2, printed in April 1988, is entitled, "Wealth Management: A Comparison of the Alaska Permanent Fund and Other Oil-Generated Savings Accounts Around the World."

Copies of *The Trustee Papers* and all other public information materials prepared by the Alaska Permanent Fund Corporation are available by request at the Corporation's offices in Juneau and Anchorage.

Executive Summary

This collection begins with a talking paper adopted by the Board of Trustees of the Alaska Permanent Fund Corporation for submission to the Commission on the Future of the Permanent Fund. Entitled **Solving Alaska's Long-Term Puzzle**, it presents a logical way of approaching the debate on the proper role of the Permanent Fund in Alaska's fiscal and economic future.

Recognizing that the Permanent Fund is only one piece of a larger puzzle, it divides the study into three segments. The first segment involves revenues and expenses: (1) what is the expected range of long-term revenues; (2) what is the expected range of long-term expenditures; and (3) what are the characteristics of any enduring gap that may develop between revenues and expenditures?

The challenge will be to eliminate that potential gap and replace it with a healthy and sustainable fiscal and economic future. There are two possible approaches -- interim or transition measures, and long-term actions.

The second segment of the puzzle, therefore, concerns possible interim measures that would operate until long-term programs can take effect. Temporary measures that have been raised in public debate include bonding, budget reserve funds, increased production of state-owned resources, increased taxation, reduced rate of growth of expenditures, as well as other measures.

The third and most important segment is the long-term approach to creating a stable and lasting positive fiscal and economic climate. There are many pieces to this puzzle, of which the Permanent Fund is but one. Depending on the overall picture that emerges from the first two segments and the other pieces, the shape of the Fund's contribution to the picture will vary. Elements relating to the Fund that should be examined include the ultimate size of the Fund, inflation-proofing changes, dividend reduction or caps, increased contributions, dedications of Fund earnings to particular programs, and other topics.

It's Time for Public Involvement in Fund Debate is an opinion piece which appeared in an Anchorage newspaper at the beginning of the 1988 legislative session. It sets the tone for the debate on the future of the Permanent Fund, and urges all Alaskans to participate.

The author is Representative H. A. "Red" Boucher. He is the legislator who successfully sponsored the bill to establish the Commission on the Future of the Permanent Fund. An Anchorage Democrat, he serves as Chairman of the House State Affairs Committee and is a member of the Commission.

Five Observations on the Permanent Fund sets forth the following case: (1) the policy of investing the Fund outside of the state has been successful; (2) the Fund, to date, has acted as a positive counter-cyclical tool keeping the economy from overheating even more than it did during times of high revenues, and cushioning the fall in the economy during times of low state revenues; (3) the Fund has provided Alaska with its most significant economic diversification to date; (4) in real, inflation-adjusted dollars, the Permanent Fund has just about reached its maximum size; and (5) the best way to maintain a high income stream from the Permanent Fund is to maximize the amount added to principal annually from non-renewable resources, and to reinvest the maximum amount of earnings not absolutely necessary for current consumption.

The author is Oliver Scott Goldsmith. He is an economist with the University of Alaska Anchorage's Institute of Social and Economic Research.

Eight Hallmarks of Good Fiscal Policy describes the following characteristics of good government: clarity, balance, consistency, fairness, prudence, equity, ease of implementation, and it promotes responsible economic behavior.

The author is Peter McDowell. He was one of the original members of the Board of Trustees of the Alaska Permanent Fund Corporation.

Debate About Use of Fund Income Is Debate About State Government makes the point that the real debate over the use of Fund earnings centers on what programs and services the state will give her citizens on an ongoing, steady basis. The real debate is not about the expenditure of Fund income and the amount of that allowable expenditure, it is about the fundamental relationship between the people of Alaska and their government.

The author is Mary A. Nordale. She is currently a practicing attorney in Juneau, was formerly Commissioner of Revenue during the Sheffield Administration, and, in that capacity, served on the Board of Trustees of the Alaska Permanent Fund Corporation.

Using the Fund as a Counter-Cyclical Force in the Economy presents eight recommendations for changes to the status quo as follows: (1) use Fund income as a positive counter-cyclical force to diversify the economy and replenish the sources of jobs now provided on the North Slope; (2) when economic indicators dip dramatically, Fund earnings should be appropriated to local governments on a per capita basis, and when those indicators climb, those earnings should be used to help inflation-proof the Fund; (3) the legislature should create an Alaska Development Board to recommend for public financing major revenue-generating investments in the State of Alaska; (4) the financing should come from a portion of the Permanent Fund's approximately $600 million earnings reserve account; (5) although the Permanent Fund dividend program is beneficial and should be continued, there should be a limit placed on the size of the dividends; (6) inflation-proofing should not be automatic in depressed economic times; (7) Fund earnings should be used for state government operations only in dire emergencies; and (8) provisions for the use of Fund earnings should be written in state statute, not the Alaska Constitution.

The author is J. J. Brecht. He is currently a practicing attorney in Anchorage, was co-chairman of the Permanent Fund Committee of Commonwealth North which originally offered the recommendations included in his article, and is a former director of the state Division of Banking.

Financing Alaska's Development Through the Permanent Fund argues that it is important to address the issue of supportable government now. This means that the state must reduce unnecessary and low-priority programs and personnel, cut spending, bring down the projected cost of state government, and reinstate personal income taxes.

The author is Gary C. Anders. He is currently an associate professor of economics at the University of Alaska Southeast.

The Fund and the Alaska Economy From an Historical Perspective offers the prescription that whatever we do concerning the Alaska economy should be done with a clear understanding of what really happened over the past 15 years of Alaska economic history, and how much of this represented sustainable expansion and how much was simply a once-in-a-lifetime windfall.

The author is George W. Rogers, Ph.D. He is an economist currently residing in Juneau, and was the second chairman of the Board of Trustees of the Alaska Permanent Fund Corporation.

Use the Fund to Support Cultural and Economic Development makes the case that the Fund needs to be thought of as an engine that can drive economic and cultural development in the state. Rather than using the Fund simply to pay bills, it should be used to generate additional revenue through economic development and to enhance the quality of life.

The author is F. Thomas Trotter. He is president of Alaska Pacific University in Anchorage.

Included in the **Appendix** are two items.

The first item is a reprint of **The Alaska Fiscal Gap**, the first in a new series of *Fiscal Policy Papers* published by the Institute of Social and Economic Research (ISER). This paper, dated August 1989, presents four different strategies for closing the fiscal gap facing Alaska, and explores the consequences of implementing each of them, as well as the tradeoffs among them. The four fiscal choices discussed here seem to encompass the range of likely alternatives: (1) Stumble From Year to Year; (2) Deplete the Permanent Fund; (3) Freeze the Budget; and (4) Cut Spending and Raise Taxes.

The second item is a News Release which tabulates the results of a statewide survey, **"Closing the Budget Gap"** which was sponsored during the 1989 legislative session by the governor, the House and the Senate.

The survey was mailed to 248,821 households, and a total of 6,541 responses were received with the following results on questions relating to the Permanent Fund:

* Would you favor increasing state revenues by ***using Permanent Fund reserves?***

39% YES   58% NO

* Would you favor increasing state revenues by ***eliminating Permanent Fund dividends?***

15% YES   83% NO

* Would you favor increasing state revenues by ***capping Permanent Fund dividends?***

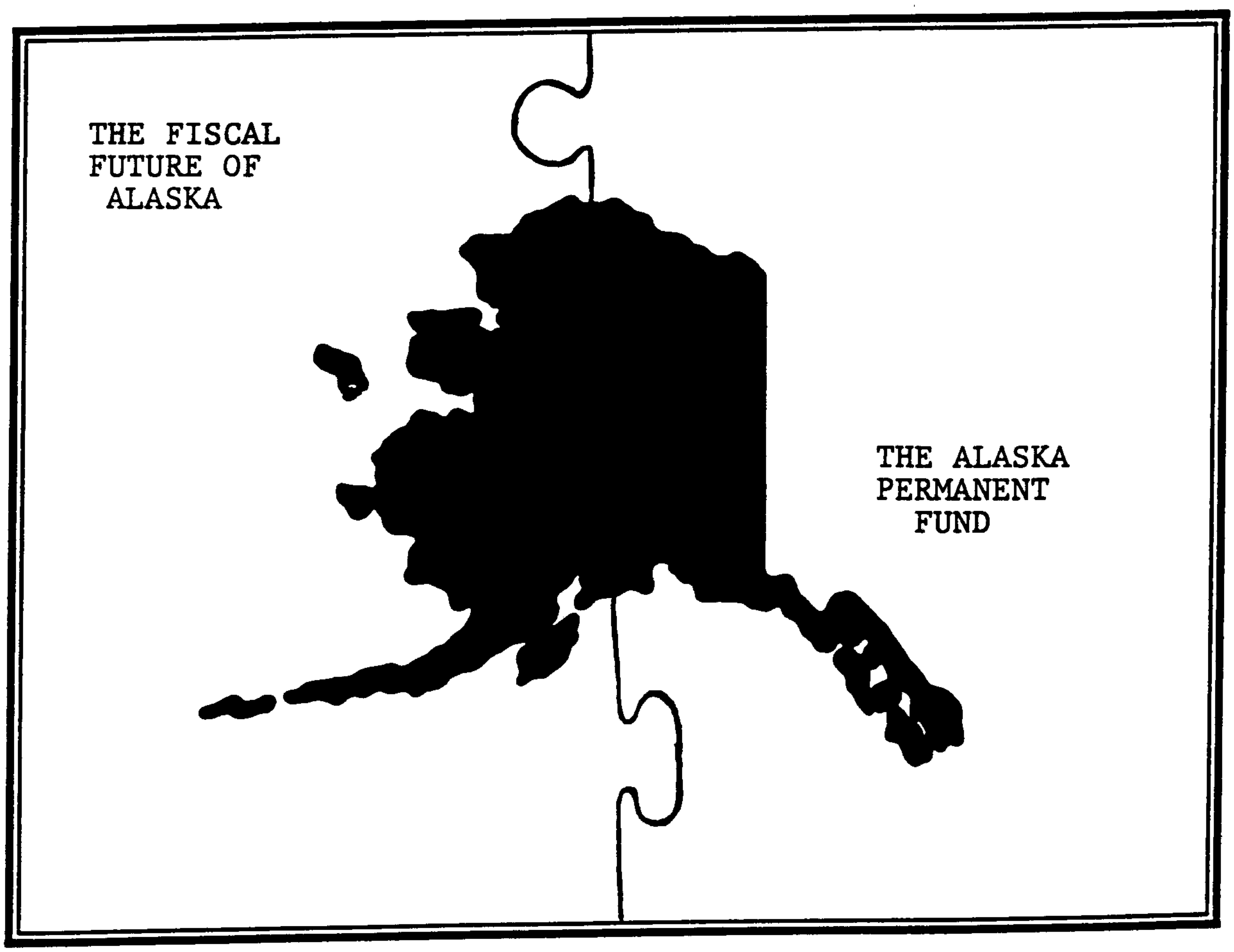
31% YES   67% NO

* Would you favor increasing state revenues by ***eliminating Fund inflation-proofing?***

13% YES   83% NO

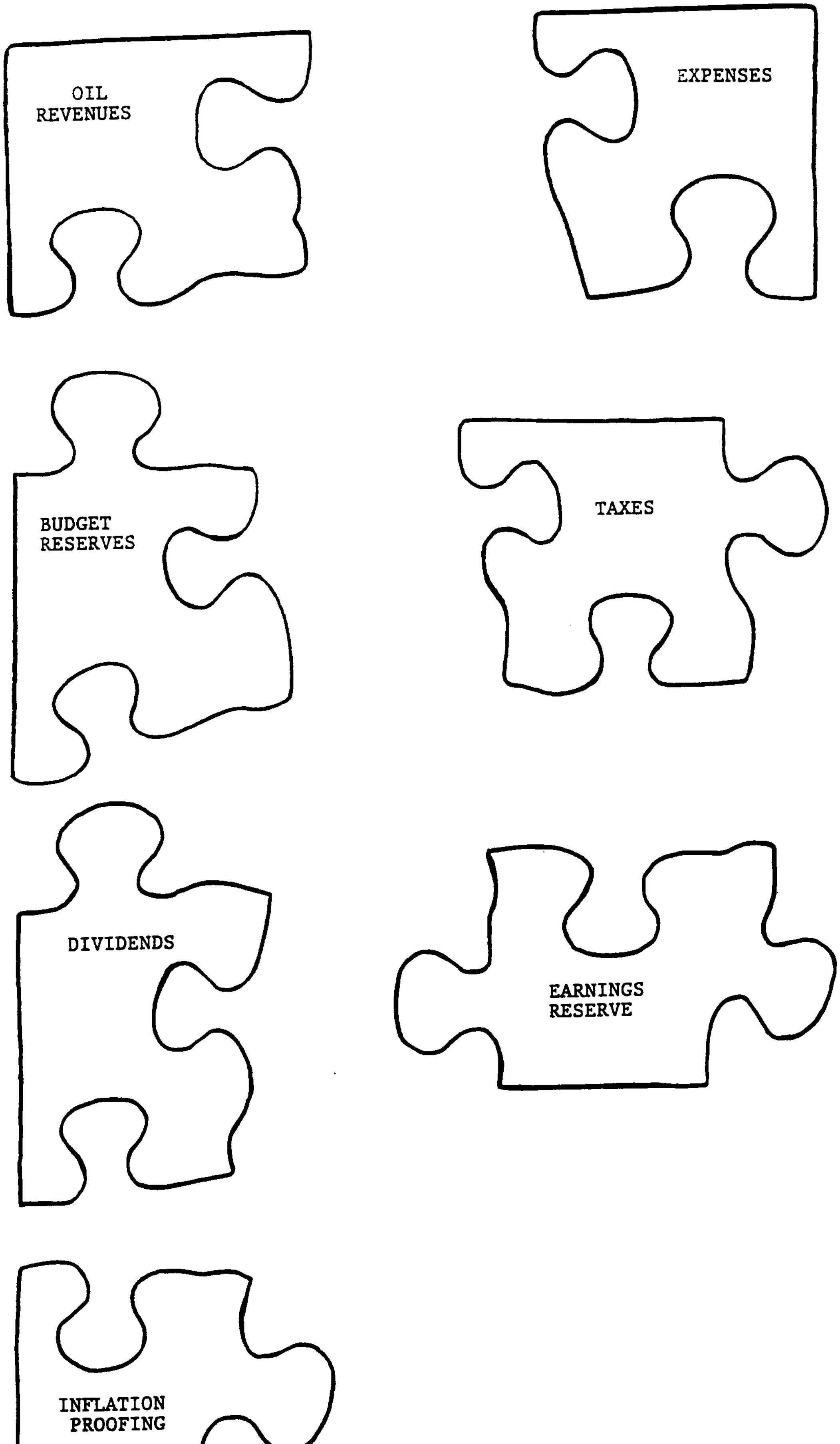
SOLVING ALASKA'S LONG-TERM PUZZLE

WHAT ROLE DOES THE ALASKA PERMANENT FUND PLAY IN THE FISCAL FUTURE OF THE STATE?



THE FISCAL FUTURE OF ALASKA WILL BE DETERMINED BY MANY VARIABLES.

THE PERMANENT FUND IS ONLY ONE PIECE OF THE PUZZLE AND WHILE THE FUND IS IMPORTANT, IT SHOULD NOT DOMINATE OR DICTATE ALASKA'S FISCAL FUTURE.


OIL
REVENUES
EXPENSES
BUDGET
RESERVES
TAXES
DIVIDENDS
EARNINGS
RESERVE
INFLATION
PROOFING

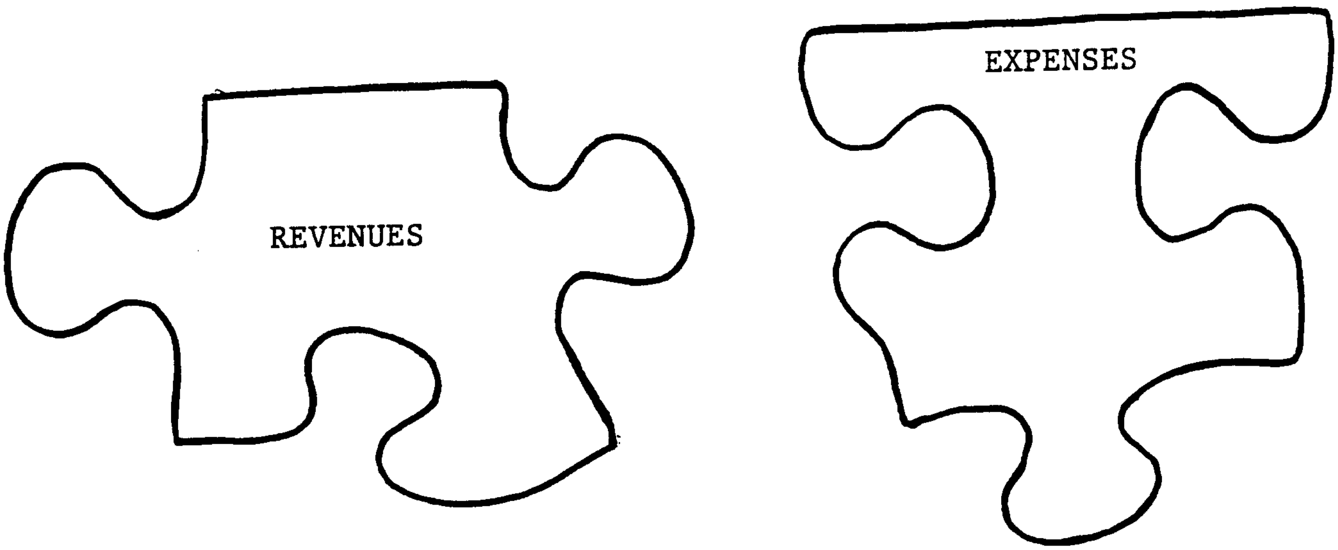
INDEED, AN EVALUATION OF ALASKA'S FISCAL FUTURE AND THE ROLE OF THE FUND CAN BE DIVIDED INTO THREE STUDY SEGMENTS.

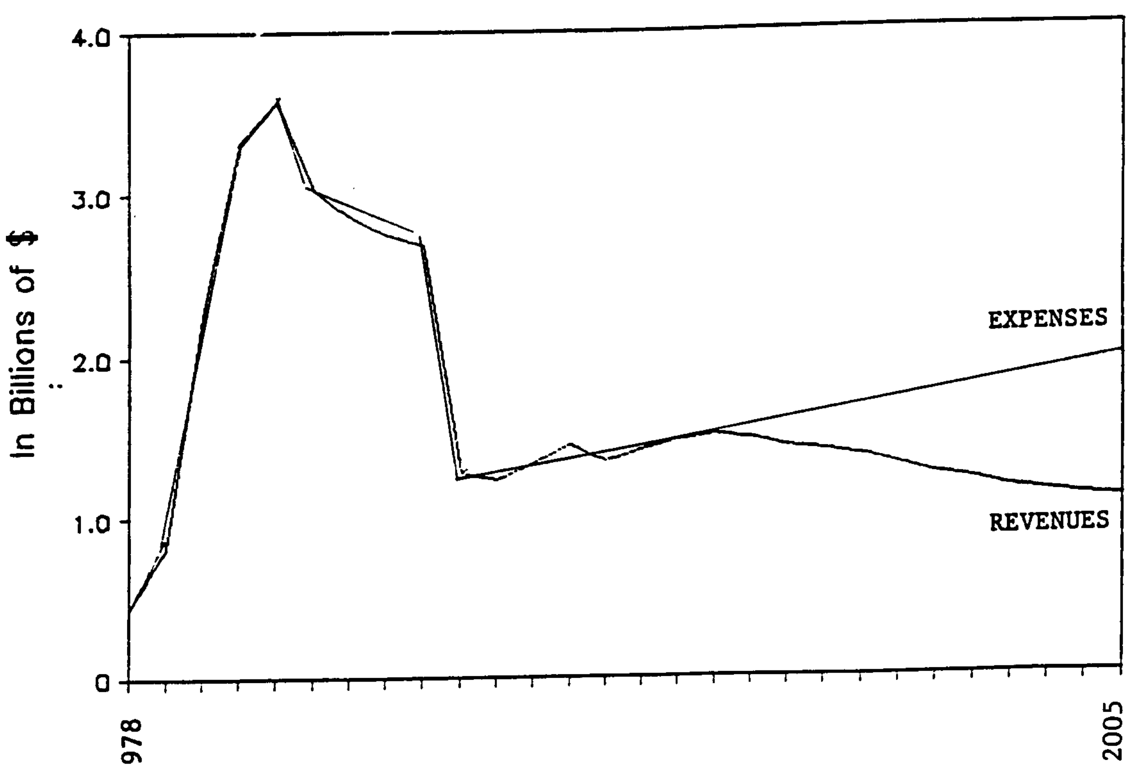
THE FIRST SEGMENT INVOLVES REVENUES AND EXPENSES.

* WHAT IS THE MOST VALID LONG-TERM REVENUE RANGE?

* WHAT IS THE MOST VALID LONG-TERM EXPENDITURE RANGE?

* WHEN WILL THE LINES CROSS WITH EXPENDITURES EXCEEDING REVENUES?


REVENUES
EXPENSES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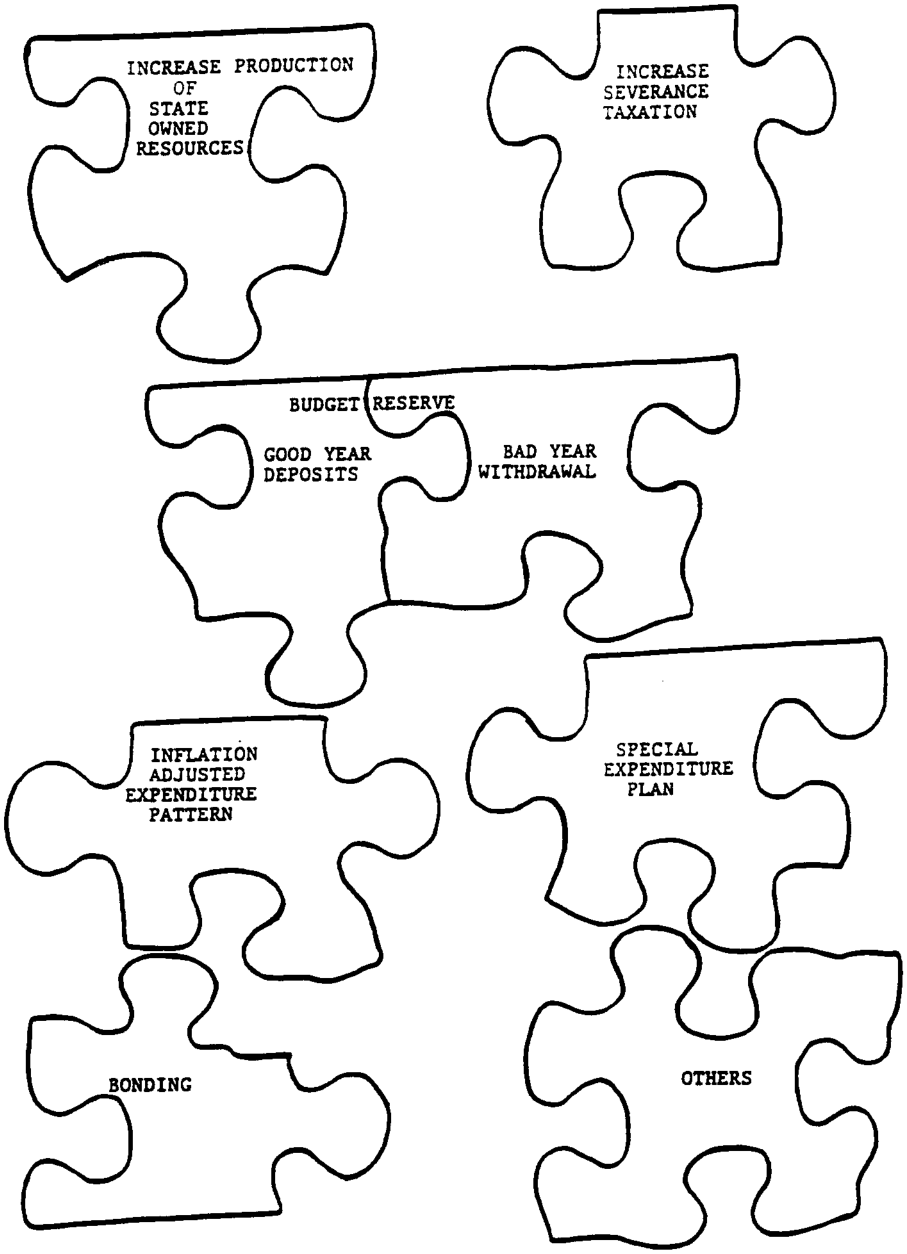
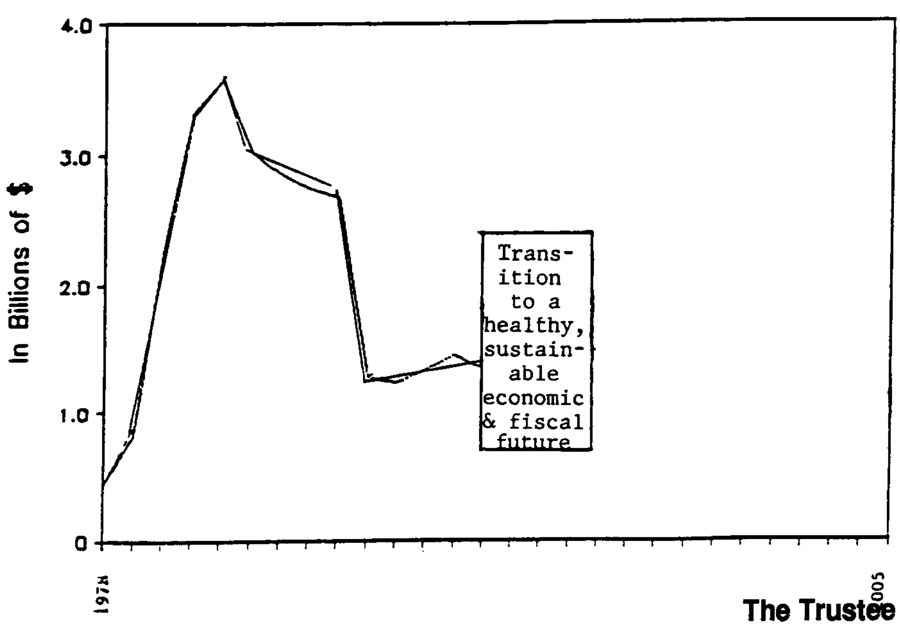
3.0
2.0
1.0
0
In Billions of $
EXPENSES
REVENUES
1978
2005

THE SECOND SEGMENT INVOLVES METHODS WHICH CAN BE INTRODUCED -- ON AN INTERIM BASIS -- TO MOVE TOWARD A HEALTHY SUSTAINABLE ECONOMIC AND FISCAL FUTURE.

* AN INCREASE IN REVENUES
* REDUCED RATE OF GROWTH OF EXPENDITURES
* A BUDGET RESERVE ACCOUNT
* OTHERS


INCREASE PRODUCTION OF STATE OWNED RESOURCES
INCREASE SEVERANCE TAXATION
BUDGET RESERVE
GOOD YEAR DEPOSITS
BAD YEAR WITHDRAWAL
INFLATION ADJUSTED EXPENDITURE PATTERN
SPECIAL EXPENDITURE PLAN
BONDING
OTHERS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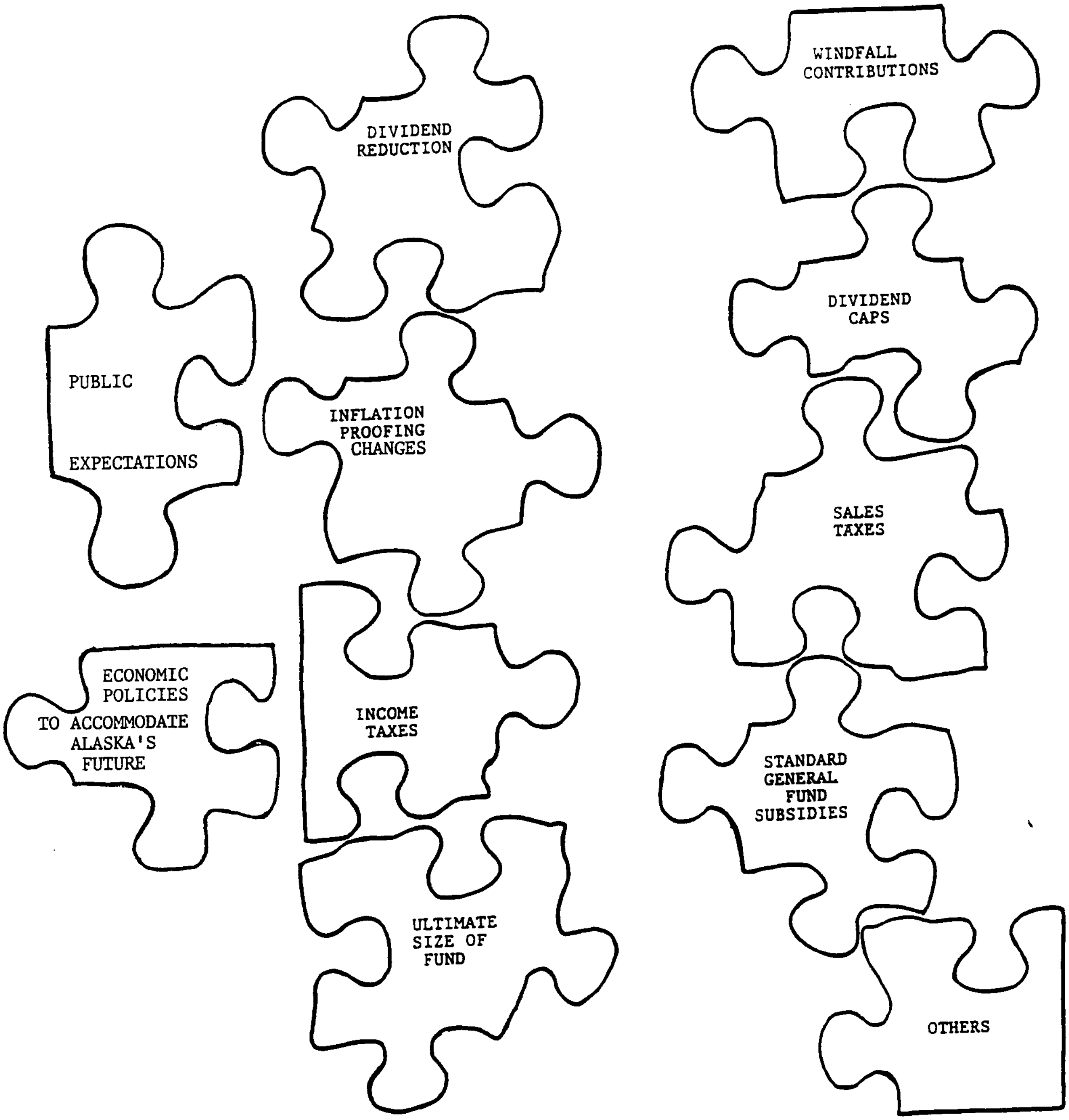
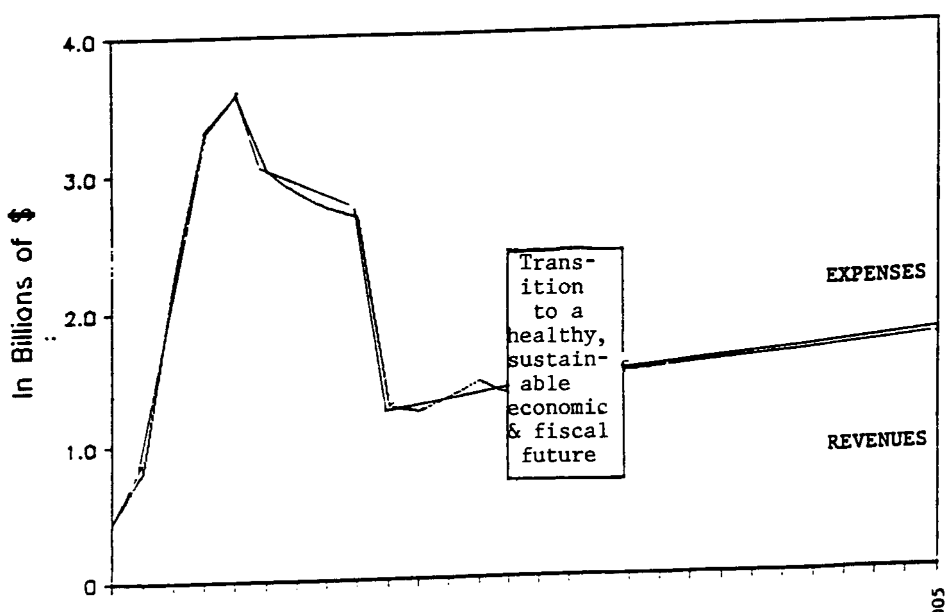
In Billions of $
Trans-ition to a healthy, sustain-able economic & fiscal future

THE THIRD SEGMENT DEALS WITH ESTABLISHING A STRATEGY FOR A HEALTHY SUSTAINABLE ECONOMIC AND FISCAL FUTURE AFTER IMPLEMENTATION OF THE FIRST TWO SEGMENTS.

IT INVOLVES EXAMINATION OF ALL COMPONENTS OF THE PERMANENT FUND AND A BLEND OF OTHER MEASURES TO MEET ALASKA'S FISCAL NEEDS.

FURTHER, IT INVOLVES THE NEED FOR DEVISING ECONOMIC POLICY TO ACCOMMODATE ALASKA'S FUTURE.


WINDFALL CONTRIBUTIONS
DIVIDEND REDUCTION
DIVIDEND CAPS
PUBLIC EXPECTATIONS
INFLATION PROOFING CHANGES
SALES TAXES
ECONOMIC POLICIES TO ACCOMMODATE ALASKA'S FUTURE
INCOME TAXES
STANDARD GENERAL FUND SUBSIDIES
ULTIMATE SIZE OF FUND
OTHERS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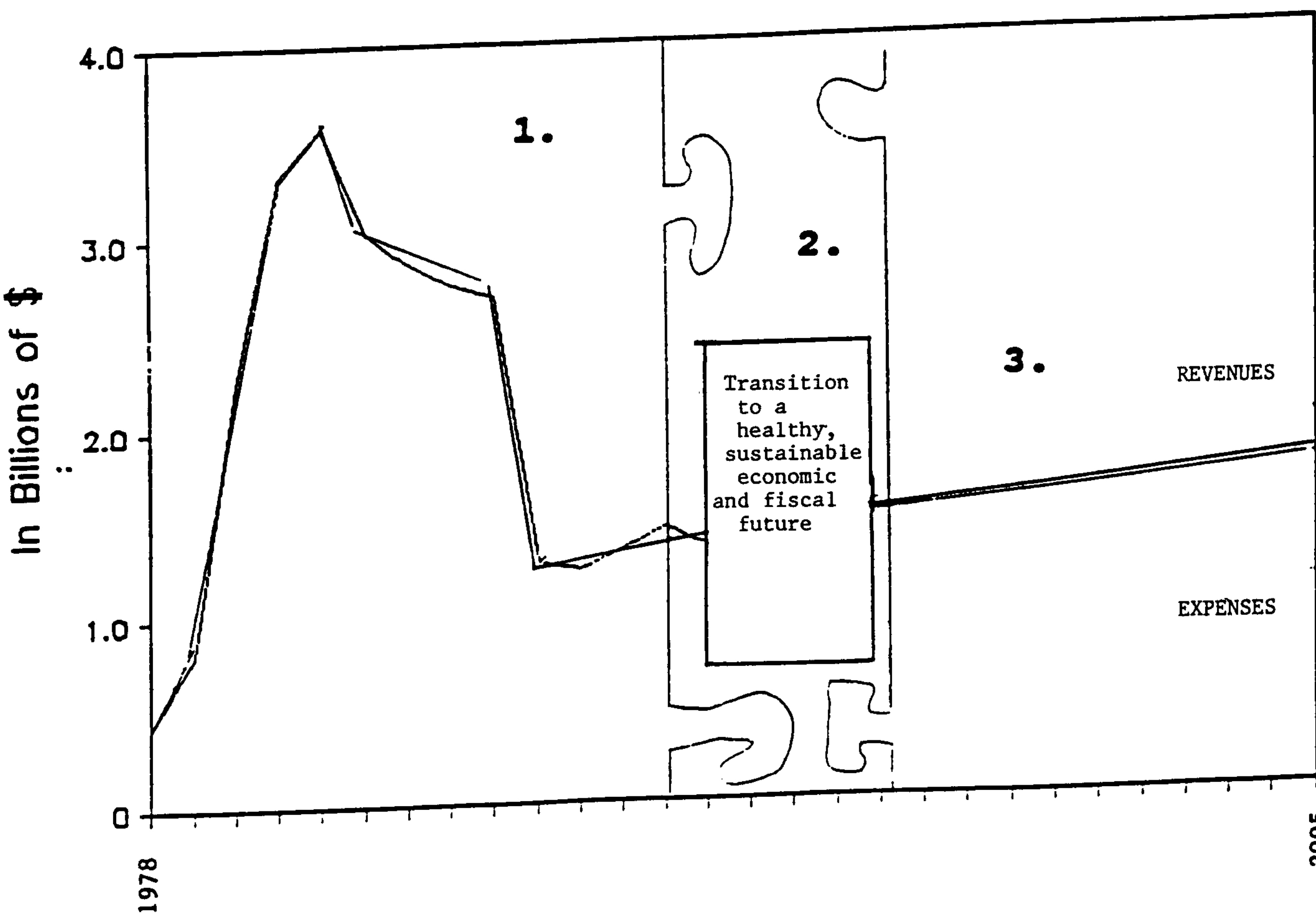
In Billions of $
Transition to a healthy, sustainable economic & fiscal future
EXPENSES
REVENUES
2005

IN CONCLUSION -- ALL THREE SEGMENTS CONTRIBUTE TO LONG-TERM STABILITY THROUGH A LONG-TERM PLAN.

1. DEFINE REVENUE AND EXPENDITURE RANGES

2. TRANSITION MEASURES

3. LONG-TERM FISCAL AND ECONOMIC MEASURES



Notes

It's Time for Public Involvement in Fund Debate

By Rep. H. A. (Red) Boucher

This originally appeared as a Compass article on the Forum page of the Anchorage Daily News *on January 11, 1989.*

Is the 1989 legislative session the time to start using the earnings of the Permanent Fund to help pay the costs of state and local government? What do you think?

As chairman of the House State Affairs Committee, I intend to focus a great deal of time, energy and public attention on the Permanent Fund. Why? Because, in my view, none of the critical budget decisions of the coming session can be made until the people of this state have reached consensus on the Permanent Fund.

I intend to make the State Affairs Committee a forum for extensive public debate on the Permanent Fund and related issues, and I wholeheartedly encourage you to participate. Your first chance to do so will come on January 27 when the committee will begin two days of public hearings in Anchorage.

The pressure to use Permanent Fund earnings to balance the state budget is great, and it is growing. Should the legislature continue to resist this pressure?

My tentative answer, based on my perception of what Alaskans want at this time, is, "Yes, it should." I don't believe it is really the people's will to divert a portion of those earnings. I am skeptical for two reasons:

I believe it is appropriate and realistic to allow the Permanent Fund to grow to $20 billion by the turn of the century.

First, I believe that an ever-growing Permanent Fund is Alaska's great hope for the future. I believe it is appropriate and realistic to allow the Permanent Fund to grow to $20 billion by the turn of the century. If we can do this, not only will we have achieved a significant measure of economic freedom for ourselves, we will have provided a legacy for our children -- and for their children.

Projections by the Alaska Permanent Fund Corporation show this is "do-able"; in fact, if we leave the earnings untouched, it will happen. However, once we begin diverting fund earnings to help pay the ongoing costs of government, this goal will begin slipping away. Instead of a magnificent legacy, we might leave future generations only another depreciating asset.

Second, I agree with former Gov. Jay Hammond who told the legislature a couple of years ago:

"Should we start dipping into the Permanent Fund, either directly or indirectly, before exhausting more appropriate means of budget balancing, we will fail to make the hard choices now which can boost us onto firmer financial ground. And, unless those choices are made, I'm convinced you can not only kiss goodbye to your dividends, but hello to a much larger reliance on future income taxes than otherwise would be the case."

We all know that state government spent too much in the early '80s and that we have been paying for it with the recession of the last three years. Would using Permanent Fund earnings now be a sound business strategy, or would we, once again, be trying to solve a problem by throwing money at it?

We have to get beyond this constantly recurring cycle of boom and bust. We need to realize that the Permanent Fund can truly and finally make a difference, but only if we develop a long-term plan which protects the Fund and encourages its growth.

We have to get beyond this constantly recurring cycle of boom and bust. We need to realize that the Permanent Fund can truly and finally make a difference, but only if we develop a long-term plan which protects the Fund and encourages its growth.

I believe that Alaskans will not support changes in the use of Fund earnings or new taxes until more cuts have been made in the budget. The state must tighten its belt before they will tighten theirs.

But the day will come when we will have to make the hard decision of whether to increase taxes, reduce dividends or use undistributed earnings. Declining oil production and/or prices make that day inevitable. We are going to have to pay more of the bill for the services which remain when the budget cutting is done.

What should we do then? What do you think? What is the best long-term policy for the annual distribution of Fund earnings? Should we distribute earnings only after inflation-proofing has been provided? Or, should we cut back on inflation-proofing?

Our state, at present, has no reserves designated for emergencies. Would it be advisable to designate the Permanent Fund's earnings reserve account (the only reserve account the state has never spent) as not only a reserve for future dividends and inflation-proofing shortfalls, but also as a reserve for state emergencies?

The Permanent Fund is something wonderful we have done for ourselves. It offers real hope for the future, as well as security for today. It represents the wisest use of our one-time oil wealth to date. We have designed it well, we have invested it wisely, we have consistently added to it, and we have ceaselessly protected it with great vigor.

Once again the legislature must make decisions about the Permanent Fund. These decisions require wisdom, vision and a sense of what the public wants.

Where do you stand? Tell me.

Five Observations on the Permanent Fund

By Oliver Scott Goldsmith

These remarks were submitted as testimony to the Joint House and Senate State Affairs Committee at their public hearing on the Permanent Fund held in Anchorage on January 28, 1989.

I have five observations on the Permanent Fund today -- three that will probably be echoed by other speakers and which should be obvious but, nonetheless, bear constant repetition, and two which are perhaps not so obvious, but which bear upon the future of the Fund and so are very important.

First, the policy of investing the Fund outside of the state has been a tremendous success.

When the Fund reports a balance of $9.7 billion, there really are investments worth $9.7 billion in the portfolio. There are no turkeys among the holdings of the Fund. Those who suggest bringing the Fund home to put it to work within Alaska really mean "consume in Alaska" when they say "invest in Alaska." We have plenty of examples from the past 8 years of so-called investments undertaken by the state which were in reality consumption for the benefit of special interests. We do not need that for the Permanent Fund.

Second, the Fund has been a tremendous success as a counter-cyclical tool.

When the state was awash in petrodollars, appropriations to the Fund kept the economy from overheating even more than it did, and now that the inevitable recession has succeeded the boom, Fund earnings are providing a successful and automatic cushion against the fall in the economy.

Third, the Fund has provided the most significant economic diversification which has occurred in the state in at least the 14 years since I have been here.

Those who want to bring the Fund home or put it to work in Alaska, or simply question why we are not using the Fund, fail to recognize that the hundreds of millions of dollars that flow into the state each year from earnings is a diversified source of income as valuable to the state as the fishing industry, the tourist industry or the mining industry. Each is a source of new money flowing into the state.

These points are obvious but bear constant repeating. The next point is not obvious to the public.

Fourth, if we maintain current policies, the Fund has just about reached its maximum size.

To see why this is the case we need look no further than the most recent monthly financial report of the Fund. Lest anyone misinterpret my point, let me stress that I am not launching into a criticism of the management of the Fund. On the contrary, I believe the quality of management of the Fund is unprecedented in the state and fully expect the pattern of professional management to continue. Factors beyond the control of management have led me to make my statement.

There is no escaping the conclusion that, in the future, we cannot look to dedicated state revenues or special appropriations for a continuation of the rapid growth experienced to date in the principal of the Permanent Fund.

The most important page in the December monthly financial report of the Permanent Fund is the last one. There you will find a table entitled Financial Projections in which the growth of the Fund over the next 16 years is portrayed based on the assumption that the policies in place at the present time will continue unchanged. I have included the page as an attachment.

At the beginning of the current fiscal year, the balance in the principal of the Fund was $8.585 billion, not including the reserve account. The Fund grows through the deposit of a portion of annual petroleum royalties known as "dedicated state revenues" in the jargon of the Fund, and also through the deposit of special legislative appropriations.

This year, fiscal year 1989, the deposit of new money from these sources into the Fund is projected to be $152 million. This represents an increase in the balance of the Fund of 1.8% -- hardly an earth-shaking amount, and hardly comparable to the $1.285 billion of dedicated state revenue and legislative appropriation which increased the Fund balance by 266% in 1981.

Over the 16-year period between 1990 and 2005, the earnings of the Fund are projected to be a mind-boggling $22.4 billion. This surely is where the growth of the Fund will come from.

If this rate of addition from dedicated state revenues continues, the Fund will have a tough time getting much bigger than it is today. In fact, this is just the case as reflected in the projection of annual contributions expected in future years.

Over the 16-year period from 1990 to 2005, additional contributions of $1.099 billion will cause the Fund to grow by only 13%, based on the November 1988 Low Revenue Case Forecast of the Alaska Department of Revenue. No special appropriations are projected during this entire period. Another way to view the level of future contributions is to recognize that over the next 16 years, cumulative new contributions to the Fund will be less than they were in the year 1981, the year 1982, or even the year 1987.

I know that you are all thinking at this moment that surely prices, production, and revenues will ultimately be much larger than reflected in these recent revenue forecasts. Let us hope that turns out to be the case. But, if it does and revenues are twice the level reflected in this analysis, the next 16 years will still result in dedicated state revenues of only $2.198 billion -- scarcely more than was contributed during the last three fiscal years. Different scenarios will give somewhat different results, but there is no escaping the conclusion that we cannot look to dedicated state revenues or special appropriations for a continuation of the rapid growth of the balance of the Permanent Fund. In fact, if the population of the state grows at all over the next decade, the per capita balance of the Fund is likely to fall.

No one will deny the fact that inflation erodes the purchasing power of the dollar over time, silently but inexorably, and everyone is aware of the necessity of cost-of-living adjustments to maintain the purchasing power of their salaries.

That brings us to the earnings of the Fund. Surely we can count on the earnings of the Fund to drive growth of the Fund balance. We have just heard that, in the first six months of this year alone, the earnings of the Fund have totaled $421 million, and earnings for the entire year are estimated to be $818 million. Furthermore, over the 16-year period between 1990 and 2005, the earnings of the Fund are projected to be a mind-boggling $22.374 billion. This surely is where the growth of the Fund will come from.

While it is true that earnings driven by the rate of return on the Fund will be the main determining factor over the potential growth of the Fund in the future, we need to consider the two uses to which the earnings of the Fund are put before earnings are reinvested to augment principal. These two uses of the earnings are the inflation offset and distributions for current consumption, which occur now in the form of dividends.

No one will deny the fact that inflation erodes the purchasing power of the dollar over time, silently but inexorably, and everyone is aware of the necessity of cost-of-living adjustments to maintain the purchasing power of their salary; but inexplicably, many people deny that the Permanent Fund balance needs to be protected in the same way from the erosion of its value.

Essentially all of the earnings after inflation-proofing will be used for dividends, leaving no earnings to be used for increasing the real balance of the Fund.

The current method of protection, known as "inflation-proofing", although not perfect, serves this purpose reasonably well by earmarking a portion of earnings for reinvestment into the balance of the Fund. Critics of the concept of inflation-proofing argue that the Fund is automatically inflation-proofed. However, inflation-proofing would be automatic only if the Fund were entirely invested in equities since the price of stocks grows over time with the general price level.

In fact, the Fund portfolio is primarily invested in fixed-income assets which do not increase in price with the general price level. The only way to maintain the purchasing power of fixed-income investments is to allocate a portion of the earnings to principal to offset the loss due to inflation. This does not mean that fixed-income assets are inferior investments, only that inflation must be accounted for directly or the value of the portfolio will deteriorate over time.

This year, an inflation rate of 4% is anticipated in the

Financial Projections of the Fund. This means that the purchasing power of the $8.585 billion in the Fund at the beginning of the year will be reduced by 4% or $343 million by the end of the fiscal year. This is almost identical to the $350 million which is actually projected for inflation-proofing using the formula now in place.

After netting this $350 million out of total projected earnings of $818 million, there remains $468 million of earnings available for other purposes. Since the appropriation for the dividend program is projected to be $457 million this fiscal year, essentially all of the earnings after inflation-proofing will be used for dividends leaving no earnings to be used for increasing the real balance of the Fund. Thus, it is easy to summarize how the Fund will grow this year by noting that virtually all the growth in the purchasing power of the Fund will come from new contributions of dedicated state revenues -- $152 million. Earnings will contribute virtually nothing to growth of the purchasing power of the Fund. The entire earnings of $818 million is used for offsetting inflation and dividend distributions.

This is the case not only this year but a pattern which generally continues over the next 16 years as well under current policy. Actually, in the Financial Projections, the draw on the earnings of the Fund for dividends does not leave enough for a complete inflation offset through inflation-proofing. Furthermore, dedicated state revenues averaging $69 million annually are just a "drop in the bucket." Taken together, these factors result in an actual decline in the purchasing power of the Fund. So, even though in the year 2005 the nominal value of the Fund is projected to be $21.404 billion, the true value of the Fund in 1989 dollars is $9.016 billion. This is less than the projected value at the beginning of 1990 -- $9.086 billion. Furthermore, although earnings in 2005 are projected to be $2.019 billion, those billions are almost identical in purchasing power to the earnings expected this year.

PROJECTED CHANGES TO THE SIZE OF THE PERMANENT FUND IN 1989

BEGINNING BALANCE (1989 $):		$8.585 billion
dedicated revenues		.152
inflation (4%)		-.343
earnings	.818	
inflation proofing		.350
dividends	.457	
reserves		.011
ENDING BALANCE (1989 $):		$8.755 billion
NET CHANGE:		$ .170

The specifics of these conclusions, of course, depend upon the assumptions made concerning the rate of inflation and the rate of earnings of the Fund. But studies have shown that the general conclusion does not change when those assumptions are varied.

An immediate and important implication of the recognition that the Permanent Fund is not going to get any bigger than it is today, is that any suggestion of a method or formula for using the earnings of the Fund which results in the consumption of a larger fraction of the earnings than is currently being used, will gradually erode the balance of the Fund. It is just not possible to take more out of the Fund for current use without diminishing its value. We must not fool ourselves into the delusion that we can consume the earnings today and still have a growing Fund that will rescue us from fiscal irresponsibility at some future time. The erosion of the Fund would occur slowly and almost imperceptibly at first, but inexorably.

A second implication of this analysis relates to the notion that Permanent Fund earnings will one day replace petroleum revenues as the most important single source of revenues for the state. Although this is a true statement, we can take little comfort in it since it will not be because Permanent Fund earnings will continue to increase. Rather, it will be due to a decline in petroleum revenues. In fact, we have nearly reached that point already if the current state revenue projections hold true.

My final point addresses the question of where do we go from here. Now that the easy years of accumulation are behind the Fund, the question is raised more and more often as to what the ultimate purpose of the Fund is. I have already pointed out the fact that the Fund is an important renewable resource for the state, annually throwing off a sustained yield of some $400 million, a feat most other natural resources would be hard pressed to match. This sustained yield belongs to all Alaskans.

I submit this is the purpose for which the Fund was created and, like all other state resources, it should be guarded, protected, and nurtured in order to maximize its sustained yield. How the annual yield should be used -- for dividends, to fund public expenditures, to pay for infrastructure development -- is an important but separate question from that of maintaining the yield.

Fifth, the best way to maintain the yield from this marvelous renewable resource is to maximize the amount added to the principal annually from non-renewable resources, and to reinvest the maximum amount of earnings not absolutely necessary for current consumption.

This rule is consistent with fiscal reality. Any suggestion for altering the policies under which the Fund has grown from an idea to a $10 billion asset, which does not recognize the Permanent Fund as the centerpiece of a long-term state fiscal policy, should be avoided like the plague. Since we do not have a long-term policy, there is no reference point for changing how earnings are used and no changes should be considered.

Elsewhere, I have suggested a number of indicators which provide a better indication of our dependence on non-renewable petroleum resources than those we currently use and could form the basis for a fiscal plan. One is the sustainable spending level. This level varies depending upon one's time horizon and the general price level, but the sustainable spending level has tended to hover in the range of $1.4 to $1.6 billion. This measure, even if correct only within half a billion dollars, suggests that our public sector is living on borrowed time and cannot sustain the current appropriation level (in terms of real purchasing power) even with full use of the yield of the Permanent Fund. If we consume more of the Fund today than is consistent with that level, the Permanent Fund will ultimately be destroyed.

Alaska Permanent Fund Corporation

FINANCIAL PROJECTIONS
(in millions)

as of December 31, 1988

	PRINCIPAL						INCOME							
								Distributions				Reserves		
FY	FY Begin Balance	Appro-priations	Dedicated State Revenues*	Inflation Proofing	FY End Balance	Inflation Proofing Shortfall	Net Income	Dividends	Per Capita Dividends**	Inflation Proofing	General Fund	Add (Delete)	FY End Balance	FY
78			54		54		2				1			78
79	54		84		139		8				7			79
80	139		344		483		32	12			12			80
81	483	900	385		1,769		150	28			28	59	59	81
82	1,769	800	401		2,969		368	71	$1,000.00		71	185	244	82
83	2,969	400	421	231	4,021		471	108	$386.15	231	110	110	354	83
84	4,021	300	366	151	4,838		530	175	$331.29	151		203	557	84
85	4,838	300	368	235	5,741		658	217	$404.00	235		206	763	85
86	5,741		323	216	6,281		1,021	303	$556.26	216		501	1,264	86
87	6,281	1,264	171	148	7,864		1,069	391	$708.19	148		529	529	87
88	7,864		418	303	8,585		789	424	$826.93	303		62	591	88
89	8,585		152	350	9,086		818	457	$834.98	350		11	602	89
90	9,086		72	458	9,616		810	474	$857.19	458		(121)	481	90
91	9,616		83	582	10,281		955	468	$837.57	582		(94)	387	91
92	10,281		89	622	10,992	$22.374	1,010	463	$819.66	622		(75)	311	92
93	10,992		88	665	11,744		1,069	490	$859.96	665		(85)	226	93
94	11,744		85	710	12,539		1,132	523	$910.36	710		(100)	126	94
95	12,539		81	757	13,377		1,197	563	$973.41	757		(123)	3	95
96	13,377	$1,099	77	672	14,126	135	1,265	596	$1,020.69	672		(3)		96
97	14,126		74	705	14,905	147	1,335	630	$1,069.78	705				97
98	14,905		69	743	15,717	156	1,408	665	$1,120.41	743				98
99	15,717		65	782	16,564	165	1,484	702	$1,172.37	782				99
0	16,564		62	823	17,449	175	1,564	741	$1,225.64	823				0
1	17,449		58	866	18,373	184	1,647	781	$1,280.83	866				1
2	18,373		55	911	19,340	195	1,734	823	$1,337.68	911				2
3	19,340		51	958	20,349	205	1,825	867	$1,396.44	958				3
4	20,349		47	1,008	21,404	216	1,920	913	$1,455.87	1,008				4
5	21,404	= $9,016	43	1,059	22,506	228	2,019	960	$1,518.91	1,059				5
Cumulative Totals:		3,964	4,586	13,955	22,506	1,806	28,290	12,843	$22,904.55	13,955	229			

ASSUMPTIONS:

STATUS QUO

1/19/89

4.00% Inflation Rate FY 89
9.01% Rate of Return FY 89

5.00% Inflation Rate FY 90
8.00% Rate of Return FY 90

6.00% Inflation Rate FY 91-05
9.00% Rate of Return FY 91-05

$\frac{1}{2.37}$ = Value in 2005 in 1990 FY $

* SOURCE: Alaska Department of Revenue Revenue Low Case Forecast - November 1988

** SOURCE: Population Projections From Revenue Low Case Forecast - November 1988

Eight Hallmarks for Good Public Fiscal Policy

By Peter McDowell

These remarks were submitted as testimony to the Joint House and Senate State Affairs Committee at their public hearing on the Permanent Fund held in Juneau on February 11, 1989.

I believe that good public fiscal policy has eight hallmarks -- qualities that distinguish it from all other kinds. I will define each hallmark and present at least one example from the public fiscal policy framework of the Alaska Permanent Fund to illustrate it.

#1 Clarity

The first hallmark is clarity -- good public fiscal policy must be clear and understandable to those affected by it. The dedication of a percentage of certain petroleum revenues to the Permanent Fund is clearly understood by all Alaskans.

#2 Balance

Good public policy should incorporate a balance among legitimate competing claims and interest. As Dave Rose stated in a recent article in the *Alaska Public Affairs Journal*, the current policy framework of the Permanent Fund is a delicate balance among the claims of dividend proponents, purchasing power protection proponents, and proponents of using fund earnings to sustain state government spending.

Balance does not eliminate conflict and controversy, but it does imply a public sector optimum -- a condition whereby everyone has been made equally unhappy.

#3 Consistency

Good public fiscal policy is usually in harmony with what has been done in the past, or what has previously been agreed upon. The 1970's debate over the management of the Permanent Fund was a classic application of consistency. It took four years, but the governor and the legislature eventually concluded that when the people voted for "permanent" in 1976, they meant to establish a trust fund -- which is exactly what we now have.

#4 Fairness

Good public fiscal policy is just, impartial, and gives everyone his or her due. Most Alaskans regard the Permanent Fund dividend program as exemplifying the hallmark of fairness. It is just (the bulk of the Fund benefits future generations, but we are entitled to this small share), impartial (every Alaskan gets it), and it is our due for residing in our great state.

#5 Prudence

Prudence is wisdom applied to practice. It is the careful, economical management of resources that includes provisions for future needs or events. It is characterized by foresight. As I said earlier, good public fiscal policy considers the needs and events of the next fiscal decade, not just the next fiscal year.

#6 Equity

In 1981 and 1982, we developed the proposal for inflation-proofing the Permanent Fund. The rationale was clearly stated -- inter-generational equity would be served if future generations of Alaskans are entitled not only to the same dollars we are, but to the same purchasing power. The next legislature agreed, and inflation-proofing became the law of the state.

#7 Ease of Implementation

Good public fiscal policy can be put into effect at a reasonable cost. There are many examples of difficult, or impossible-to-implement public fiscal policies. The Permanent Fund dividend program was just the opposite -- it came together very quickly with the first $1,000 in 1980 -- and has been operated in a straightforward, economical fashion ever since.

Finally, the most important hallmark of good public fiscal policy:

#8 It Promotes Responsible Economic Behavior

Responsible economic behavior consists of:

- rational responses to market incentives;

- promotion of a market-driven economy based on competition; and,

- preference for investment in productive economic capacity over consumption.

The Permanent Fund falls somewhere in the middle -- it does promote savings (almost $10 billion to date), but they are public savings which don't do much to expand productive economic capacity.

The dividend promotes personal consumption, as shown by all the surveys conducted over the years of how people use their dividends. The dividend does, however, discourage "rent-seeking" which my colleague Gary Anders has defined as a subcategory of directly unproductive profit-seeking behavior whereby individuals spend their time manipulating the political process in order to increase their share of the public fiscal pie.

I believe that Alaskans' excessive propensity for rent-seeking was the foremost cause of the recession of which we are now in the third year. The dividend does not encourage rent-seeking because 1) it is too small, and 2) there is no practical way to increase one's share at the expense of others.

In conclusion, I ask that you, and our fellow Alaskans, join together in working to hold our public fiscal policy makers accountable for leading with wisdom and skill. Fiscal statesmanship is not optional, it is essential.

I hope these eight hallmarks will help give you the tools to make a difference in the debate. Please use them.

Debate About Use of Fund Income Is Debate About State Government

By Mary A. Nordale

These remarks were submitted as testimony to the Joint House and Senate State Affairs Committee at their public hearing on the Permanent Fund held in Juneau on February 11, 1989.

Alaska's Permanent Fund is a unique experiment in the use of government funds. While the establishment of the Fund resembles special purpose or dedicated funds created in other states, both the constitutionally-approved use of income and the subsequently-enacted uses of Permanent Fund income are unique.

Article IX, Section 15, contemplates using Permanent Fund income to fund general government operations and, impliedly, relieving Alaskans of all or a portion of their individual income tax burdens. The subsequently-enacted uses of the Fund contemplate the primary use of the income to be the payment of a portion of that income to each citizen, while the balance is or will be used to compensate the Fund for the ravages of inflation.

In contemplating and discussing the role which the Permanent Fund should or could play in Alaska's economic future, we must address a number of questions relating to the fundamental relationship between the people of Alaska and their government. It seems to me that the answers we reach are almost less important than the fact that we have seriously considered the questions.

The first question which I think must be asked is: Should Alaska have a dedicated fund?

I think all of us are in agreement that we were ill-prepared to deal objectively and with long-term perspective with the sudden inflow of revenues far beyond our wildest imagination. I think we are candid and objective in our self-assessment in stating that we could not have spent the money wisely, nor could we have saved it wisely, absent the constraint of the Permanent Fund. And none of us now wants to see the Permanent Fund dissolved.

The debate over use of the Permanent Fund earnings,

The real debate over the use of Fund earnings centers on what programs and services the state will give her citizens on an ongoing, steady basis.

The Alaska Constitution forbids the dedication of the proceeds of any tax or license. The Permanent Fund is an exception to that rule and had to be established by constitutional amendment. I raise this issue because the problem of the dedication of the proceeds of the Permanent Fund has posed such significant problems even in the Fund's brief history.

however, is not really about the actual use of those funds, and I think we do ourselves a vast disservice when we allow the debate to center solely on the expenditure of the money and the amount of that allowable expenditure.

The real debate over the use of the earnings of the Permanent Fund centers on what programs and services the state will give her citizens on an ongoing, steady basis. Expressed another way, it is an argument over the programs to which the earnings will be dedicated.

> **Any dedication of Fund earnings creates the same political problems which the delegates to the constitutional convention sought to alleviate by the prohibition of dedicated tax or license revenues.**

The constitutional amendment which established the Fund contemplated usage of those funds to support state government without dedication to a particular purpose. Until we resolve the questions about what our state government is to be about, we cannot resolve the question of the use of the Fund's earnings.

I submit to you that no amount of debate will reach a conclusion unless we define the role the state government will play in our lives. Even though a dedication of the Fund's earnings would escape constitutional prohibition, any dedication of funds creates the same political problems which the delegates to the constitutional convention sought to alleviate by the prohibition of dedicated tax or license revenues.

Another question which must be addressed is: Should the state's taxing powers be used to fund non-public purposes?

The dividend itself is, I think, a highly questionable use of the state's taxing power and raises an issue which I believe merits extensive debate. At the present time, the income of the Permanent Fund is used for two primary purposes -- payment of dividends to individuals and inflation-proofing. The excess of income after fulfillment of those purposes is held in an "earnings reserve" account.

> **Every comment I have heard or read from economists suggests that, as an injection of money into the economy, the dividend has a positive effect, at least for retail merchants.**

The projected growth of the principal of the Fund clearly shows that the earnings reserve will be required to meet inflation-proofing needs. The frequently published estimates by the Permanent Fund indicate that in the next year or two, the principal of the Fund will have grown to the point that the Fund will have to start drawing on the earnings reserve in order to inflation-proof the Fund fully under the present formula.

Every comment I have heard or read from economists or people who speak of economic matters suggests that, as an injection of money into the economy, the dividend has a positive effect, at least for retail merchants.

Many people argue that the dividends permit people to purchase consumer goods they might not otherwise have, to pay bills already incurred, to take trips they might not otherwise take, to buy necessities which they are otherwise unable to do, and to do a number of things, including saving the money, all of which are deemed good and acceptable activities. It is safe to say, therefore, that no one objects to the good that the dividends can do.

Some people comment that because the principal of the Fund represents, in part, the monetary value of Alaska's retained royalty interest in its mineral resources, the payment of a dividend is simply giving a present return on investment or capital. This argument analogizes to the corporation which pays dividends on its shares.

The analogy ignores, however, the fact that more than half of the principal of the Fund has come from appropriations of tax revenues from the general fund and inflation-proofing. Thus, we are back to my question and that is, does it make good public policy for the state to tax in order to fund inflation-proofing and per capita distributions of money to individuals?

> **Does it make good public policy for the state to tax in order to fund inflation-proofing and per capita distributions of money to individuals?**

Another question which I believe merits debate is: What government programs and services should the state provide and how should they be funded?

It seems to me that it is essential to address this question in any discussion of the Permanent Fund because we are already taxing to pay dividends and we are all aware of the enormous public interest in retaining the dividends. Thus, a confrontation arises between the services people desire the state to provide and the state's financial ability to provide them.

> **I, for one, am unwilling to say that an ever-diminishing level of services to Alaskans is good.**

Should we tax to provide government services at the same time we tax to pay dividends?

Many people say "yes." One would think that those who most vocally and ardently support continuation of the dividend would agree that taxation to pay for government services is appropriate. However, my sense of their probable response is that not only should the state continue to tax to support the dividend, it should diminish all government services to whatever extent necessary to prevent enactment of any new or additional taxes.

If that is the case, should people be asked to use their dividends, or other funds, to purchase those services which they deem desirable? For example, should the state enact a requirement that pupils and students pay tuition as a way of diminishing the requirement for state funding of education?

I think it is safe to say that not a lot of people would welcome such a requirement. But if the voters object to that type of proposal, what source of funds do they wish to use to insure that when Alaska offers education to her children, she offers good quality education to all of her children?

Revenues from existing tax programs are steadily diminishing, notwithstanding their volatility. There are many demands on those revenues for services which it is difficult to do without, even though we could probably achieve a consensus that education is the fundamental service the state should provide. I, for one, do not want to say that we do not need police protection, that we do not need to provide health and welfare assistance to our needy, that we do not need to cherish our history, that we do not need transportation services and facilities. I, for one, am unwilling to say that an ever-diminishing level of services to Alaskans is good.

Approaching the point at which one should begin addressing the topic of this proceeding, one can ask the question: Does the level of government services affect the level of the economy? Or, perhaps expressed another way, is there a point at which a reduction in government services adversely affects the economy?

My belief, since I have no knowledge of the matter, is that there is a point beyond which we should not go in reducing government services. I believe that once we go beyond a certain level, people who are not wealthy simply cannot afford to live here and the state becomes unattractive as a place in which to work, do business and live.

Why should the Permanent Fund earnings be dedicated to particular uses regardless of need or regardless of competing needs?

I do not think Alaska will do well by her citizens, present and future, if we do not have an annual debate about our government and its level of services. I think it is important to retain the flexible and responsive system contemplated by our constitution. Dedicating funds to specific purposes means rigidity, inflexibility, unresponsiveness, and the growth of segments of our population which have a stake or vested interest in the survival of their programs, even if the programs no longer serve the purposes for which they were established.

I would like to return to the proposition that sold the establishment of the Fund to the voters in 1976 -- that the earnings would be used to support state government and to lessen the tax burden we shall have to bear.

Furthermore, dedicating funds likewise means that public scrutiny is lessened. Examples are rife that support that proposition. And it is not difficult to understand why the public devotes less time to oversight of programs which have guaranteed funding. People have only so much time to spend in oversight, and the allocation of public funds to competing programs consumes as much as they have to offer. Once a program is removed from the battle for funding, it simply cannot command the attention it should have.

Frankly, I would like to return to the proposition that sold the establishment of the Fund to the Alaska voters in 1976 -- that the earnings would be used to support state government and to lessen the tax burdens we shall have to bear. I prefer to debate each year how the public funds will be spent. I consider that debate the best means of maintaining democratic, responsive government.

Using the Fund as a Counter-Cyclical Force in the Economy

By J. J. Brecht

These remarks were submitted as testimony to the Joint House and Senate State Affairs Committee at their public hearing on the Permanent Fund held in Anchorage on January 28, 1989.

I am here to make a presentation on behalf of myself and 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.

As well as providing a forum for national and international speakers, working committees of Commonwealth North study critical issues facing the state and the nation and have, in the past, prepared action papers. I am a past member of the Board of Directors of Commonwealth North and have served on several of its committees.

I had the pleasure of serving as co-chairman of such a committee established in 1987 which produced a report in February, 1988, entitled "Using the Permanent Fund as a Positive Counter-Cyclical Force in the Alaska Economy."

Let me begin by saying that the Permanent Fund represents visionary public policy and, as a savings account, has been well managed. Although the citizens of Alaska are nearly unanimous in their enthusiasm for the Fund and its management, there is less consensus on how to use the Fund's earnings, except for the popular dividend program.

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

During the mid-1980s, there was little need for using the "non-dividend" or undistributed earnings. Times were good, generally, throughout the state. However, the time period from 1987 through the present has been one in which many Alaskans have faced difficult economic circumstances. There is a growing sense of urgency and frustration.

It is in this context that the Permanent Fund Committee of Commonwealth North was formed. I will share the committee's recommenda-

Most proposals for use of Fund earnings have been met with suspicion and warnings against "raiding the Fund." This highly-charged environment has led to hesitancy and inaction by Alaska's leaders. The central question has gone unanswered: For what are we saving the money?

tions with you, but first, I would like to convey some of my personal observations regarding the Fund.

The Alaska legislature and your committees, in particular, simply cannot overlook the crying need for the

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

The social and human needs of Alaskans are important. The government of Alaska has a responsibility to respond to those needs. However, should the Alaska legislature focus on these needs to the exclusion of encouraging a growing, developing, and sound private sector economy in Alaska, the result will be a calamity of enormous consequence to all Alaskans, both now and in the future.

Traditionally, it is the private sector which responds to these social and human needs, through direct contributions to the arts and charities, as well as through taxes which support government programs in these areas. If we do not have a strong private sector, there will be no business and corporate entities to contribute large sums to the arts and charities and no businesses for the state to tax for those programs.

Alaska government to carry out its responsibilities under the Alaska Constitution to develop the resources of Alaska, while at the same time deliberate on, and appropriate funds for, reasonable and sustainable state budgets into the next century.

The budget crisis presents an opportunity for individual legislators to analyze critically what needs of Alaskans are to be provided by state government.

If you, as individual legislators, do not resolve to attain this goal of fiscally responsible government, then I believe there will be no hope of maintaining an Alaska Permanent Fund beyond the next few years. The Fund will be breached and sapped of its wealth in a matter of a very short time.

Fiscal responsibility on state budgets was the subject of another Commonwealth North report issued in 1986 entitled "Alaska's Budget Crisis, Facing the Facts - Closing the Gaps." I had the honor and pleasure of serving as chairman of the committee that produced that report.

The thrust of the report was that, even given the use of the undistributed earnings of the Permanent Fund, the dividends from the Fund, a statewide sales tax, and a personal income tax, one cannot sustain state spending at present levels of approximately $2.0 billion per year or even at $1.4 billion per year (which happens to be twice the national per capita average government spending level) without eventually dipping into the corpus of the Permanent Fund.

For example, at a state spending level of $2.2 billion per year (approximately what has occurred over the three years since the report was published), we would have to breach the Permanent Fund by 1994.

Second, the missing element in Alaska's overall state spending and investment strategy is an aggressive program to diversify the economy and replenish the sources of jobs and revenues now provided on the North Slope. The Alaska legislature must become an activist in this regard.

Third, the budget crisis before the Alaska legislature presents an opportunity for individual legislators to rise above political ties and to analyze critically what needs of Alaskans are to be provided by state government. It is also a time for Alaskans and, in particular, the Alaska legislature, to decide what level of state government we Alaskans can afford.

Fourth, it occurs to me that the Permanent Fund presents tremendous challenges to Alaskans. The Fund is one of our greatest assets and one of our greatest detriments. It is an obvious asset in that it represents a savings account for all Alaskans of truly immense proportions. However, therein also lies its greatest drawback to Alaskans.

Many might say, why develop the natural resources of Alaska? We do not need it; we have the Permanent Fund on which to rely. There is no need to get serious about a faltering private economy. We can rely on the Permanent Fund to provide a sustained source of funds for government budgets (at least for a while).

In this way, the Permanent Fund has already and will continue to sap the intellectual strength and relegate entrepreneurs in Alaska to an eternal and insufferable embryonic stage. We must stop thinking of the Fund as the panacea for all our ills. We as Alaskans must rise to the occasion. We must maintain and invest the Permanent Fund wisely, and at the same time the Alaska legislature must appropriate funds for sane and reasonable levels of government and promote a stable economic environment in which we can live.

Alaska is a great place to live and to raise a family. We must strive to develop a plan which will perpetuate this opportunity for future generations in Alaska.

The Commonwealth North report makes eight recommendations regarding the Permanent Fund, as follows:

Recommendation #1:

The Permanent Fund earnings should be used as a countercyclical force in the Alaska economy.

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

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

This index should include available Alaska economic indicators such as the following: (1) consumer spending, (2) savings and investments, (3) public and private sector employment, (4) wage and salary rates, (5) housing starts, (6) retail and wholesale sales, (7) value of contract construction, (8) personal income, (9) gross state product, and (10) state revenues.

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

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

Recommendation #2:

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

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

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

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

Recommendation #3:

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

As you may already know, it is predicted that Prudhoe Bay production will begin a rapid decline within the next twenty-four months. According to the Alaska Division of Oil and Gas, that decline will reduce the TransAlaska Pipeline throughput from today's two million barrels per day to five hundred thousand barrels per day by the year 2002. In other words, in just fourteen years, production from the resource development activity which now accounts for 82% of state revenue will be just one quarter of what it is today.

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

To begin an aggressive program to diversify the economy and replenish the sources of jobs and revenues now provided on the North Slope, in a thoughtful but activist manner, the legislature should create an Alaska Development Board similar in structure to the Permanent Fund Board of Trustees. The task of this new board would be to research, study feasibility, and recommend to the Alaska legislature and the governor major revenue-generating, instate capital investments which can help diversify the economy into the next century.

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

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

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

Recommendation #4:

Using a portion of the approximately $590 million in the Permanent Fund's earnings reserve account, the legislature should establish an Alaska Development Fund.

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

In addition, the legislature should set aside a one-time deposit of a portion of the undistributed earnings from the Permanent Fund. Another possible source to establish an Alaska Development Fund might be windfall monies from oil litigation settlements. The reserves in the Alaska Development Fund would be saved and invested by the Permanent Fund trustees until they are appropriated by the legislature to facilitate projects recommended by the Alaska Development Board.

Recommendation #5:

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

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

The benefits to the state's economy are recognized by nearly all Alaskans. The size of the dividend distribution, however, should be capped at an amount such as 40% of the annual earnings as recommended previously by the State Senate, or at $1,000 per person per annum.

Recommendation #6:

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

A portion of the Permanent Fund's earnings has been used annually to strengthen the Fund and help it to grow and combat inflation. The legislature has also demonstrated fiscal wisdom by appropriating large additional sums to the principal of the Permanent Fund during years of affluence. In fact, an impressive $4 billion resulted from such actions. This policy has been a wise one, especially in times of great wealth.

However, inflation-proofing in a seriously depressed economy does not fulfill the original intent of the Permanent Fund.

That is, I believe the original purpose was to benefit all generations of Alaskans, including those currently trying to survive and make ends meet.

In times of a shrinking economy, inflation-proofing, if continued apace, will choke out all other uses of the earnings when, instead, a portion of those earnings should be injected into the economy. The legislature should not make annual anti-inflation appropriations regardless of the real world circumstances being faced by Alaska's citizens.

Recommendation #7:

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

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

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

It should be remembered that approximately 85% of all royalties and revenues derived from the North Slope oil activities are funneled directly into the General Fund out of which the legislature appropriates monies for government operations. The Commonwealth North report concluded that earnings from the remaining 15% set aside in the Permanent Fund should be added to the

General Fund only in a case of a major calamity or emergency.

Recommendation #8:

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

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

Furthermore, if the recommendations set forth in the Commonwealth North report are adopted by the Alaska legislature and function successfully, then there will be no need to lock them into the constitution. Public support will keep them in tact. If they are poorly managed or are unsuccessful for other reasons, they can and should be changed by a future legislature without having to go through the constitutional amendment process.

In summary, the Permanent Fund represents visionary public policy. Its earnings should be used as a counter-cyclical force to funnel monies into the grass roots economy through local government in particularly troubled economic times. When times are good, these earnings should be placed in the Fund.

The more fundamental crisis -- the long-term lack of diversification in the Alaska economy -- must also be addressed by the legislature.

My final personal observation is that while the earnings from the Permanent Fund may certainly be used for various purposes as I have previously outlined, I believe that the corpus or principal of the Permanent Fund should remain untouched for now.

In the meantime, we must answer some very candid questions as to the level of government which we Alaskans need and the level of government which we Alaskans can afford.

Financing Alaska's Development Through the Permanent Fund

By Gary C. Anders

These remarks were submitted as testimony to the Joint House and Senate State Affairs Committee at their public hearing on the Permanent Fund held in Juneau on February 11, 1989.

My understanding of the issue before us is whether or not it is a good idea to make changes in the current use of Alaska's Permanent Fund, and specifically if a portion of the earnings reserve account should be utilized to support the state government's operating budget.

I do believe that there are good reasons for making some changes in the management and composition of the Permanent Fund for the sake of long-term security and growth, but I am strongly opposed to tapping either the inflation-proofing or the earnings reserve account to support the shortfall in state revenues, or to provide endowments for pet programs.

First, I will explain my rationale for keeping the Permanent Fund in tact, then I will suggest some policy changes relating to the need to change the law to allow a portion of the Permanent Fund to be placed in international investments.

We will be increasingly subjected to a strong appeal from various special interests and members of the legislature to tap the Permanent Fund because of the reduction in oil revenues and the impending deficit. A great deal of attention needs to be focused on this issue, because the people of Alaska have not yet determined what they want or can realistically expect from the state. Our proven experience over the last few years is that wants exceed needs, and both exceed existing resources, even in flush times.

The people of Alaska have not yet determined what they want or can realistically expect from the state. Our proven experience over the last few years is that wants exceed needs, and both exceed existing resources -- even in flush times.

Our greatest weakness is that we have not forced the players in the political process to exercise their mandated leadership responsibility in prioritizing the services to be delivered and to establish viable levels of government.

Government services are necessary, and though Alaska is a big state requiring high levels of government involvement in education, health and social services, environmental conservation, natural resources, fish and game, and so on, we must realize, however, that there has been no objective determination of what the optimal levels of employment and service delivery should be in terms of economic policy.

The easy way out is to tap additional monies to serve us at the current level. Sustaining government spending from the Permanent Fund, however, would be an inefficient form of fiscal policy to counter economic cycles. The appeal is so strong because we are told that cuts in state government will increase unemployment, and further weaken the economy. Yet, we are in this situation today because we did not apply economic common sense in the first place.

I think we will be far better off if we address the issue of supportable government now. This means that we reduce unnecessary and low-priority programs and personnel, cut spending, bring our projected cost of state government down, and reinstate state income taxes.

If our concern is to keep as many people working in the state as possible, then even bolstering state spending is not an optimal way of achieving this end, because administrative costs and bureaucratic drains reduce the employment multipliers which increase the demand for service sector jobs. There are teachers in our state making over $80,000 per year, and state and municipal employees making over $100,000 whose secondary form of employment in the private sector would be far lower.

Certainly some kind of economic realignment needs to occur, but the opportunity cost of the Fund earnings is too large to disregard, and the precedent we would be setting would, in a short time, undermine the long-term vision of the Fund.

I think we will be far better off if we address the issue of supportable government now. This means that we reduce unnecessary and low-priority programs and personnel, cut spending, bring our projected cost of state government down, and reinstate state income taxes.

In reading over *The Trustee Papers, Volume No. 1*, I see that a number of distinguished economists such as Kenneth Arrow, Malcolm Gillis, and Maxwell Fry have provided advice to the state regarding the inadvisability of subsidizing development. Their counsel, which is based upon extensive experience in many underdeveloped countries, should have particular bearing on us. The acid logic of these economists is that we should invest in only those projects that will be viable and self-supporting; but if they are economically viable, why can't these projects attract private financing in the first place?

An analysis of the political decision-making process reaffirms the suspicion that our legislature is unable to provide economic rationality to allocations of public resources unless they have a strong motivation. Because needs and wants are greater than existing funds, the compromise process results in not completely funding worthwhile programs. Because of political considerations, funding levels are adjusted and spread out over competing regions, agencies, and programs. Thus, funds are misallocated, and economically sound programs are given too little money and others are given too much.

Government does need to provide social services and infrastructure to support economic development projects such as highways, ports, and transportation systems, but can you guarantee that our political system will ensure that

Permanent Fund dollars would be invested in capital projects where they would foster economic growth? We can't afford any more performing arts Taj Mahals.

These spend now/pay later policies suffer, in my opinion, from a lack of appreciation for the fundamentals. We can see it at the national level in even greater terms. The U.S. has been turned into the largest debtor nation because we have not been willing to adjust spending levels or raise taxes. The consequences are likely to be far-ranging in magnitude and duration.

These spend now/pay later policies suffer, in my opinion, from a lack of appreciation for the fundamentals. We can see it at the national level in even greater terms. The U.S. has turned into the largest debtor nation because we have not been willing to adjust spending levels or raise taxes.

This brings me to my second point which is that we should seriously entertain revisions in the law that will allow adding foreign investments to the Permanent Fund portfolio.

As you know, both the trade and budgetary deficits of the U.S. are reaching staggering proportions. While there may be some economic miracle that the President and Congress can pull off together that will alleviate the immediate crisis, rising interests and inflation are becoming more threatening.

Alaska's Permanent Fund managers are to be commended for the excellent job they have done in times of great financial uncertainty. Their conservative approach has carefully balanced risk and return far better than any similar-sized fund. But, about 83% of the Fund's assets are currently invested in fixed-income securities, only 12% in stocks and another 5% in real estate and other properties. When the inflationary pressures building in the American economy are eventually vented, we will not have an adequate hedge to insure the corpus of the Fund. Even if the stock and real estate components of the Permanent Fund were increased, it is still conceivable that inflation may be at such a high rate that the earnings would not be sufficient to provide the necessary annual adjustments to bring the Fund up in real terms.

Given the prospect of rising interest rates and a depreciating dollar, it would be prudent to change the law to allow for a portion of the Permanent Fund to be invested in overseas markets. This would do several things.

First, in the event of an increase in inflation in the U.S. and a further devaluation of the dollar, investments in secure foreign investments would provide a hedge against the loss of principal. Second, since many of these equity markets are more vibrant than our own domestic markets, the potential rates of return for comparable risk are likely to be several percentage points higher. Finally, in light of our Pacific and East Asian orientation, financial investments of Alaska's capital might serve as useful leverage for increasing investment and operations of Asian firms in the state's economy.

The Fund and the Alaska Economy From an Historical Perspective

By George W. Rogers, Ph.D.

These remarks were submitted as testimony to the Joint House and Senate State Affairs Committee at their public hearing on the Permanent Fund held in Juneau on February 11, 1989.

Rather than debating or repeating what was presented at the Anchorage hearing this month, I will focus on the historical context in which the Fund was conceived and has operated, and, from there, try to present a realistic view of Alaska's future.

Whatever we do concerning the Alaska economy should be done with a clear understanding of what really happened over the past 15 years or so, and how much of this represented sustainable expansion.

Taking a long-term view, Alaska has progressed, not along a continuous evolutionary line, but by means of a series of overlapping tidal motions of ebb and flow. Each ebbing stage ends up at a higher level than before, because the flow phase of economic expansion brings about changes which survive into the next stage. At this point in time, Alaska's economy and population are redefined and it is at these points that we can take a hand in the process.

Since World War II the ebb and flow of construction activity has been a major dynamic force in the economy -- the Cold War build-up, the Great Alaska Earthquake reconstruction, the TransAlaska pipeline. The disastrous ebbing of fisheries reversed and a newly-defined fisheries began a long-run flow. Significant timber and pulp development appeared in the 1950s and plateaued in the 1970s. But overshadowing all has been the flood tide of petrodollars into the state Treasury in the 1980s and its sudden collapse. This was based upon a combination of factors which probably will not be repeated in our lifetimes, if ever.

Prudhoe Bay is a giant. Petroleum development will continue to be part of Alaska's future, but it is unlikely that there will be another field of this magnitude. Secondly, the field was owned by the state, by the people of Alaska. In technical terms, Alaska had the potential of becoming an "oil *rentier.*" The most the state can probably expect from developments beyond Prudhoe, however, will be a share of the "rent" paid to the federal government. Oil prices were a third factor. When the Trans-Alaska pipeline was announced, the Los Angeles prices were about \$3 per barrel. OPEC and volatile Middle East politics fueled an explosive inflation. Prices rose more than ten-fold within a decade, followed by the free fall from about \$30 to \$10 or

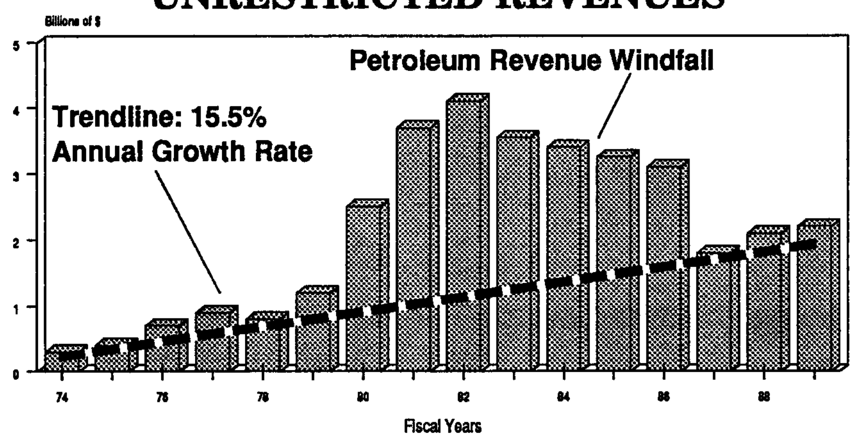
Whatever we do concerning the Alaska economy should be done with a clear understanding of what really happened over the past 15 years or so, and how much of this represented sustainable expansion.

less between November 1985 and mid-1986.

The magnitude of the transitory expansion of state revenues resulting from these factors can be estimated from the "General Fund Unrestricted Revenues" table in the quarterly reports of the Department of Revenue (Figure 1). Drawing a line between 1975 and the mid-1989 projection results in a curve with a 15.5% annual rate of growth. This will be taken to approximate what revenues might have been based upon a combination of the Prudhoe Bay production curve and a more normally inflating oil price.

Figure 1

GENERAL FUND UNRESTRICTED REVENUES



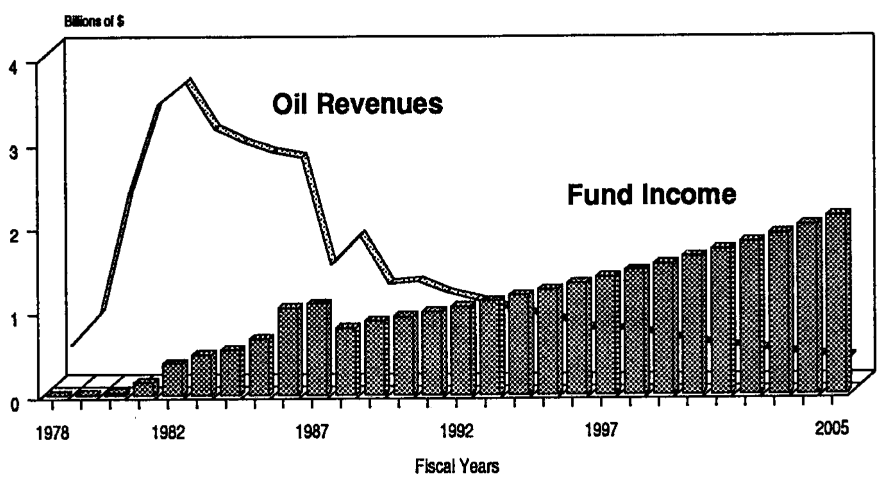
In this perspective, we are not suffering a recession at this time, but are on schedule in a healthy, long-run growth trend. The area between this and the actual revenue curve represents a non-sustainable expansion (not growth) of state revenues resulting largely from OPEC-managed prices. The first step in planning for the future is to recognize that we cannot return to this level of high living. For humanitarian reasons we might seek to minimize the pain withdrawal, but this will not influence our future. We do not have a recession, but we do have a serious readjustment problem. The magnitude of the readjustment can be measured from the two curves in Figure 1 and a review of how the windfall was used.

The area between the 15.5% curve and the actual revenue curve in Figure 1 represents $26 billion. Adding the Alaska Permanent Fund net earnings brings Alaska's total windfall to $30 billion. Most of this was spent on current consumption. Approximately $6 billion was used to increase the disposable income of Alaskans -- repeal of the personal income tax (the revenue forgone being replaced by petrodollars), the longevity bonus for seniors, the Permanent Fund dividends to all Alaskans, and liberalized and expanded housing and other loan programs. We went on a construction spree. Capital expenditures increased from an annual average of $41 million during the 1970s to $1.6 billion for fiscal year 1981, and then fell to $98 million for 1989. Another $6 billion disposal of the windfall might be attributed to these expanded capital expenditures. Finally, allocations of $9 billion each were made for expanded operating programs and savings (the Alaska Permanent Fund).

With the exception of the Alaska Permanent Fund savings program and possibly some of the truly-productive capital expenditures, oil revenues were consumed as though they were "income." These revenues (or oil rents) were not income, however, but the transformation of one form of asset (depletable natural resources) into another (cash or its equivalent). With the two exceptions noted, the expansion of state programs was fueled by consumption of capital assets, not expenditure of income. (Kuwait, recognizing this, put all its oil revenues into investment portfolios and is now totally free of dependence upon oil production). This in turn fueled a non-sustainable employment and population expansion and caused a loss of touch with reality in our expectations.

With our feet back on the ground of reality, there is a sound basis for healthy future growth, if we recognize that reconstruction and not recovery is the order of the day. Defense will remain a constant. Timber has recovered from the decline attributed to the dollar's appreciation against the yen and depressed Japanese markets. Fisheries continue to prosper and there is hope of future expansion through "Americanization" and "Alaskanization" of harvests and processing. Petroleum will continue to a be big part of our future and there will be other mineral developments. And we have more than $9 billion in the bank.

Figure 2
PERMANENT FUND INCOME AND STATE OIL REVENUES 1978-2005



The Alaska Permanent Fund provides a means of giving Alaska's petroleum "life after death" from income generated through investment of the converted assets. This has been illustrated by a graph comparing Permanent Fund income and oil revenues from 1978 through 2005 (Figure 2). According to the projections in Figure 2, Permanent Fund earnings will overtake oil revenues and become the number one producer of state income by 1992. This provides something unique in our history, a means of overcoming the future economic ebb associated with declining petroleum production. It is critical that we embrace this vision of our future. With prudent management and protection, income generated by the Fund will add a needed element of stability and growth to our total future.

Use the Fund to Support Cultural and Economic Development

By F. Thomas Trotter

These remarks were submitted as testimony to the Joint House and Senate State Affairs Committee at their public hearing on the Permanent Fund held in Anchorage on January 28, 1989.

I am new to the state, having been elected to my present position one year ago. Therefore, I have very limited experience in Alaska politics and I am relatively innocent of the details surrounding the Permanent Fund. I do have some impressions and some judgements about the future of the state and, to the degree that the Fund is becoming a major part of that future, I venture to share some of these items with the committee.

It is inevitable that the Fund will attract increasing attention as the cycles of the economy drive legislators into more and more desperate and innovative directions in the quest for revenue. Someone once said of the Ford Foundation, once the largest philanthropic fund, that it was an island of money surrounded by an invasion force of suppliants. Discretion and great care must be taken to insure the preservation of the corpus. Furthermore, adequate reinvestment policies should be followed to guarantee growth of the corpus.

The Fund, in my opinion, should not be used as the instrument for solving the normal expenditure needs of the state. It seems to me to be a good public policy to depend on general and traditional tax policies for basic governmental services. This provides the advantage of keeping more accountability and electoral control over government than might be the case in a state where operations were supported by an abstract and remote source of revenue.

We Alaskans are tempted by the myth of the Fund, its promise of providing an environment in which taxes would be missing and services plentiful.

I do think that a portion of the Fund should be available under restraints for clear fiscal emergencies. But the justification for that use should be carefully drawn.

In a positive vein, my judgement is that some income from the Fund should be available for underwriting programs that have long-term capital impact on the welfare of the state. That is, the Fund needs to be thought of as an engine that can drive economic and cultural development in the state. Rather than using the Fund simply to pay bills, it should be used to generate additional revenue through economic development and to enhance the quality of life of the state through carefully designed and managed programs of public good.

The Fund should not be used as the instrument for solving the normal expenditure needs of the state. It seems to me to be a good public policy to depend on general and traditional tax policies for basic governmental services.

By directing revenues to capital and cultural enhancement, the Fund will fulfill its implicit purpose, that is, to preserve for Alaskans the benefits of the natural resource that provided the Fund in the first place.

My suggestion will be that attention be given to designating a portion of the Fund as an endowment for education, particularly higher education. Alaska does not have a portable loan program and has had state scholarship subvention in an earlier time. The student loan program is helpful, but in a time when costs of public and private higher education are rising sharply and federal student aid programs have shifted from grants to loans, our nation is requiring students to prepare for socially useful and necessary careers by saddling them with enormous debt.

The Fund needs to be thought of as an engine that can drive economic and cultural development in the state. Rather than using the Fund simply to pay bills, it should be used to generate additional revenue through economic development and to enhance the quality of life.

The portability of the student support has reflected the state's need for student access to programs not available in Alaska, such as medicine and law. But if I were to press my suggestion that the Fund enhance the economic and cultural resources of the state, then an educational component should be designed to encourage Alaskans to study in the state. The long-range good of the state will be served by having very strong higher educational institutions of national and international quality. Since constitutional restraints have restrained direct support to private sector schools, grant and scholarship aid to students electing the private sector alternative does enhance academic development of institutions.

My personal vision includes the development in Alaska of higher educational programs, developed in cooperation between the public university and the private sector -- Alaska Pacific University and Sheldon Jackson College -- that will make the state the premier educational and scientific research center in the Pacific.

With judicious use of Fund revenues, and careful planning and cooperation between the public and private sectors, such a vision is achievable. As I see it, this development would enhance the quality of life through leadership, through the attraction of persons to invest in Alaska, and through support for Alaska commerce and industry.

The Fund holds enormous potential for good for the state. If it is not used with care, it could dissipate quickly and provide only the relief of a temporary bromide. If it is used judiciously and within a wider debate on state goals and public policy, it holds promise for benefits far beyond the temporary pleasure of the dividend.

ISER
FISCAL POLICY PAPERS
No. 1, August 1989
Institute of Social and Economic Research University of Alaska Anchorage

THE ALASKA FISCAL GAP

by Oliver Scott Goldsmith

Alaska faces a problem that will be very tough to solve but is easy to explain: state government is spending more than it collects. The problem will get much worse as time goes on. If state general fund spending stays at the current level of $2.25 billion (in 1989 dollars), we face a fiscal gap—the difference between current spending and projected revenues—that could soon grow to $1 billion annually.

This budget crisis looms because oil production, which supplies 85 percent of the state's general fund revenues, will soon begin dropping as the huge Prudhoe Bay oil field is depleted. Likely new petroleum production, higher oil prices, and other economic activity in the coming decade won't be able to generate nearly enough tax and royalty income to replace the loss of Prudhoe Bay production.

Figure 1 shows projected oil production and state petroleum revenues over the next 20 years, based on the Alaska Department of Revenue's estimates from producing fields and our own estimates of new field production and per barrel revenue. Production is at its peak and will soon begin a long decline. Even assuming production from new fields such as West Sak—the timing of which is uncertain—production in 2000 will be only half of what it is today. Petroleum revenues have already fallen to just half of what they were in the early 1980s, because oil prices are much lower now. If the real price of oil remains in the range where it has been for the last few years, petroleum revenues will drop by half again by 2000.

This figure does not include potential production and revenues from oil fields that may exist in the Arctic National Wildlife Refuge (ANWR). Such revenues would of course help reduce the budget shortfall in the next century. But under any reasonable assumptions (see the box on page 4) they would fall far short of revenues we've enjoyed from Prudhoe Bay, and could not reverse the downward trend. Also, future production from ANWR is extremely speculative right now. Congress would first have to open the refuge to exploration and oil companies would have to discover commercial quantities of oil; after such discoveries it would take years to bring new fields into production.

THE FISCAL GAP

How shrinking production and revenues translate into trouble for Alaska is apparent in Figure 2. It shows the potential size of the future gap

This is the first in a series of *ISER Fiscal Policy Papers* that will examine aspects of state government spending. We intend these papers to focus the attention of state officials and of Alaskans in general on the serious budget crisis we face, and on the necessity for dealing with it soon. We hope this and later papers will provide policymakers with information and analysis they will need when making the difficult decisions ahead.

The author, Oliver Scott Goldsmith, is professor of economics with ISER. He has fourteen years of experience examining state spending. Lee Gorsuch, ISER director, is responsible for the design and presentation of this series. Linda Leask edited the paper.

The *ISER Fiscal Policy Papers* series is financed by a grant from ARCO Alaska.

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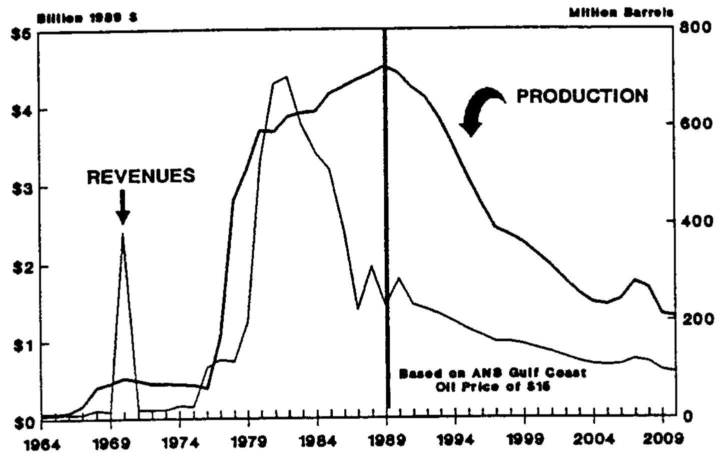
FIGURE 1. PROJECTED ALASKA PETROLEUM REVENUES AND PRODUCTION



between general fund revenues and spending. If annual spending were held at its current level of about $2.25 billion (in 1989 dollars), the gap between spending and revenues could be several hundred million dollars a year in the early 1990s and more than $1 billion annually after the turn of the century. If future revenues turn out to be larger than we anticipate, the fiscal gap could be reduced for a short time but the overall picture would be the same. (See the box on page 4 for a description of how our results would change under different assumptions about future developments and other factors.)

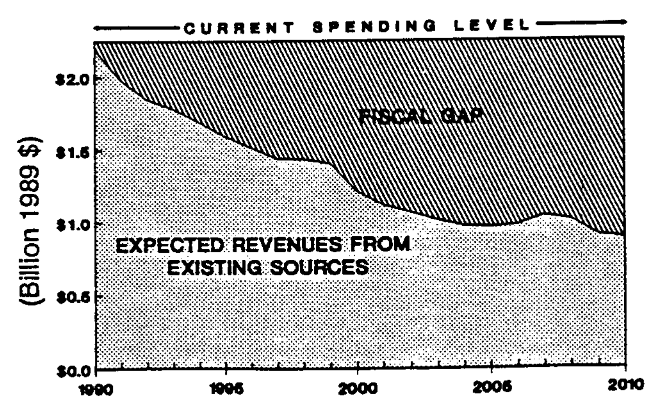
Such a gap of course can't persist. We'll have to balance the budget by cutting spending, raising taxes, using savings, or some combination of the three. These changes will affect not only those who currently enjoy state services, work for state government, or pay taxes. Everyone who benefits from local government services like schools and street maintenance will also be affected. Budget cuts will also affect recipients of government transfers—including Permanent Fund dividends—and businesses that depend on the purchasing power provided by a large public sector.

Balancing the budget will affect all Alaskans, because the economy and people of Alaska are dangerously dependent on state government spending financed by oil revenues. Even now, after several years of recession and a precipitous drop in revenues, state government spending still accounts directly and indirectly for more than one in four Alaska jobs.

Below we look at four possible ways to deal with the fiscal gap between now and the year 2010. Briefly, our four cases are: (1) Stumble From Year to Year; this case assumes that the state tries to maintain current spending for as long as possible by using all available reserves except the principal of the Permanent Fund and then cuts spending to match reduced revenues. (2) Deplete the Permanent Fund; this case examines what would happen if the state maintained the current budget level by spending the principal of the Permanent Fund. (3) Freeze the Budget; this case looks at how the fiscal gap would be affected if the state did not adjust the budget for inflation—in effect cutting the budget by the annual rate of inflation. (4) Cut Spending and Raise Taxes; this case describes the combined effects of reducing state spending, reimposing the personal income tax, and eliminating the Permanent Fund dividend.

There are other possible combinations, but these four scenarios include the main options available to the state. We do not discuss, nor have we attempted to analyze, the enormous political difficulties inherent in exercising any of these options. Some would require changes in law or even amendments to the Alaska constitution. All would generate intense public debate, and most

Figure 2. PROJECTED STATE FISCAL GAP*
(Difference Between Revenues and Spending)



*Projected at the current level of state general fund expenditures. Revenues include oil settlement estimate.

REAL VS. INFLATED DOLLARS IN FISCAL ANALYSIS

For simplicity and clarity all revenues and expenditures are presented in 1989 dollars. Using this technique eliminates the need to estimate the rate of inflation—the value of which has only a marginal effect on the rest of our analysis—and avoids the confusion that inflation can introduce when we try to compare the purchasing power of dollars received at different times. For example, $1 of revenue collected in 2000 would have the purchasing power of just 61 cents, if inflation were 5 percent annually over the next decade. Our use of 1989 dollars throughout the analysis allows direct comparisons of current and future purchasing power.

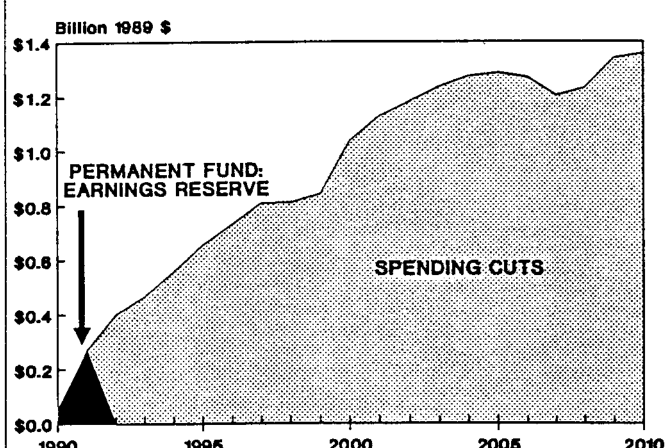
The use of real dollars also corrects a misinterpretation that can arise in revenue projections that use nominal dollars. In such projections, the inflation-proofing portion of Permanent Fund earnings can appear to be a source of recurring revenues. In fact, inflation-proofing is just the portion of earnings needed to offset the devaluation of the fund principal by inflation. Because we use real dollars in our analysis, inflation-proofing does not appear as a separate revenue source, and we avoid any potential misinterpretation. This assumption does not preclude the policy option of appropriating inflation-proofing to fund government spending.

would face extremely strong opposition from specific groups or from Alaskans in general. This paper does not endorse any particular strategy to balance the budget. Rather, it describes in general the tradeoffs—who bears the pain—and the ramifications of the various choices.

Doing an analysis like this requires making certain economic assumptions. Those assumptions are summarized in the box on page 4 and in the individual case descriptions. We can't be sure that these assumptions will prove correct, but changing those assumptions in any reasonable way would not substantially alter our findings.

FISCAL CHOICE 1: STUMBLE FROM YEAR TO YEAR

CHOICE 1. FISCAL GAP FILLED BY:



In this case we look at what would happen if the state government budgeted from year to year, trying to maintain the current level of spending ($2.25 billion in 1989 dollars) for as long as possible, using available fund balances but making no changes in current fiscal policies. The dividend program would not be changed, the principal of the Permanent Fund would be retained, and no new tax measures would be enacted.

Revenues from the settlement of disputes with the oil companies over past royalty and tax payments, as well as with the federal government over ownership of leases in the Beaufort Sea, are an important element of our revenue estimates for the 1990s. The amount and timing of any settlement money the state might receive is extremely uncertain, but we assume for this and the other cases that the settlements occur regularly over the next decade in an amount equivalent to $1.7 billion today. (See also the box on page 4 for an example of how changing this settlement total would change the analysis.) In reality the state may not be so fortunate as to receive a steady stream of income from this source, and the budget shortfall would pressure the state to accept quick negotiated settlements in these disputes.

Under these conditions, the Railbelt Energy Fund, the Earnings Reserve Account of the Permanent Fund, and other fund balances could balance the budget for a short time. A fiscal gap of $400 million would open in 1992 and grow to an annual deficit of $1 billion by 2000. In this scenario, state government and the economy would adjust to reduced state spending as discussed below and shown in the graphs on page 7.

Permanent Fund: The Permanent Fund would remain just about the same size (inflation-proofed) that it is today. Contrary to popular belief, future earnings of the Permanent Fund will not be able to replace petroleum revenues in the support of state government. Annual additions to the fund from petroleum revenues—which the state constitution currently requires go directly to the principal of the Permanent Fund—plus earnings would largely be consumed by the Permanent Fund dividend program, with little or nothing left

ECONOMIC ASSUMPTIONS USED IN ANALYSIS

If we changed the economic assumptions used in this analysis, the rate at which the fiscal gap grows would be different but the options for dealing with the gap would be the same. To focus on those options we held the economic assumptions constant throughout the four cases. The most important assumptions are listed below. (Full details on the assumptions are available from the author.)

OIL PRODUCTION: **Alaska Department of Revenue estimate, Spring 1989, plus West Sak production scenario developed by author (oil companies recently announced postponement of West Sak exploration)**

OIL PRICE: **Gulf Coast delivered price for Alaska North Slope (ANS) crude averages $15 a barrel (in 1989 dollars)**

RETURN ON PERMANENT FUND: **3 percent annually, net of inflation**

EMPLOYMENT GROWTH RATE: **1.75 percent annually, independent of government spending**

SETTLEMENT REVENUES FROM PETROLEUM DISPUTES: **$1.7 billion (in 1989 dollars), received over 10 years**

TAX REGIME: **Reflects the Economic Limit Factor (ELF) as revised by the Alaska Legislature in June 1989**

INFLATION RATE: **5 percent annually**

RECURRING REVENUES (Non-petroleum revenues): **1 percent growth annually, net of inflation**

for fund growth. The total amount available to pay dividends and the payments to individual Alaskans would stay fairly constant because population growth would roughly match growth in the total available for dividends. Dividends as a component of government spending would increase because of decreased spending in all other functional areas.

Revenues: With no new recurring revenues, general fund revenues would steadily decline to about $1.2 billion in 2000. Permanent Fund additions and earnings would remain relatively constant because of the stable size of the fund.

Expenditures: Declining petroleum revenues would force significant budget cutbacks beginning in earnest in 1992. The general fund would need to be cut 18 percent that year to balance the budget. Smaller annual cuts would be the rule over the next two decades. Expenditures in 2000 would be $1.2 billion—equal to revenues collected that year. These cuts in state spending would mean underfunding many and eliminating some government programs; reducing transfers to local governments (creating pressure on local governments to increase taxes and try to shift government functions back to the state); and reducing financial support for individuals. Projected population growth would add to the problem of deciding how the cuts should occur. Uncertainty about the timing and magnitude of cuts from year to year would create continuing confusion and negative attitudes both within government and the private sector.

Alaska Employment: During the next decade 26,000 public and private jobs would be lost as

WHAT IF WE CHANGED THE ASSUMPTIONS?

A question likely to be asked is: How much longer could we maintain current spending if revenues turned out to be greater than we have assumed? If we used up the entire Permanent Fund (as discussed in Case 2), we could maintain current spending up until 2003. Alternate assumptions would add to the number of years that the current spending level could be maintained as follows:

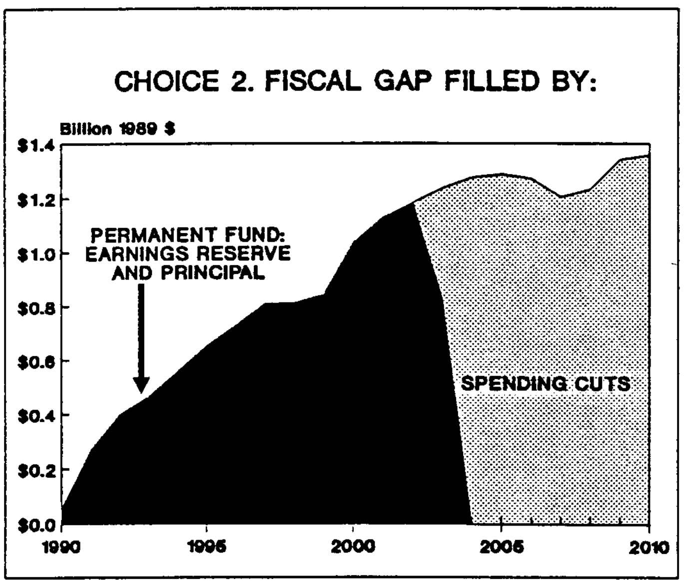
$1 increase in the price of oil	1 year
Gas pipeline in the 1990s	1 year
ANWR production shortly after 2000	1 year
Petroleum settlements of $3.4 billion	2 years

Another likely question is: What would be the cost of a one-year delay in closing the fiscal gap? Our analysis in Case 4 indicates that the state can sustain annual spending of about $1.45 billion (in 1989 dollars) based on the current tax regime, compared with the current spending level of $2.65 billion (including the approximately $400 million paid in Permanent Fund dividends). The difference between current and sustainable spending—$1.2 billion—approximates the loss in state fiscal assets associated with each year of delay in closing the gap.

state general fund spending was cut virtually in half. (For simplicity we assume public sector jobs would be eliminated in proportion to the budget cuts. Wage rate reductions could partially offset this job loss. We also assume that local governments do not raise taxes in response to less state fiscal support.) The drag on the economy created by a job loss of this magnitude would make it difficult if not impossible for the economy to grow, even assuming the private sector could generate new jobs at about the same rate projected for the national economy—1.75 percent annually. Total employment in Alaska in 2000 would be only slightly above what it is today.

Economic Well-Being: Annual percentage changes in employment would hover near zero for most of the next 10 years, with a dramatic drop when government spending was first reduced in 1992. Per capita general fund government spending would fall about 5 percent annually through most of the next 20 years.

FISCAL CHOICE 2: DEPLETE THE PERMANENT FUND



Another strategy for dealing with the budget crisis—the most drastic and one which would require an amendment of the Alaska constitution—would be to use the entire $10 billion in the Permanent Fund to plug the fiscal gap and keep spending at $2.25 billion (in 1989 dollars) for as long as possible. We do not endorse this strategy, but include it to cover the range of options available to the state. Under this scenario, the portion of Permanent Fund earnings now used to protect the principal of the fund from inflation would be spent, as well as the principal of the fund itself.

The first draw—$400 million from inflation-proofing—would be required in 1992. Within two years, however, we would begin taking from the principal of the fund, and the withdrawals would grow rapidly—topping $1 billion for the first time in 2000. The fund principal would be drawn down faster as time went on not only because of the growing fiscal gap but also because the shrinking Permanent Fund would generate less earnings each year. Under this scenario, the effects would be as discussed below and shown in the graphs on page 8.

Permanent Fund: More than $6 billion from the Permanent Fund would be needed to fill the budget gap between 1992 and 2000. The last year of withdrawals would be 2003, when the Permanent Fund would be depleted. The Permanent Fund dividend would be an additional casualty, declining each year as the fund shrank and disappearing when the fund disappeared.

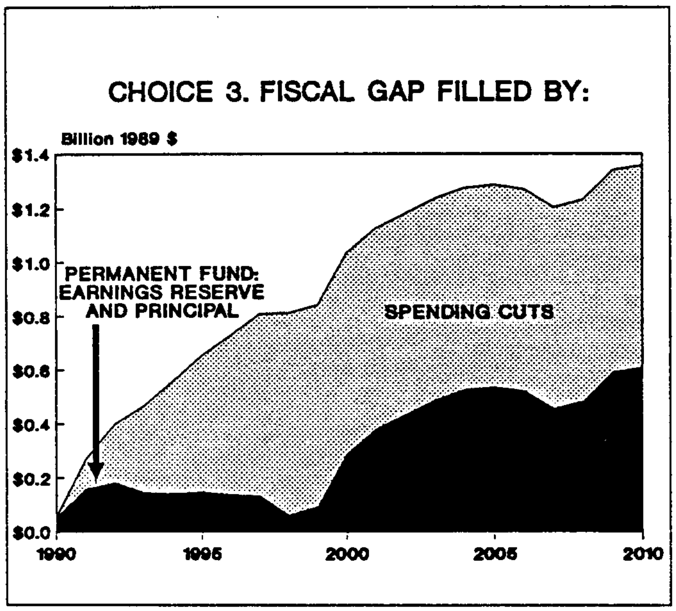
Revenues: Revenues flowing into the general fund would be the same as in Case 1, but the use of Permanent Fund earnings and principal would disguise the shortfall until 2003, when the Permanent Fund would be gone. By 2005, revenues would be about $1 billion—60 percent less than the level expected in 1990. The additions and earnings of the Permanent Fund would fall as the fund itself shrank.

Expenditures: The Permanent Fund would prop up expenditures until 2003. Then a massive "forced transformation" of the public sector and the entire Alaska economy would occur because of the sudden drop in state general fund spending—from $2.25 billion to $1 billion in just two years. All public services at the state and local levels would suffer dramatic cutbacks.

Alaska Employment: Extreme dislocation and a serious economic recession would start in 2003. About 30,000 jobs—both public and private—supported by general fund spending would disappear over a two-year period. (To put such a drop in perspective, job loss during the 1985-1988 recession was about 25,000.) Even assuming private industry would continue to generate jobs at the rate of 1.75 percent annually, by 2010 Alaska would still not have replaced all the jobs lost during the recession.

Economic Well-Being: Alaska employment would increase through 2002 because of growth in the private economy and constant general fund government spending. In the following two years, 12 percent of total state jobs would disappear. Despite constant government spending through 2002, per capita state general fund spending would decline because private economic growth would be drawing people to Alaska. Per capita state general fund spending would be cut nearly in half when the "forced transformation" occurred.

FISCAL CHOICE 3: FREEZE THE BUDGET



The forced transformation of the public sector and the severe recession described in Case 2 could be mitigated under a scenario in which the budget was held constant in nominal dollars—that is, not adjusted for inflation. Such a strategy would reduce the purchasing power of the budget each year by the rate of inflation.

The average annual rate of inflation in the coming years is expected to be in the neighborhood of 5 percent. If the budget were not adjusted for that inflation, the real dollar value (the effective purchasing power) of the budget would fall by 5 percent each year. If the state government implemented a constant budget policy starting in 1991, the budget could be reduced to an arbitrary target level of $1.5 billion (in 1989 dollars) by 1998.

A gradual policy like this would require a large amount of political discipline, but it would have several attractive features--even though it would not entirely solve the state's long-term fiscal problem. Public programs could be phased out on the basis of plans developed to minimize the effects of the budget reductions. The economy would not suffer the kind of massive shock described under Case 2, when state spending would be reduced by half in just two years. The effects of using inflation to cut the budget are discussed below and shown in the graphs on page 9.

Permanent Fund: This strategy at first glance appears to preserve the Permanent Fund, since the balance would hold relatively constant for several years after budget cuts ended. It would require use of portions of the annual appropriations for inflation-proofing during the 1990s. After 2000 continuing declines in revenues would force significant withdrawals from principal. By 2010 the fund principal would be only about $3.5 billion, as compared with $10 billion today. As the Permanent Fund shrank, the amount paid out as dividends would also fall off.

Revenues: General fund revenues would be the same as in Cases 1 and 2. The spending reductions would not be sufficient to produce a general fund surplus; such a surplus could in itself be a new source of earnings. Additions and earnings of the Permanent Fund would taper off after 2000 as the principal of the fund was spent.

Expenditures: State expenditures would fall off gradually but steadily each year until 1998 and then hold steady at $1.5 billion through the next decade—but only because we would be using the principal of the Permanent Fund to supplement other revenues. After 2010 the Permanent Fund would be used up and a smaller "forced transformation" of the public sector and the economy would occur. Under this scenario, dramatic cuts in state spending—as much as 40 percent—would be forced by 2015 (not shown on the graph).

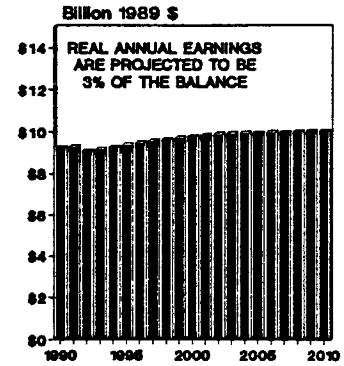
(Text continued on page 11)

Fiscal Choice 1: Stumble from Year to Year

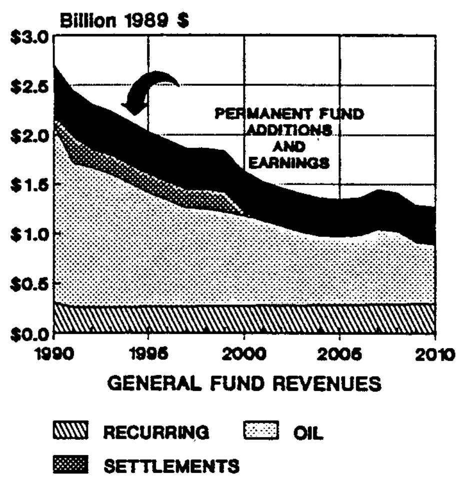
CASE ASSUMPTIONS

- SPENDING: General Fund spending based on availability of revenues up to $ 2.25 billion (1989$)
- TAXES: No new taxes
- DIVIDEND: Retain Permanent Fund dividend
- PERMANENT FUND: Leave Permanent Fund principal intact, continue contributions and inflation proofing, spend earnings reserve account
- OIL PRICE (constant across cases): Average ANS Gulf Coast oil price $15 (1989$)
- SETTLEMENTS (constant across cases): $1.7 billion of oil settlements collected and spent over 10 years

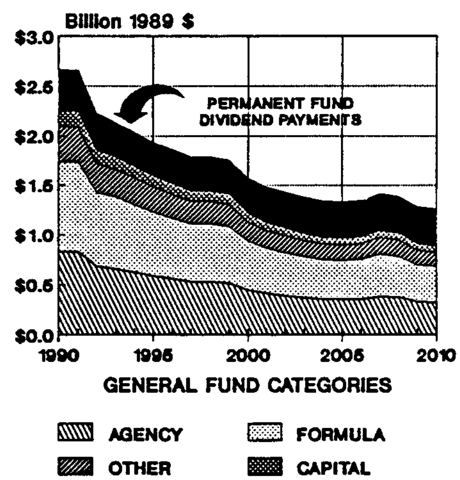
PERMANENT FUND BALANCE



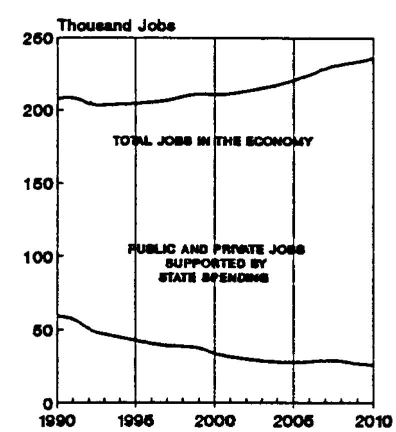
STATE GOVERNMENT REVENUES
(Permanent Fund Included)



STATE GOVERNMENT EXPENDITURES
(Dividend Included)

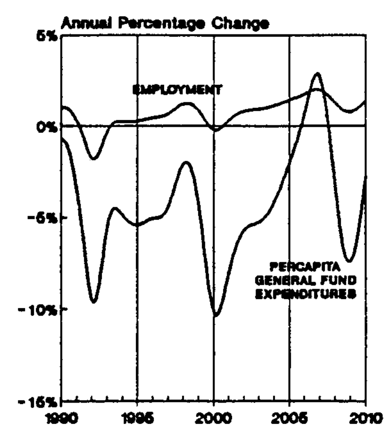


ALASKA EMPLOYMENT



Wage and Salary Employment Only

ECONOMIC WELL-BEING

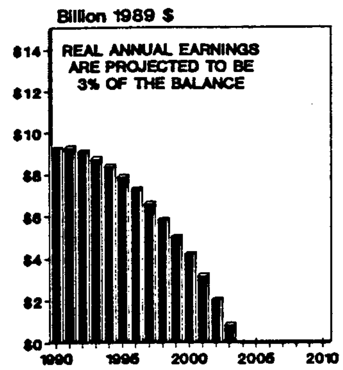


Fiscal Choice 2: Deplete the Permanent Fund

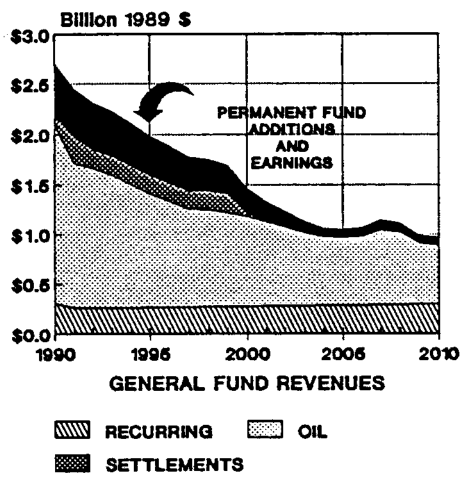
CASE ASSUMPTIONS

- SPENDING: General Fund spending based on availability of revenues up to $ 2.25 billion (1989$)
- TAXES: No new taxes
- DIVIDEND: Retain Permanent Fund dividend
- PERMANENT FUND: Use Permanent Fund principal to maintain spending as long as possible
- OIL PRICE (constant across cases): Average ANS Gulf Coast oil price $15 (1989$)
- SETTLEMENTS (constant across cases): $1.7 billion of oil settlements collected and spent over 10 years

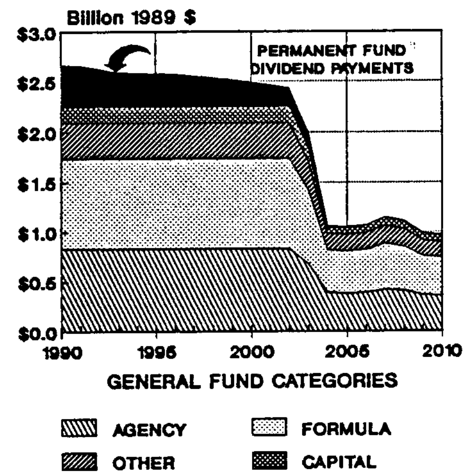
PERMANENT FUND BALANCE



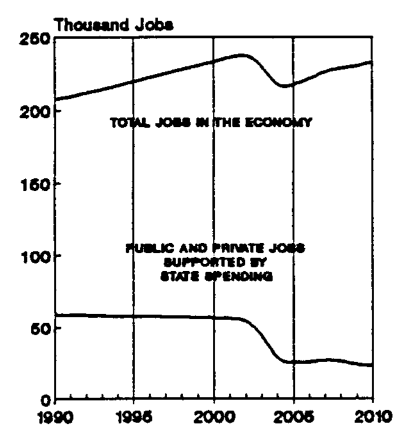
STATE GOVERNMENT REVENUES
(Permanent Fund Included)



STATE GOVERNMENT EXPENDITURES
(Dividend Included)

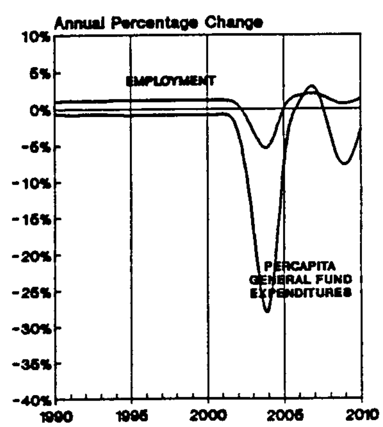


ALASKA EMPLOYMENT



Wage and Salary Employment Only

ECONOMIC WELL-BEING

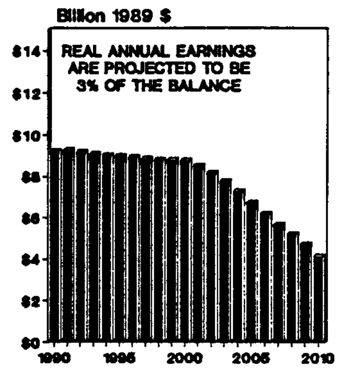


Fiscal Choice 3: Freeze the Budget

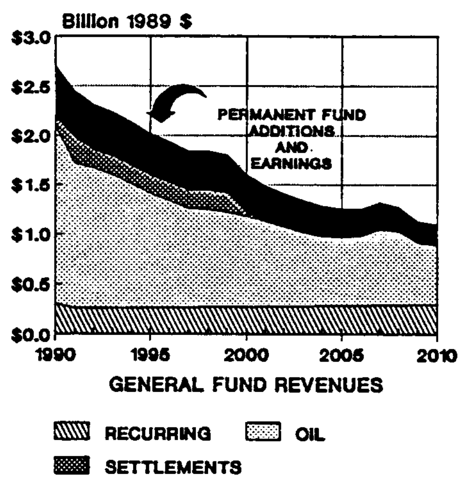
CASE ASSUMPTIONS

- SPENDING: General Fund spending constant in nominal dollars from 1991 to 1998. (The budget declines to a target of $1.5 billion in 1989$)
- TAXES: No new taxes
- DIVIDEND: Retain Permanent Fund dividend
- PERMANENT FUND: Use Permanent Fund principal to maintain spending at targeted level as long as possible
- OIL PRICE (constant across cases): Average ANS Gulf Coast oil price $15 (1989$)
- SETTLEMENTS (constant across cases): $1.7 billion of oil settlements collected and spent over 10 years

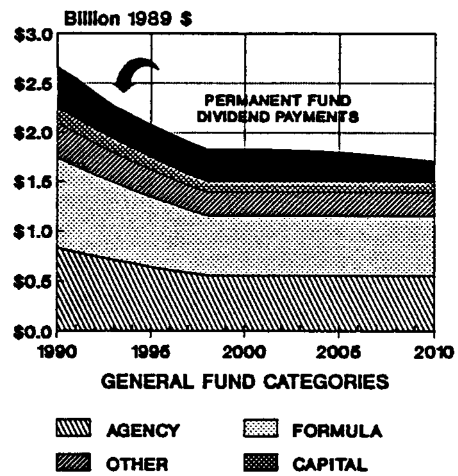
PERMANENT FUND BALANCE



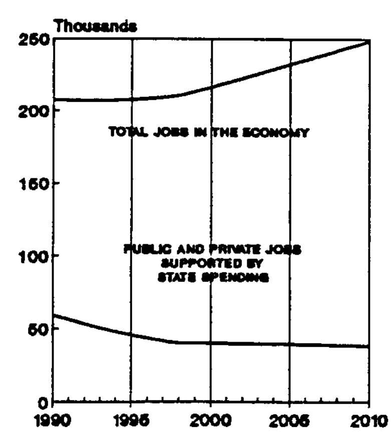
STATE GOVERNMENT REVENUES
(Permanent Fund Included)



STATE GOVERNMENT EXPENDITURES
(Dividend Included)

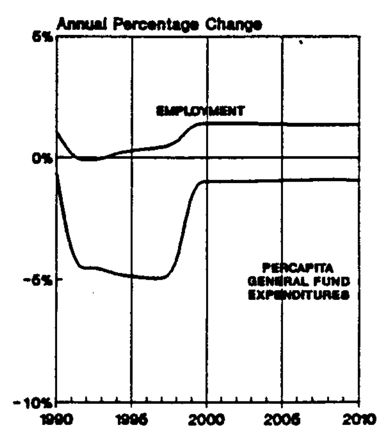


ALASKA EMPLOYMENT



Wage and Salary Employment Only

ECONOMIC WELL-BEING

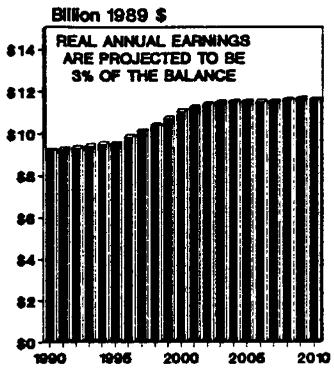


Fiscal Choice 4: Cut Spending and Raise Taxes

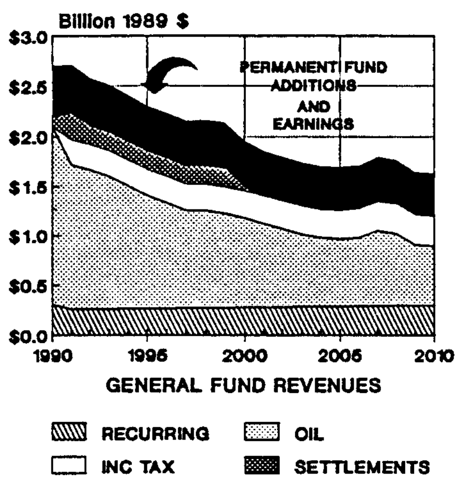
CASE ASSUMPTIONS

- SPENDING: General Fund spending is reduced 2.5% annually (1989$) from 1991 to 2000. (The budget declines to a target of $1.7 billion in 1989$)
- TAXES: Personal income tax reimposed in 1991
- DIVIDEND: Permanent Fund dividend eliminated in 1995
- PERMANENT FUND: Leave Permanent Fund principal intact, continue contributions, spend earnings reserve account. Appropriate real earnings to General Fund. Use inflation proofing to fill revenue gap.
- OIL PRICE (constant across cases): Average ANS Gulf Coast oil price $15 (1989$)
- SETTLEMENTS (constant across cases): $1.7 billion of oil settlements collected and spent over 10 years

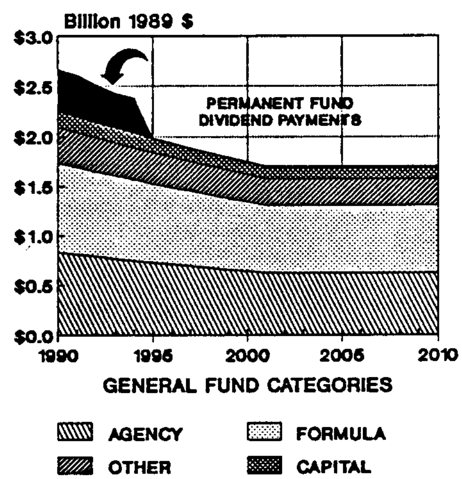
PERMANENT FUND BALANCE



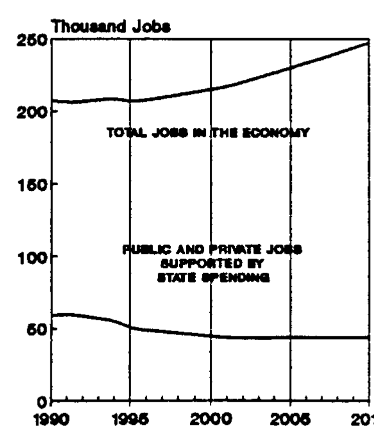
STATE GOVERNMENT REVENUES
(Permanent Fund Included)



STATE GOVERNMENT EXPENDITURES
(Dividend Included)

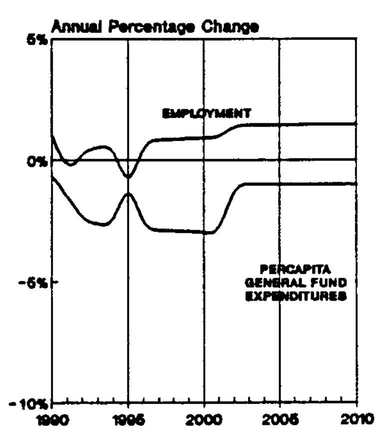


ALASKA EMPLOYMENT



Wage and Salary Employment Only

ECONOMIC WELL-BEING

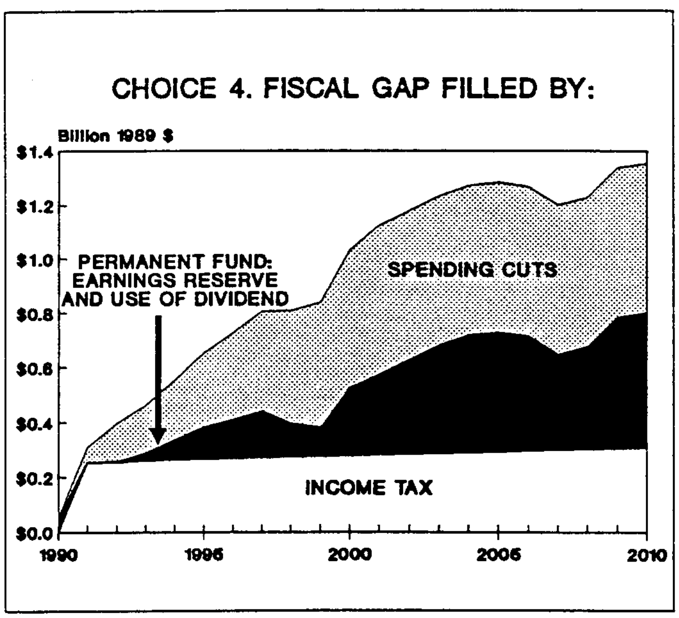


(Text continued from page 6)

Alaska Employment: The number of public and private jobs supported by state spending would suffer gradual attrition throughout most of the 1990s, dropping by about 20,000 over the decade. Private industry would be hard pressed to replace those jobs that had been supported by state spending. Total Alaska employment would stagnate until 1995 and only then begin a gradual increase. However, after 2010, when state spending dropped off very abruptly, a shock wave would again travel throughout the economy, eliminating public and private sector jobs and precipitating another recession.

Economic Well-Being: There would be little year-to-year change in Alaska employment until the late 1990s. In the following decade, modest growth in the private sector combined with stable public employment would result in small annual increases in employment. Per capita general fund state spending would decline every year for the next two decades, but the drops would be smaller after the 1990s. Again, both per capita state spending and employment would suffer after 2010, when state spending dropped sharply.

FISCAL CHOICE 4: CUT SPENDING AND RAISE TAXES



The cumulative budget reductions described in the first three cases, combined with the elimination of the Permanent Fund in the second and third, may be more than Alaskans are willing to endure. An alternative to those kinds of reductions would be for the state government to use new sources of revenues. The most likely sources are a personal income tax and the earnings of the Permanent Fund that now finance the dividend program. Those two together could contribute $650 million annually – $250 million from the income tax and $400 million from the dividend program – to the general fund. In this scenario, we look at what would happen under one possible combination of these two new revenues. We assume the income tax is reimposed in 1991 and that beginning in 1995 the revenues now used to fund the Permanent Fund dividend program are instead used to supplement general fund revenues.

The state would still need to cut the budget, because at the current level of spending the fiscal gap would soon exceed the $650 million generated by these new revenue sources. Furthermore, cutting the budget at the same time new revenues were added would distribute the pain between the taxpayers and the beneficiaries of public spending.

Our analysis suggests that the state is spending $1.2 billion more annually than it can support in the long run, without an income tax ($800 million in general fund spending and $400 million in dividends). If we chose to reimpose the income tax and use the earnings of the Permanent Fund to support public spending, sustainable revenues would increase $650 million annually and $550 million in non-sustainable spending would remain. Thus the general fund budget would need to be cut to $1.7 billion – about a 25 percent reduction. In combination with the revenue generating measures, such a budget cut would eliminate the fiscal gap not only in the 1990s but into the following decades as well – and the Permanent Fund would remain intact.

Depending on when the state receives settlements in tax and other disputes, this scenario might require budget cuts in years of increasing revenues. The state would intentionally collect more than it spent – thus setting aside a small balance of settlement reserves to smooth the transition to a smaller budget. Although that might be a rational decision when we consider the projected revenue decline in the later years, the plan would be tough to justify in the short run, particularly in the presence of fluctuating oil prices. The effects of this fourth scenario are discussed below and shown in the graphs on page 10.

Permanent Fund: The principal of the Permanent Fund would grow slowly through the next two decades, with the addition of revenues from petroleum and withdrawals only of real earnings to fund government. The fund would have a continuing capacity to generate real earnings of $400 million annually that could be used to support public spending. Individual Alaskans would, however, lose their annual dividends in 1995.

Revenues: Even with the addition of new revenues from the income tax, total general fund revenues would still fall under this scenario, because the new taxes would not completely offset lost petroleum revenues. But the drop would not be as dramatic as in the other cases—revenues independent of the Permanent Fund would be $1.5 billion in 2000 and fall to $1.25 billion in 2005. As noted above, the Permanent Fund would produce about $400 million in real earnings annually, some of which could be reinvested in early years.

Expenditures: Annual budget reductions would continue for 10 years, cutting expenditures by 25 percent over the decade. (If the annual rate of inflation averaged 5 percent, then the budget in nominal dollars would be increasing at 2.5 percent in this case.) These cuts would of course reduce the level of government services, but the reductions would be much more gradual than in the other cases we've looked at. After 2000 expenditures could be maintained at the target level indefinitely.

Alaska Employment: About 12,000 public and private jobs supported by general fund spending would disappear as state spending declined. Another 3,000 jobs would be eliminated when the income tax was reimposed and 5,000 more when the dividend program ended. Although the rate of job loss from these government actions over a 10-year period would be gradual, private industry would have to create new jobs at a rate greater than 1.75 percent annually to produce significant total employment growth before 1996.

Economic Well-Being: The economy would contract when the income tax was reimposed, and again when the Permanent Fund dividend was eliminated. Reimposition of the income tax would draw purchasing power out of the private economy. Elimination of the Permanent Fund dividend would shift purchasing power from an activity with a high multiplier to one with a lower multiplier—because the money would be spent not by thousands of individuals but by government. Per capita general fund spending would decline in the 1990s, but the loss would be less than in the other cases. In contrast, per capita discretionary income of Alaskans (not shown on the graph) would fall in this case due to the reimposition of the income tax and the elimination of the dividend.

TRADEOFFS AMONG STRATEGIES

We have described four ways—all of them painful—of dealing with the fiscal gap. In each case the level of public services—both aggregate and per capita—would fall. In each case the private economy would also suffer, since reduced public spending and transfers and increased taxes would mean less buying power. There is no strategy that would close the fiscal gap without creating pain, because the gap can only be filled by taking from somewhere in the economy.

In each case the pain would be distributed among citizens—present and future—in a different way. Those different distributions are the distinguishing features of each strategy. We recognize, of course, that the effects of balancing the budget will vary among individual Alaskans and in different areas of the state. For example, areas where state spending makes up a larger share of economic activity would be harder hit by budget cuts. Similarly, eliminating or reducing Permanent Fund dividends would affect the pocketbooks of low-income Alaskans more than those with higher incomes, while reimposing the personal income tax would have more impact on those with higher incomes. Despite these individual and regional differences, there are broad kinds of tradeoffs all Alaskans will need to consider; some of these are discussed below.

Present vs. Future Public Spending: If we spend less of our petroleum wealth now, more will remain for future needs—our own or those of later generations. Should we discount the needs of the future, because such needs are not easily identifiable or because we think the wealth of future generations is currently underestimated? Or should we weight the needs of the future heavily because new public needs are continually being identified, the population is growing, and we may be overestimating future revenues?

Figure 3 shows state spending levels over the next 20 years under our four choices. All the choices show much lower spending by 2010 – but how much we spend along the way varies sharply among the choices. Choice 1 and Choice 2 offer the biggest contrast in spending over the next decade; under Choice 1 we would continue current fiscal policy, using all available reserves except the Permanent Fund, while in Choice 2 we would prop up spending by draining the Permanent Fund. Although spending would obviously be much higher under Choice 2 over the next decade, by 2010 spending under both cases would fall to about the same level – but the Permanent Fund would be gone under Choice 2. Choice 3 also would prop up state spending by using the Permanent Fund, but at a slower rate. Spending under Choice 4 would be highest in 2010 – but we would maintain that spending level without drawing on the Permanent Fund principal.

Figure 4 shows how each of our four choices would affect the Permanent Fund, our primary repository of oil wealth. The fund and its earning power would not last long if we opted to use the principal to prop up state spending. In Choice 2, the fund would be used up in 2003; in Choice 3 it would dwindle after the 1990s and be gone by 2015. The fund would increase somewhat under both Choices 1 and 4. But under Choice 1 the fund would be left intact while state spending shrank and the state government and the economy floundered from year to year. Under Choice 4, state spending would be stabilized and the economy would not be jolted by continuing spending cuts over 20 years – but it would be stabilized at the cost of a new personal income tax and the elimination of Permanent Fund dividends.

The most straightforward benefit to the average Alaskan from the Permanent Fund has been the annual dividends paid out of fund earnings. Figure 5 shows how dividend payments would be affected under each of our four choices. Under Choice 1, real dividend payments (in 1989 dollars) to each Alaskan would remain fairly constant over the next 20 years, since population growth would roughly match growth in the amount available for dividends. Under Choice 2, the dividends would shrink over the next decade as the principal of the fund was being drawn down and its earnings reduced; the last dividends would be paid in 2004. The attrition of dividends would be somewhat slower under Choice 3, but the result would be the same: shrinking and then disappearing dividends by 2015. Under Choice 4, the dividend program would end in 1995 and the money that formerly went into that program would be shifted over to the general fund.

To conclude our discussion of spending, we should note that in the past decade the state government has spent part of its oil wealth in ways intended to stimulate future economic growth rather than simply to maintain current programs. Many of these ventures have so far had limited success, and it's outside the scope of this paper to assess their value to the state as investments. But to the extent that the state can use its oil wealth to promote economic growth, that kind of spending should be viewed as investment and distinct from spending that simply creates jobs and income in the present.

Present vs. Future Economic Activity: The Alaska recession that followed the "petrodollar boom" of the early 1980s demonstrated that a large portion of the economic activity stimulated by state spending of oil revenues could be sustained only as long as the flow of oil dollars continued. We can continue to spend oil revenues when we receive them, and immediately receive the benefits of the jobs and income produced by that spending. Alternatively, we can postpone spending some of the revenues and receive the economic benefits at some future time. The choice should depend on when those jobs and income will contribute most to the economy and on what we want to save for future generations. Until we make such a choice, the marketplace – essentially the OPEC cartel and the petroleum production cycle – will continue to dictate the booms and busts of our economy.

Figures 6 and 7 show how the number of jobs supported by state spending – including both public and private jobs – and the total number of jobs in Alaska would vary under our four choices. Under Choice 1, the number of jobs supported by public spending would decline steadily for the next 20 years. Under Choice 2, spending of the Permanent Fund would keep such jobs at about their current level until the fund was exhausted in 2003 – then many jobs would be eliminated quickly, and by 2010 there would be about half as many jobs supported by public spending as there are today. Under Choice 3, which involves more gradual use of the Permanent Fund, the number of jobs created directly and indirectly by state spending would drop somewhat by 2010 – but not shown on the graph is a very sharp drop that would occur after 2010, when the Permanent Fund was depleted. As with the other cases, the number of jobs supported by state spending would also drop under Choice 4, but the decline would be somewhat smaller and the number of such jobs would stabilize after 2000.

How total jobs in the state – including both those supported by public spending and those by private industry – would fare under each of our choices depends largely on the timing of public spending and on whether the Permanent Fund is depleted. We assume in all cases that private industry in Alaska is able to generate new jobs at an average annual rate of 1.75 percent. Under Choice 1, it would take about 10 years for private growth to offset the job loss from reduced public spending. Use of the Permanent Fund would keep the number of jobs growing under Choice 2 – until the fund was used up; then a severe recession would occur. By 2010 Alaska employment would be lowest under Choice 2. Under Choice 3, total jobs would grow slowly but steadily through 2010 – but again, not shown on this graph is a sharp decline in jobs that would happen around 2015. Employment under Choice 4 would be slightly lower than under Choice 3, because in that case spending of the Permanent Fund would not be supporting jobs. However, unlike Choice 3, Choice 4 would not involve a recession in 2015.

Public vs. Private Consumption: How much we are able to consume as a state ultimately depends on the productive capacity of our basic industries – petroleum, seafood, tourism, mining, forest products and federal government spending. The split between public and private consumption does not affect this capacity unless government raises taxes so high that private economic incentives are adversely affected. However, the distribution of the benefits **does** depend on that split. We have argued that the current rate of consumption can't be sustained (because public spending exceeds sustainable public revenues), but we have not suggested what the proper balance is between public and private consumption. Is public consumption in Alaska too large because of historical accident and because the only constraint on public spending seems to have been the availability of revenues? Or should we increase public consumption relative to private consumption to meet the continuing growth in those needs best served through public action? Do we need a large public sector to balance the dominant economic influence of a single commodity? Or does high public consumption hamper diversification in the private sector?

Gradual vs. Abrupt Transition: A gradual transition to a sustainable level of public spending would allow both the public and private sectors to adjust in ways that would minimize the pain from the loss of public services, income, and employment. At the same time, a gradual transition would be very difficult to manage politically and would have a lasting negative psychological effect on the state and population. A quick transition would not leave much time for adjustments and would cause some inefficiencies as public agencies, businesses, and individuals reorganized in the wake of budget cuts. On the other hand, the detrimental psychological effects would be short-lived.

Figure 8 shows the different rates of spending cuts under the four cases. The most drastic would be Choice 2, where state spending would drop by more than half shortly after 2000. Choice 1 would see sharp cuts in the early 1990s and then a continual downward drift for the next 20 years. Choice 3 would result in a fairly stiff drop in the early 1990s followed by relatively stable state spending through 2010 – but then another sharp cut in the next decade. Under Choice 4 we'd see small but steady decreases throughout the 1990s but a leveling off after that.

Public vs. Private Economic Activity: Delivering public services requires hiring public employees – teachers, construction workers, office workers – and indirectly generates private employment. Delivering private goods and services requires hiring private employees – clerks, construction workers, office workers. Is the mix

Comparisons Across Fiscal Choices

Figure 3

STATE GENERAL FUND EXPENDITURES

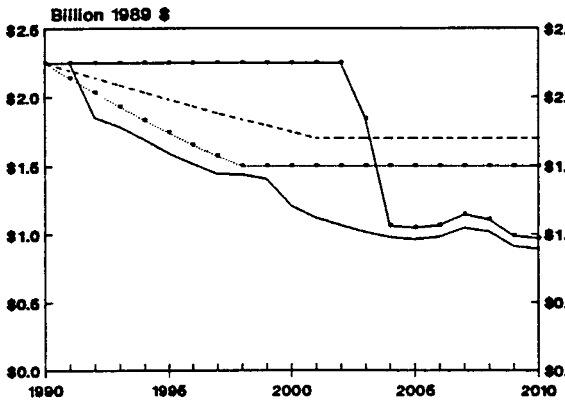


Figure 4

PERMANENT FUND BALANCE

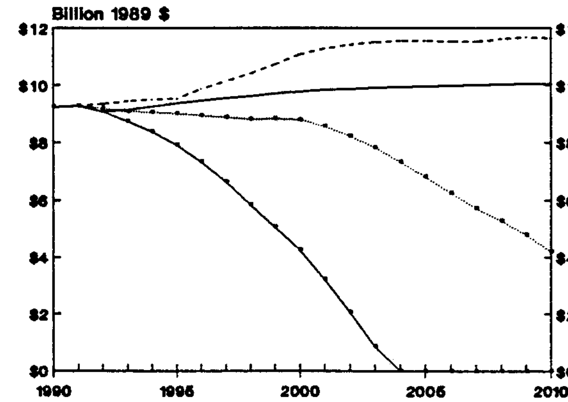


Figure 5

PERMANENT FUND DIVIDEND

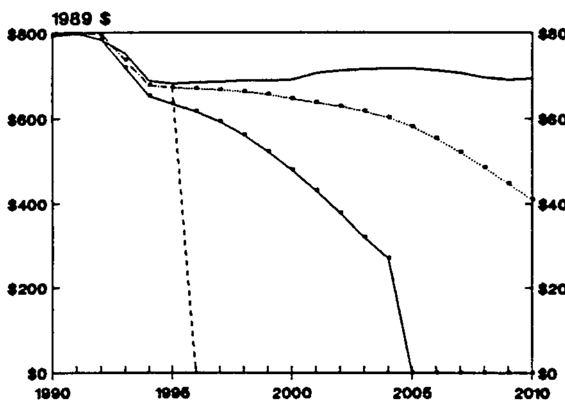


Figure 6

STATE SUPPORTED EMPLOYMENT

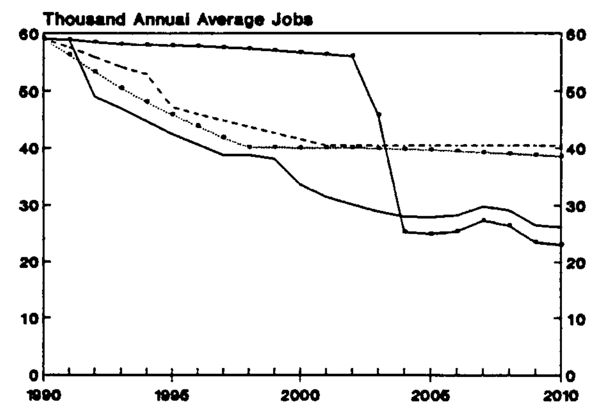


Figure 7

ALASKA WAGE AND SALARY EMPLOYMENT

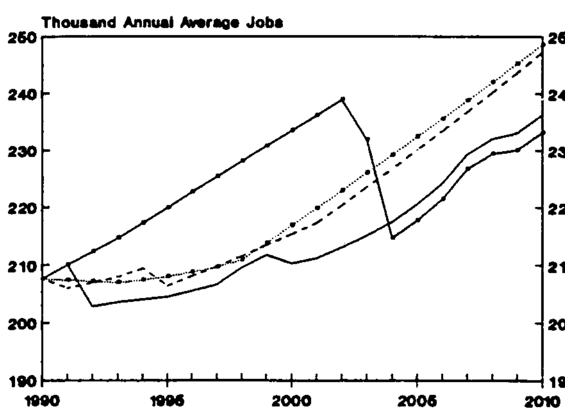
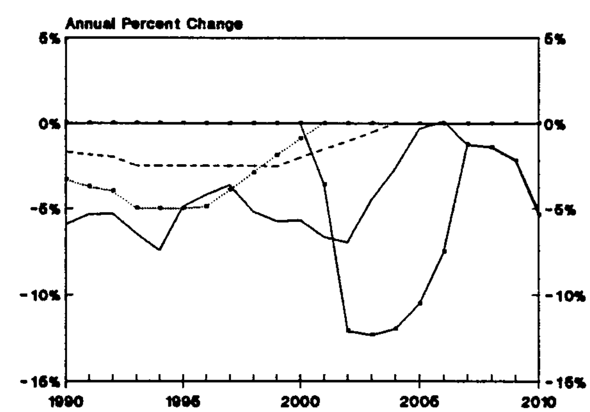


Figure 8

GENERAL FUND SPENDING: YEARLY CHANGE



Values have been smoothed.

SCENARIO

1 STUMBLE ALONG — 2 USE PERMANENT FUND

3 BUDGET FREEZE — 4 BUDGET CUT & TAXES

of public and private jobs in the economy an important consideration, independent of the mix of goods and services provided?

It would be if the economic multiplier—the capacity of one job to create other jobs—were significantly different for public and private jobs. However, there doesn't seem to be a significant difference between the multiplier effects of public and private jobs, since most of the multiplier effect in the Alaska economy comes from the successive re-spending of income earned as wages and salaries, independent of who writes the checks.

CONCLUSION: A CALL FOR ACTION

These cases show some of the consequences of four different choices for closing the fiscal gap facing Alaska. As we noted at the outset, we have not assessed the political difficulties of putting budget changes into effect—but of course we recognize that enormous difficulties will accompany any such plan. Further, we don't know whether the assumptions we've used in this analysis will turn out to be accurate. But whether the price of oil is higher or lower than we've assumed, or other circumstances are somewhat different than we project, Alaska faces a serious fiscal problem. Despite the uncertainties always inherent in planning for the future, this analysis suggests positive action is warranted—and the sooner it is taken the better.

Differences among the four choices demonstrate that we can influence outcomes and change tradeoffs through public choices. For example, we can choose whether the Permanent Fund will be a lasting asset, throwing off income for future generations of Alaskans, or whether we will spend it to get ourselves through the next decade without sacrifice. We can decide on the mix of current versus future spending, total public versus private spending, and when to take the inevitable hit on the economy. With advance warning, we have an opportunity to plan spending reductions in an orderly fashion.

It is clear that what actions to take are political rather than economic decisions. Nonetheless, each decision will have significant economic consequences. Policymakers need information about the implications of different choices to make informed political decisions. Future issues of this series will seek to enlarge the scope of public information to help in this important public debate.

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April 12, 1989

News Release

Tabulation of the results of the statewide Closing the Budget Gap survey of all Alaska households has been completed.

The results were tabulated statewide and by region. Also included is a graphic representation of statewide totals illustrating the prevailing opinion on each question in percentages.

The survey, which was part of an eight-page tabloid publication sponsored by the Governor, the House and the Senate, was mailed to 248,821 households. A total of 6,541 surveys were returned for a response rate of approximately three percent. Approximately 150 communities are represented. The publication was mailed during the first week of March and the majority of responses were received by March 20.

The results are not presented as the product of a scientific poll as it is not a random sampling of opinion. Due to the length and complexity of the informational mailer, those who responded were likely to feel particularly strong about state fiscal policy. The results should be viewed as a barometer of Alaska public opinion on the admittedly broad areas of public policy covered in the publication.

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Statewide Results

Number Surveys Mailed:	248,821				
Number of Responses:	6,541				
Percentage Responding:	3%				
Number of Communities Responding:	150				
Would you favor reductions in the following areas?					
State Government Programs	**Yes**	**No**	**No Opn**	**% Yes**	**% No**
Education	2,784	3,493	197	43%	54%
Justice and Public Protection	2,538	3,771	231	39%	58%
Health and Social Services	3,172	3,155	213	49%	48%
Transportation	3,455	2,846	239	53%	44%
University of Alaska	3,512	2,824	204	54%	43%
Natural Resources	3,346	2,942	252	51%	45%
Environmental Protection	2,631	3,698	211	40%	57%
Business Development	3,711	2,599	230	57%	40%
Revenue	2,494	3,766	280	38%	58%
Individuals & Local Governments	**Yes**	**No**	**No Opn**	**% Yes**	**% No**
Public Schools	2,840	3,740	230	42%	55%
Aid to Local Governments	4,185	2,134	221	64%	33%
Public and Medical Assistance	3,075	3,235	230	47%	49%
Senior Programs	3,145	3,185	212	48%	49%
Power Cost Equalization	4,420	1,878	242	68%	29%
Loan Programs	**3,997**	**2,327**	**216**	**61%**	**36%**
Would you favor increasing revenues in the following ways?					
Taxes & User Fees	**Yes**	**No**	**No Opn**	**% Yes**	**% No**
Personal Income Tax	2,199	4,202	139	34%	64%
Severance Tax ELF	3,654	2,627	259	56%	40%
Statewide Sales Tax	2,232	4,135	173	34%	63%
Fish Landing Tax	3,633	2,573	334	56%	39%
Gasoline Tax	2,891	3,471	175	44%	53%
Alcohol and Cigarette Tax	5,253	1,198	81	80%	18%
Statewide School Tax	3,088	3,231	209	47%	49%
User Fees	3,186	3,131	222	49%	48%
Reallocate Cash & Reserves	**Yes**	**No**	**No Opn**	**% Yes**	**%No**
Railbelt Energy Fund	3,587	2,607	346	55%	40%
Permanent Fund Reserves	2,571	3,796	173	39%	58%
Eliminate PF Dividends	1,004	5,410	126	15%	83%
Cap PF Dividends	2,036	4,356	148	31%	67%
Eliminate PF Inflation Proofing	833	5,425	282	13%	83%

MADE IN ALASKA