The Early History of the Alaska Permanent Fund

Perspectives on the Origins of Alaska's Oil Savings Account

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Dear Fellow Alaskans,

The Board of Trustees is pleased to present the fifth in a series of Trustee Papers that trace and examine the major issues surrounding the establishment and development of the Alaska Permanent Fund. This latest edition is entitled: "The Early History of the Alaska Permanent Fund: Perspectives on the Origins of Alaska's Oil Savings Account." It examines the initial debate that defined the Fund's mission and its early policy decisions.

This paper consists of four separate documents. The first, a speech by Elmer Rasmuson, the Trustees' first president, examines the establishment of the Alaska Permanent Fund Corporation and the Fund's early investment philosophy.

Joan Kasson's "The Creation of the Alaska Permanent Fund Corporation" follows the debate about the shape and powers of the corporation and the many purposes it could fulfill.

The third section, "The Permanent Fund Dividend Program," looks at Alaska's unique decision to distribute dividends directly to its residents instead of following the more conventional program of using revenues to fund traditional governmental programs.

The final document is an in-depth analysis of the "Legislative History, Intent and Operations" of the Fund, and examines such policy decisions as the Fund's intent, its corporate structure, the dividend program and the prudent investor rule.

We hope you will find this paper as informative as the others that have preceded it. If you have ideas or suggestions about future Trustee Papers, please don't hesitate to contact me.

Sincerely,

Grace Berg Schaible

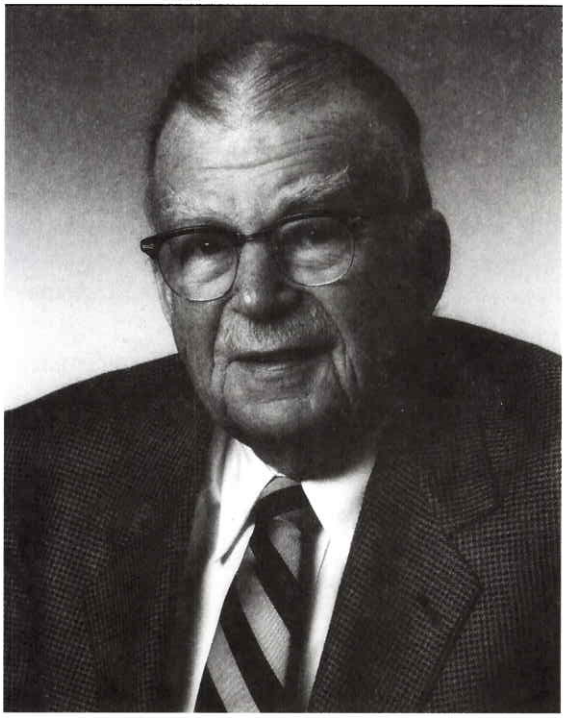
Grace Berg Schaible
Chair, Board of Trustees

Table of Contents

Historical photos courtesy of the Anchorage Daily News

A Founder's Reflections on the Early Days of the Alaska Permanent Fund Corporation

By Elmer Rasmuson



Elmer Rasmuson of Anchorage, a respected long-time Alaska banker, served as the first Chairman of the Permanent Fund's Board of Trustees.

"The Fund will always be an institution in which I have a close and abiding interest."

Elmer Rasmuson, a respected long-time Anchorage banker, was the first Chairman of the Board of Trustees of the Alaska Permanent Fund Corporation, and served on the board until 1986. The following paper is a transcription of his address to the 1993 annual meeting of the Corporation's Board of Trustees in Ketchikan on September 28, 1993.

Mr. Chairman, Trustees, Ladies and Gentlemen:

First, I wish to express my deep appreciation of the honor and privilege of addressing you on the occasion of the 1993 Annual Meeting of the Alaska Permanent Fund Corporation. The Fund will always be an institution in which I have a close and abiding interest.

Concerns about the Permanent Fund usually cluster around three aspects:

- First, investment operations and results.
- Second, purpose and use of the Fund principal and income.
- Third, social and political consequences and influence.

In my remarks tonight, I will touch on all three. I am going to start with some review of the history of the Fund and the basis for some of the early decision-making in which I was involved.

Fund History

Ordinarily, I do not spend much time in looking backward. I rather follow the philosophy of that pitching great – Satchel Paige. "Don't look back; the bastards may be gaining on you!"

Alaska's great oil reserves made the Permanent Fund possible. Here bidders crowd the Sydney Lawrence Auditorium for the opening of North Slope oil lease bids offered by the state in 1969.

However, it has been well said also that, "Those who do not learn from history are condemned to relive it."

Another reason I feel it desirable to describe the basis of some of the early decisions, is that it is not disclosed in the official history of the Permanent Fund. When I was appointed to the Board of Trustees, I was the only member who was not a resident of Juneau. The Board elected me chairman. Much of the agenda of the early meetings was contained in memoranda that I entitled "Thoughts of the Chairman." Nevertheless, when the Legislative History of the Fund was written in 1986, I was never contacted, nor is the whole story written of why certain decisions were made – both positive and negative.

In evaluating historical events, time is the greatest instrument of perspective. What is not supported by the test of time can be dropped out. But recommendations, not supported originally, yet still pertinent, deserve to be re-surfaced and hopefully followed.

I shall identify in these remarks certain recommendations which I continue to feel would be beneficial for the long-run management of the Fund. In this connection, I might mention that all of us who have had the responsibility of advocating courses for public action, are afflicted at times by what I call "Cassandraism." That is a word I have coined to

describe the fate of Cassandra, daughter of the king of Troy. She was granted the spirit of prophecy but got crosswise with the god Apollo. The latter could not take away her gift but ordained that her prophecies would never be believed.

Constitutional Amendment Necessary

The dissipation, through state spending, of the bonus payments received from both the Cook Inlet and North Slope leases prompted many concerned Alaskans to vow to do better with the royalty income. This resolution was led by Gov. Hammond.

However, because the Alaska Constitution prohibited any dedicated funds, it was necessary to have an amendment thereto. This was accomplished in the fall of 1976 when the people of Alaska voted to set aside in a Permanent Fund at least 25 percent of the state's oil royalties and related income. It is important to note that, under the terms of the amendment, while the principal of the Fund is permanently stashed away, the disposition of the income is completely up to the discretion of the Legislature.

The Constitutional Amendment that created the Permanent Fund mandates that at least 25 percent of all oil royalties and bonus bids be deposited in the Permanent Fund.

In truth the Permanent Fund began, chiefly, with a "negative" goal, to place a part of the one-time oil wealth beyond the reach of day-to-day government spending. That this savings approach has been accomplished is evidenced by the handling of the $41.8 billion of state oil revenues received during the fiscal years 1977-1993. Eighty percent, or $33.5 billion, has been spent in the General Fund. Eighteen percent, or $7.6 billion, has been saved in the Permanent Fund. Two percent, or $691 million, has been saved in the Constitutional Budget Reserve Fund.

It took four years after the Constitutional authorization before the Legislature passed a bill in 1980 creating the Alaska Permanent Fund Corporation, providing for independent management by a Board of Trustees, a cautious list of authorized investments – principally government bonds – and a dividend program for the public from the Fund's earnings. In this interim period, there was much debate in the Legislature and press about the use of the Fund, with emphasis on economic development and social benefits.

Fortunately, the Legislature limited the charge to the Fund trustees to investment responsibilities. The "soft dollar" allocations of oil money and economic stimuli were left to other corporations or specific appropriations. This was a crucial and wise decision by the Legislature. By restricting the duties of the Trustees to investment management, their task was simplified, their performance could be objectively measured in the marketplace and they were freed in large measure from social and political pressures. In truth, much of the success and prestige of the Permanent Fund is due to their singleness of financial stewardship. The contrast with the early performance of the Alberta Heritage Fund is eloquent proof of the superiority of the Alaska course of action.

"In truth the Permanent Fund began, chiefly, with a 'negative' goal, to place a part of the one-time oil wealth beyond the reach of day-to-day government spending."

Board's First Meeting

The first meeting of the Fund's Board of Trustees was in September 1980. There were two obvious tasks confronting the Board. The first was to set up the organization that could independently manage the investments belonging to the Fund but currently in the custody of the Department of Revenue. The second was to establish criteria for developing a portfolio and the mechanism for managing it.

Because these and other considerations would probably merit public input and cer-

tainly legislative action, it was agreed by the Board to use the first year to study the problem and then submit our recommendations for legislative authority. This was acceptable to the governor and we established close working relations with the Legislative Budget and Audit Committee so there would be no surprises when we submitted our legislative proposals.

I think it is probably safe to say that none of the original Board of Trustees had had any real investment experience in Fund management. Certainly, I did not. I was a commercial banker, not an investment analyst. However, being thrust into a situation wherein I had no previous experience seems to be the story of my life. I have found the best procedure is to read what I can and learn from those who have good track records.

Consequently, I made arrangements to meet with available fund managers or policy makers on the East Coast. These were around 10 of the largest business concerns, one state manager and two university fund experts – Harvard and Yale. Subsequent to this trip I visited a smaller but representative group on the West Coast.

Researching Existing Funds

In the initial trip, I could not get any of the other Trustees to travel with me. The commissioners were busy with their departmental duties. The two other public members apparently had other commitments of higher priority. This difficulty of enlisting Trustee support for travel and management duties, outside of meeting attendance, has colored my perception of what the Trustee responsibilities should embrace.

In each interview I asked questions seeking to identify a common thread of superior investment performance and the preferred organization. Three principles came through loud and clear. First is an emphasis on a common stock portfolio – anywhere between 50 percent and 80 percent of assets. Second is a continuous monitoring of performance and selection, using a combination of in-house and outside management. Third is a long-term adherence to the policy of reinvesting up to half of the annual earnings as an addition to principal to cover inflation and to increase earnings.

Striking the right asset balance is a major consideration for the Board of Trustees, chaired by Grace Berg Schaible, shown here with former Gov. Bill Sheffield.

The pension funds were very helpful in determining best investment performance. However, their objective is quite different from that of the Permanent Fund. Pension funds have only one concern – to fund defined retirement benefits. Superior investment performance does not increase benefits; it merely reduces the corporate contribution.

Most analogous to the Permanent Fund are the university endowment funds. The objective of the latter is to maximize income within the bounds of safety, provide a dependable amount of annual income to the academic departments and to preserve and enlarge the investment pool. The outside source of additional capital to the Permanent Fund is the 25 percent oil royalty income. The similar infusion for university endowments comes from annual giving by alumni and friends.

Most helpful in developing my learning curve were the words of advice from George Bennett, chairman then of State Street Investment Company. George had previously been treasurer of Harvard University and a key founder in the Harvard Management Company. I will relate an anecdote from our conversations.

On entering his office I noticed an abundance of yachting pictures on the walls. In the course of our visit I asked him what was the best single guide in choosing an investment manager and evaluating his performance. His reply was that in yacht racing he did not try to be the first in a race. His goal was to come in second or third, and if he could do this consistently, he would win the regatta.

His point is that the top performer in a particular year is due largely to that investment style coming into favor. Top performance carries more risk in volatility and the number one in any year is likely to be a dud in the next. Diversification in style as well as security is essential.

Seeking Public Comment

During the course of this initial year of study, the Trustees sponsored a series of seminars in different locations in Alaska. There was a twofold purpose in these seminars. The first was to develop a more informed constituency among the Alaska public. We invited lecturers of various views but with impressive credentials from studying and advising other governments with large oil revenues. Most of these lectures are preserved in the publication of "The Trustee Papers." The second objective was to obtain directly and informally views of the Alaska public.

With the benefit of ideas from these various sources, discussions with the legislative oversight committee and input from each member of the Board of Trustees, the task was begun of developing a consensus within the Board for official recommendations for legislative action. My own ideas are set forth in some detail in a memorandum to the Board in November 1981 on "Considerations for Permanent Fund Legislation."

Advice on how to structure the Permanent Fund came from Milton Friedman, the Nobel-Prize-winning conservative economist from the University of Chicago.

There was unanimous support within the Board for broadening the investment base to include equities, such as common stocks and selected real estate. This followed the advice and experience of outside funds and meant the Permanent Fund could benefit from the general economic growth of the nation as well as receive an annual income.

The Legislature accepted this recommendation with respect to domestic stocks. The Board also wanted to include foreign stocks. There are many reasons for this but one statistic is illustrative. Twenty-five years ago, 75 percent of the listed securities of the world were on U.S. exchanges. Today this percentage has dropped to around 25 percent. The foreign stock issue failed largely because of parochialism of certain legislators. The merits of this issue finally prevailed and the necessary authority was given in 1989. The cost of this delay has undoubtedly been multi-million dollars in lost income.

Inflation-proofing was another issue which was accepted rather easily. Although this concept was not in prominent discussion prior to the Enabling Act of 1980 and was not mentioned in that act, the importance of reinvesting some portion of Fund earnings to offset the ravages of inflation and thus preserve permanently the purchasing power of the Fund as well as its nominal value, was persuasive. Influential in this consideration were the horror stories of what happened to the real earnings' value of the Ford and Rockefeller foundations. Also the Legislative Budget and Audit Committee had independently received a legal opinion from a prestigious New York law firm that the legislative requirement of the "Prudent Investor" rule mandated selection of investments and procedures which would maintain the purchasing power of the Fund dollar. Currently, the public has overwhelmingly supported this concept by an 83 percent to 13 percent vote in a 1989 poll.

"There was unanimous support within the Board for broadening the investment base to include equities, such as common stocks and selected real estate."

Corporation is Insulated from Politics

The independence and composition of the Board of Trustees became a controversial issue. At first blush, it would seem simple to comply with the legislative intent in the 1980 Act. This declares that the Permanent Fund Corporation is to be " ... managed by the board of trustees. The purpose of the board is to manage and invest the assets of the corporation in accordance with this chapter." (AS.37.13.040)

However, there is a double-ended elusiveness about the meaning of the term "manage." On the one hand, how much is the Board independent of the governor and the legis-

lators? On the other hand, how much direction and supervision does the Board give to the staff and vice-versa?

To appreciate the intricacy of the situation, a little background is helpful. There is no doubt from the public and legislative debate that the majority view was to insulate the management of the Fund from political pressures. This was ostensibly achieved through the creation of a separate managerial corporation, providing for transfer of the funds from the Department of Revenue and the appointment of three public members.

However, there is much subtlety in the political process, whether this be state or federal. The Permanent Fund Corporation was created at a time when the Legislature had followed a practice in the creation of boards and commissions to name either legislative members or executive commissioners over which they had confirmation or budget review. Else why select three commissioners? The Legislature retains oversight authority through its Legislative Budget and Audit Committee, maintains budget control over the Corporation's expenditures and has final decision over the eligible investment list.

Board Membership Issues

The Alaska Permanent Fund Corporation public board members in 1987 (from left): Hugh Malone, Byron Mallott, Clyde Sherwood and Oral Freeman.

Being aware of this and having observed the participation of the Board members during the year of study, I recommended in my memorandum to the Board that: "The movement towards beneficial independence can be facilitated by a change in the composition of the Board of Trustees to limit the cabinet representation to the Commissioner of Revenue and have four public members with staggered terms of office of four years each."

The then-incumbent Commissioner of Revenue argued against reducing cabinet representation to only one commissioner and in the interest of getting the full bill passed, I dropped the issue. I submit to you, if there are valid arguments to reduce cabinet representation (and possible gubernatorial influence) from three to two, why not to one?

The question of compensation to the public members proved an even thornier issue and one that I believe is of continuous and substantive importance to the management and preservation of the Fund.

The 1980 Act provided for compensation to the public Board members to be an honorarium of $400 for attendance at meetings. Believing strongly that in this practical world you get what you pay for, I recommended that there be substituted an annual fee for all personal services of each public member. I stated my reasoning as follows:

> "The attendance honorarium is illogical in that it assumes that the Trustees' services are performed only at a stated meeting. It ignores the fact that the Board is a working body involving continuous services in committees, traveling, consultation with staff, investment managers, other Fund Trustees, participation in work shops with legislators, interested public groups, etc."

I suggested the annual fee be on a par with that of the legislators. My rationale was that it be

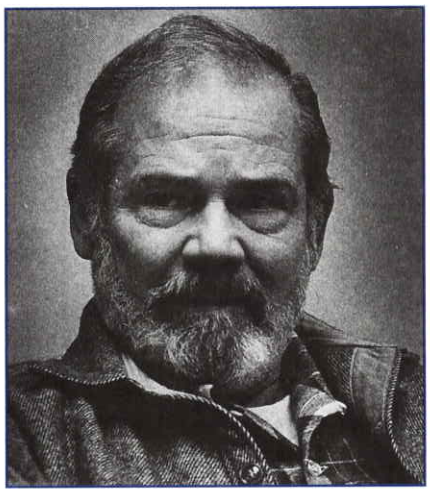
> " ... set midway between the value of the Trustee's services in the marketplace and a pure donation of time which is not within the ability of many fine,

potential Trustees. It is not so large as to be a sought-after prize for political appointment but it is enough to demand the commitment and time of qualified Trustees."

I got little support for this recommendation. The commissioners had no personal interest. The public members apparently did not want an expanded role. The Legislature was suspicious of paying the Board members a salary.

When Gov. Hammond called me a year later to ask as to my availability to continue on the Board of Trustees, I responded in the negative, followed up by a letter from which I quote in part:

> "I feel that my own contribution was possibly most significant in the organizational stage. I have personal obligations that can take all my time available. I am also persuaded that the Board should be heavily involved in operational decisions. Unfortunately, the Legislature, by failing to provide for adequate compensation to the public members, does not recognize the necessity of Trustee participation. I would not feel comfortable with the prospects of relegating the future operations and destiny of the Fund to the staff."



In 1980, Gov. Jay Hammond was still pushing his ideas for Alaska, Inc.

Governor May Replace Board Members

When the 1982 bill was developed, the Board and the Legislature gave great attention to structuring the terms of the Trustees with the idea that appointments were permanent and stability of the Board are essential. The Enabling Act states that, "The governor may remove a member of the board from office. A removal by the governor must be in writing and must state the reason for the removal." (Sec.37.13.070 AS)

I was shocked when our present governor (Gov. Hickel) removed two of the public members and I can find no written submission of cause. I was disappointed that there was no outcry from the press, the Legislature or the public.

Review in Conclusion

I will conclude my remarks with an overall review of the Fund.

First, I would say that in the primary objective of the Permanent Fund, it has been a resounding success. It has saved billions which would otherwise have been dissipated.

Secondly, it has had a superior return on investments. And through inflation-proofing, it has maintained the real value of the Fund. Performance evaluation is a very complex and even more difficult task than developing an investment strategy. Consequently, I will say no more on this subject except to comment that if I had been on the Board of Trustees during its operational stage, I would probably have urged a higher allocation in common stocks.

Thirdly, I am impressed with the clarity and completeness of the disclosures in the annual reports. They are excellent in stating what has been done; they could be improved in telling why. Some examples: reasons for deciding and changing investment allocations in fixed income and equity instruments; why the Alaska residential mortgage portfolio was sold; the criteria for real estate investments; the choice of passive vs. managed portfolios; the basis for in-house vs. outside managers; the strategy for Alaska vs. outside investments.

Explaining why an action is taken is always good discipline for the decision-maker. More important, sharing with the public the reasoning for taking various actions makes the public more informed and hopefully a more determined champion of the Fund.

"In the primary objective of the Permanent Fund, it has been a resounding success."

Corporation Board as State Fiscal Leaders?

I feel very strongly that the greatest expanded service that the Board of Trustees could render all Alaskans would be to take on the conceptual leadership for the financial policies of the state. We certainly need this leadership, and who else is going to do it? Any governor or legislator, regardless of party, is focused on spending, operations and the writing of law.

Actually, this enlarged role for the Trustees involves more a concept of responsibility rather than any additional duties. I offer as a model the various boards of the Federal Reserve Banking System. When that system was created, there was no thought that the Reserve Board would have any responsibility for price levels or interest rates. They moved into that role to fill a vacuum. The studies by the various Reserve Boards are eagerly sought after today and serve as examples of thoughtful and substantive reasoning.

Comparably, the Trustees of the Permanent Fund have the best access to all the economic and financial data of the state, nation and world. The Trustees have the benefit of top economists and analysts. Sharing the Board's reasoning and conclusions with the general public will not only enlighten the thinking of all of us but add to the Board's stature and influence.

I compliment the Board and staff on the initiation of the educational program for elementary students called *Learning is Permanent* which helps young Alaskans learn about economics and about the Permanent Fund. I strongly urge the Board to reinstitute the process of holding public seminars throughout Alaska with qualified experts to stimulate thought and enlarge our horizons. This has an additional practical benefit in permitting the Trustees to float trial balloons without attribution.

By the end of FY 1996, $5.71 billion of oil revenues had flowed into the Permanent Fund. This grand view of the trans-Alaska pipeline looks south through the Brooks Range and Atigun Pass near Pump Station 4.

Views on Permanent Fund Dividends

Finally, I will make some comments on the sensitive subject of the dividend program.

Technically, the dividend program is not a responsibility of the Trustees, even though it uses half of the Fund's earnings. However, the Trustees are Alaskans and, if the Trustees accept the enlarged stature which I hope they will, they cannot escape being drawn into the crucial debates which I envision will develop in the near future.

Again, I believe that an inquiry into the history of the dividend program is illuminating. In the intense discussion of the uses of the Fund principal or income prior to the Enabling Act of 1980, there is little indication that a dividend program was of much public interest. It appears to have been primarily a concept of Gov. Hammond. An original dividend program based on longevity of residency was included in the 1980 Act but struck down by the U.S. Supreme Court as discriminatory.

While the litigation was in progress, the Trustees were carrying out their program of public seminars. At each meeting, I made a specific point of asking whether the attendees, either in their individual capacity or as representatives of an organization, wanted a dividend or rather an appropriation of income that would benefit all the people of Alaska through block grants or public works. I remember only one person who testified in favor of the dividend program. In an address to the Anchorage Chamber of Commerce in October 1981, where the use of the Fund income was discussed, I pointed out that if the residency feature of the dividend program be stricken down, the problem of in-migration could be serious.

The significance of this historical reference is that there is little indication that the

public was greatly interested originally in the dividend program. However, there is no doubt whatsoever that, like a chemical dependency, the public is now strongly supportive of receiving the annual dividends.

Dividend Support is Broad, Fragile

Let us examine the consequences of the dividend program and particularly the impact on the Permanent Fund.

The benefits of the dividend program are obvious in increasing individual disposable income and at the same time expanding merchant sales, to the extent the money is spent in Alaska. Another argument of popular repetition is that the dividend gives a supportive constituency to maintenance of the integrity of the Fund.

But like all single issues of popular support, there is a fragility in this protection. Up to now, the governor and the Legislature have pretty much left the Fund and the Trustees alone because they have asked one thing only – earn enough money to maintain the dividend program. What will happen when oil revenue drops to a point where the spending appetites of the Legislature are not satisfied? Then I predict there will be strong attacks on the Permanent Fund.

The Legislature based its fiscal year 1994 budget on $18.38 per barrel of oil. We are not averaging this and the current year deficit is estimated as upwards of $500 million. Short of another windfall, the easiest additional source of money is the Constitutional Budget Reserve of $691 million and the Permanent Fund's earnings' reserve which is almost $1 billion.

The Permanent Fund Dividend Program has grown into one of the largest economic forces in the state today, giving every qualified Alaskan, such as this Anchorage junior high student, an annual check.

After this is exhausted, the next target will be the inflation-proofing procedure. Don't automatically assume the Legislature will protect you there. Ever since the Fund was created, the Legislature has placed the dividend fund as number-one priority ahead of inflation-proofing. There are self-dubbed economists who actually argue that inflation-proofing is socially undesirable. I call this the "Wimpy" philosophy: "Gladly would I pay next Tuesday for a hamburger today!"

Dividend Recipients Increasing

In the meantime, the eligible population, which is the denominator in calculating the per person dividend, is steadily increasing. This results from births and in-migration of oldsters. The developer of a senior housing co-op in Anchorage is quoted:

> "But seniors are the fastest-growing group in Alaska. Although they make up about 4 percent of the population, as compared to an average of 12 percent in the lower 48, more and more seniors are wanting to stay here after they retire. In fact, there are seniors moving up here to retire now."

At the same time more and more grumbling is heard from Alaskans who feel disenfranchised from eligibility because of traveling restrictions and yet observe violations from those who are not qualified within the intent of the law.

In evaluating the future consequences of the dividend program bear in mind that with the dividend program taking one-half of the Fund earnings and inflation-proofing needing close to the other half, the Fund can never grow in the future except through infusion of mineral receipts.

I mention these sobering realities because the decisions are a responsibility of all Alaskans and fiscal soundness, like liberty, must ever be vigilantly defended and guarded.

I will sum up by saying that money may not be everything, but I tell you, having the Permanent Fund gives us all a lot of confidence and determination for the future.

"There is no doubt whatsoever that, like a chemical dependency, the public is now strongly supportive of receiving the annual dividends."

The Creation of the Alaska Permanent Fund: A Short History

By Joan Kasson

Former Gov. Bill Sheffield, left, and former Fund Trustee Marc Langland – shown here at the Corporation's 1996 annual meeting – played a key role in the Fund's development.

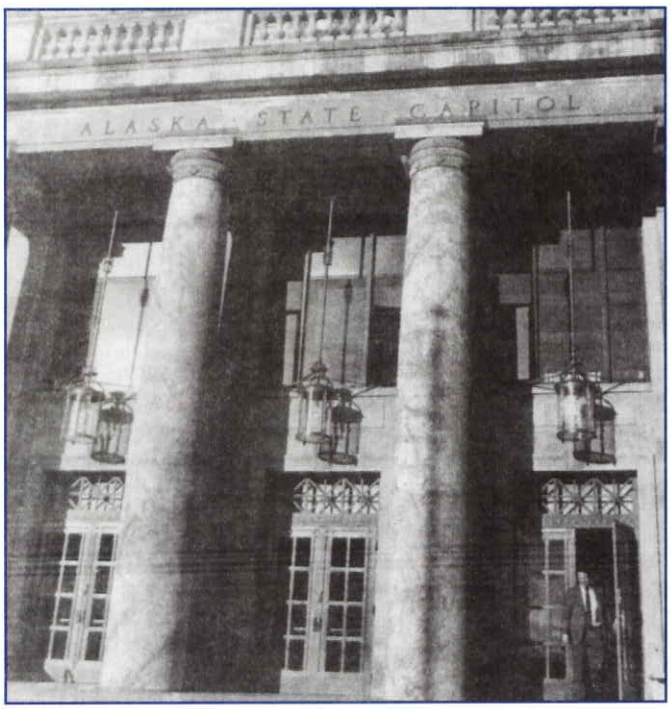
"The Permanent Fund is a savings account geared to make money for Alaskans."

Writer Joan Kasson researched and wrote this paper for the Alaska Permanent Fund Corporation in November 1983, as part of an early effort to record the history of the Fund. Publication in the Trustee Papers Volume No. 5 marks the first time this paper has been widely available to the public.

Introduction: An Overview

In 1976, the voters of Alaska passed a Constitutional amendment establishing the Alaska Permanent Fund. The amendment required the dedication of 25 percent of mineral bonuses, royalties and related income to a special fund to be put into income-producing investments. On June 30, 1983, the assets of the Fund stood at about $4.3 billion, a hefty sum by any standard.

The Fund is operated as a public trust, much like trust funds established for pension funds. This means Fund managers must balance the idea of "income producing" against ordinary prudence about risk. In its simplest terms, the Permanent Fund is a savings account geared to make money for Alaskans.



The seat of legislative power in Alaska, the Capitol building in Juneau, was the site of historic votes creating the Permanent Fund, the Alaska Permanent Fund Corporation and the dividend program.

How the Fund came to exist, and how it came to be operated in this manner, is the subject of this history. The Fund exists as a result of evolution of thought regarding state ownership of wealth, and how that money should be managed to best benefit all Alaskans, present and future.

This evolution occurred in three stages: first, the decision on what was wanted; next, the decision on how it was to be accomplished; and finally, the beginning of a process to decide what it is to do.

Many people were part of this evolutionary process. The executive and legislative branches of state government played major roles. The public, through voting and participating in the legislative hearing process, contributed their views. What are called special interests also played a large part. The business community, banks, fishing and agriculture advocates all registered their views on the Permanent Fund.

The evolution of the Permanent Fund took several years. During this time, many things happened in Alaska to affect it. Large oil and gas deposits were discovered on state-owned lands. The state chose to raise taxes on the petroleum industry to increase state revenues. These revenues increased even more as the Organization of Petroleum Exporting Countries' (OPEC) price hikes took effect. Finally, state expenditures increased along with revenues.

The Alaska Permanent Fund is a trust. Early proposals and discussions considered the use of the Fund as a vehicle to diversify the Alaska economy. However, the trust concept for the principal of the Fund prevailed at every turn. The later issues debated during the evolution of the Fund were, instead, questions regarding management and use of the Permanent Fund earnings.

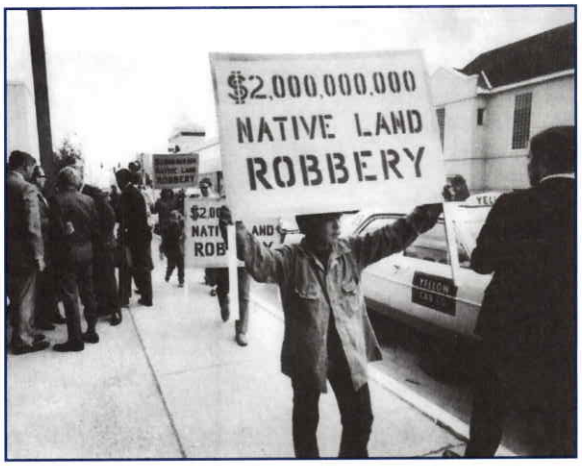
Background: Resources Belong to Alaskans

In 1955, Alaska was still a territory of the United States. Late that year, fifty-five people met in Fairbanks to write a constitution in preparation for statehood. The resulting document was viewed by many as a model constitution. Two themes present in the Constitution bear directly on the Permanent Fund.

The constitutional convention delegates saw the importance of resource development. Alaska has long been dependent on its natural resources. All the economic booms that Alaska had experienced, except the World War II military boom, had been caused by resource development. Furs, gold, then fish, were harvested and in the eyes of the delegates, the benefits from these harvests primarily went outside Alaska.

The constitutional convention delegates were not opposed to resource development, but they wanted Alaskans to get the maximum benefit. Thus, Article VIII of the Alaska Constitution, stressed just that:

> Article VIII, Section 2, General Authority. The legislature shall provide for the utilization, development, and conservation of all natural resources belonging to the State, including land and waters, for the maximum benefit of its people.



The Alaska Native Claims Settlement Act of 1971 extinguished Native rights to much land in Alaska. Some Natives protested sales of oil leases on the North Slope into the early 1980s. The lease sales produced the initial income of the Permanent Fund.

The second theme was opposition to the dedication of revenues. Dedication of revenues means that certain revenues are assigned to special funds for special purposes, bypassing the appropriations process. At the time of the convention, many states had such dedications. The delegates believed that dedicated revenues constrained the government from pursuing the maximum welfare for its citizens, so they forbade dedication except in certain, limited cases.

The delegates realized the importance of Alaska's resources. They wanted Alaskans to realize the maximum benefit from them. They did not, however, foresee that the state would later become financially dependent on one source of revenue.

$900 Million Oil Lease Sale

On September 10, 1969, the state received $900,041,605.34 in bonuses from the Prudhoe Bay oil lease sale. Earlier discoveries, in particular the Swanson River Oil Field on the Kenai Peninsula, had increased state revenues, and therefore expenditures, but nothing on the order of Prudhoe Bay had ever happened before. The $900 million, as it came to be commonly called, was nearly as much as all previous state budgets combined. The fiscal year (FY) 1970 budget had totaled only $172.8 million.

The question before Alaskans was what to do with all that money. Should it be saved, or should it be spent to meet Alaska's many needs, such as rural schools, safe water, transportation and communication links? The Legislature appropriated money to look into the question. The Brookings Institute held four seminars in late 1969 to decide what should be done. Discussion covered issues as diverse as Alaskans themselves.

> There are plenty of details, but the basic point is, we're going to invest in Alaska – its people, through education, health and well-being opportunities, and in the physical through esthetics and their preservation and natural resources, using the non-renewable in the best interests of the state, both economically and environmentally.[1]

Spending, then, was to be the course to take.

"The question before Alaskans was what to do with all that money. Should it be saved, or should it be spent to meet Alaska's many needs. . ."

The Idea: Saving Mineral Wealth

Although the Brookings seminars may have called for spending, the idea of investing some of the state's wealth was being mentioned here and there. Before the 10th Annual Convention of the Alaska State Chamber of Commerce in October 1969, Robert Krantz, of the investment firm Kidder, Peabody & Company, called for the establishment of a "perpetual and permanent capital fund for the continuing development of Alaska."[2] Krantz envisioned a fund where the principal would remain intact but the income would be available for appropriation by the Legislature. His reasoning:

> In the investment banking world, we are constantly exposed on an almost day-to-day basis to situations which demonstrate the insatiability of the demand for funds once they become available and the ease with which capital can be dissipated. This is found at all levels – unfortunately in our own homes as well as within business and philanthropic organizations. It is at the government level, however, that we find this intense pressure for current expenditure in its most extreme degree.[3]

Krantz's speech did not receive much notice nor was his idea new. Other states had similar funds. However, it is the first written record of the idea of a permanent fund for Alaska.

The idea behind the Permanent Fund was to save a portion of Alaska's vast natural resource wealth for future generations. Gold mining in the Interior brought the benefits of mineral wealth to only a few.

At the same time, Gov. Keith Miller was outlining his idea for a resources permanent fund. He introduced legislation to create the fund in 1970. It passed the Senate, but died in the House. It was, however, a taste of things to come. It was the first formal legislation on the subject, and it brought out issues that were to be major points of contention later.

Miller's resources permanent fund was not a dedicated fund. Instead, the Legislature was to appropriate money to it. In addition to this dedication question, the legislation showed that management would be a major issue. Who would control all that money? Should it be the legislature or the executive, Republicans or Democrats?

Not until 1975 was the idea looked at again. In the meantime, state budgets increased annually, and the state began to bond itself into debt based upon expectations of future income from the oil fields. In 1972, $124.5 million worth of general obligation bonds were approved, and in 1974, $189.5 million more.

Legislature Feels Pressure to Invest, not Spend

By 1975, the idea of a permanent fund had gained a following in the Alaska Legislature. The primary reason was negative reaction to the spending of the $900 million received from the Prudhoe Bay lease sale. People asked, "What happened to the $900 million?" – implying it had been wasted.

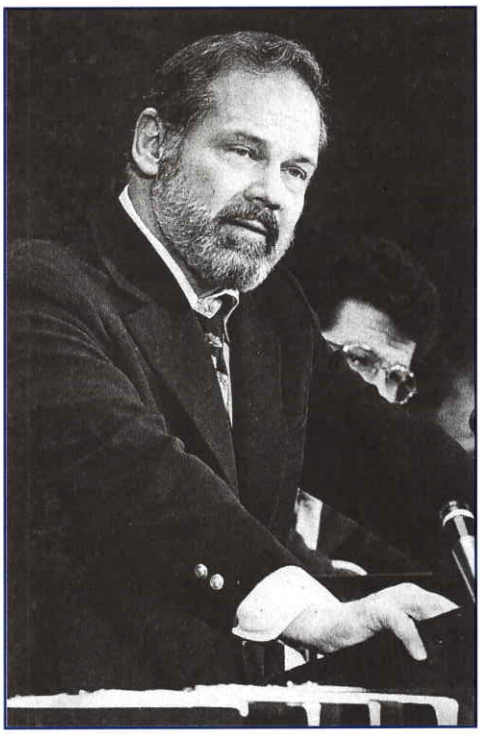
Committee Substitute for House Bill 324 amended Senate, (CSHB 324 am S),[4] "An Act establishing the Alaska mineral lease bonus permanent fund; and providing for an effective date," passed the Legislature during the 1975 session. Its purpose:

> The Legislature finds and declares that it is essential to preserve a portion of the revenue derived from mineral lease bonus sales, a nonrenewable resource, for future generations of Alaskans, and further, that this purpose best can be served by preserving this income in a permanent fund to be used for investment capital by Alaska residents.

CSHB 324 am S was the first bill passed by the Legislature that specifically created a permanent fund for the benefit of future generations.

It is important to note the uses to which the money could be put. This bill dedicated 50 percent of mineral lease bonuses (money received for the sale of leases) to the fund. This principal was to be invested as other state surplus funds and in approved loan programs. The income resulting from this investment either could be reinvested in the fund, or appropriated for the administration of the fund or for other operating and capital expenses of state government as provided by law.

This first successful attempt was promptly vetoed by Gov. Jay Hammond. Hammond said that allocating 50 percent of mineral lease bonuses to the permanent fund was an unconstitutional dedication of revenues. The state Constitution specifically prohibited such dedications. Therefore, Hammond called for a Constitutional amendment, rather than a statute. He was, however, fully in favor of a permanent fund.



In 1976, Gov. Hammond introduced a state constitutional amendment, that, as amended, won support in the November general election and created Alaska's Permanent Fund.

Gov. Hammond Offers Plan

In 1976, Hammond introduced Sponsor Substitute for House Joint Resolution 39 (SSHJR 39) to the Alaska Legislature. The important section:

> Sec. 2. Article IX, Constitution of the State of Alaska, is amended by adding a new section to read:
>
> Section 15. ALASKA PERMANENT FUND. Ten percent of all mineral lease rentals, royalties, royalty sale proceeds, revenue sharing payments, bonuses, and mineral production taxes received by the State shall be placed in a permanent fund, the principal of which shall be used only for income investments. The legislature may appropriate additional amounts to the permanent fund which shall become part of the principal of the fund. All income from the permanent fund shall be deposited in the General Fund.

A committee substitute for SSHJR 9 passed the Legislature overwhelmingly and was successfully put before the voters of Alaska at the November 1976 general election. The important section now read:

> Sect. 2. Article IX, Constitution of the State of Alaska, is amended by addition a new section to read:
>
> Section 15. ALASKA PERMANENT FUND. At least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the state shall be placed in a permanent fund, the principal of which shall be used only for those income producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the General Fund unless otherwise provided by law.

The state had its Permanent Fund. Now, the question was how to run it.

An Analogy: What to Do With a Windfall

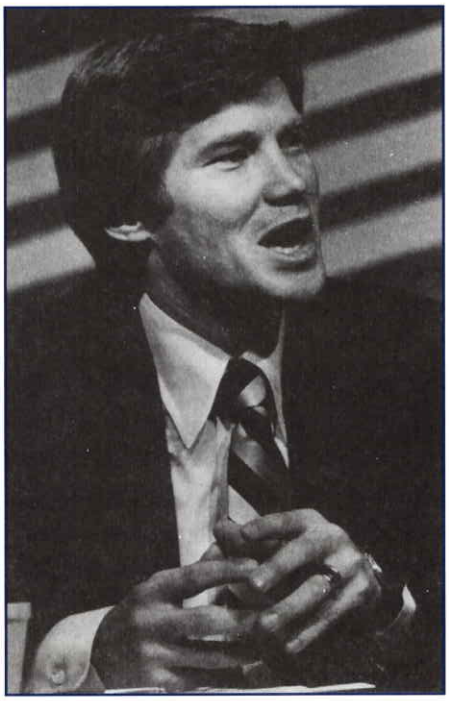
Let us suppose for a moment that you come from a large family and someone leaves you a large sum of money unexpectedly; in short, a windfall. Your first inclination might be to buy that house you needed and get the operation for one of the kids you haven't

"Hammond said that allocating 50 percent of mineral lease bonuses to the permanent fund was an unconstitutional dedication of revenues."

been able to afford. Then, perhaps you buy a van to help out Aunt Millie's catering business. Now that home for wayward children down the street could sure use some money.

At some point you may realize that this money will not last forever. So, you decide to save some for later. Do you put it into a straight savings account and earn 5 1/4 percent? Not if you can earn 11 percent through one of those money market accounts. But wait, if you invest it in the stock market you might even make more money. Then again, you might lose some, too. Maybe you could make loans to all those relatives for what they want and need. Will they pay you back?

The connection may seem a bit thin, but it illustrates the kinds of choices that were available in 1977 on how to structure the Alaska Permanent Fund. In a 1976 working paper, Robert Richards of Alaska Pacific Bank outlined a series of investment options. He identified the options as falling into three areas: social orientation, economic orientation, and fiscal management orientation. Some examples:



Rep. Clark Gruening was chairman in 1977 of the Special House Permanent Fund committee which held hearings around the state to learn how Alaskans wanted the Permanent Fund to be managed.

- Social orientation – income redistribution from high-income to low-income earners, subsidies to low-income families, geographic redistribution, i.e., from urban to rural environments, subsidies to any Alaskan to improve the quality of life.
- Economic orientation – subsidizing small businesses, or traditional industries such as fishing and timber, or providing subsidies to create a more broad-based economy.
- Fiscal management orientation – to save and invest the Fund conservatively to hold for when revenues fell, or use the Fund to reduce state debt and/or taxes.

In a paper prepared for distribution prior to the 1976 election, the Department of Revenue outlined its view of the objectives of the Permanent Fund. These included economic diversification for the state, controlling expenditures by government, saving the money for the future, revenue sharing with local governments, or perhaps community development through capital construction, increased social services, direct aid to community businesses.[5]

It was up to the Legislature to decide which one or combination of the above the Permanent Fund should be managed to achieve.

First Efforts: Seeking a Direction for the Fund

Anticipating the passage by the voters of HJR 39, Gov. Hammond expanded the size of the State Investment Advisory Committee (SIAC), and directed it to look into organizational structures and investment options for the Permanent Fund. The committee was composed of representatives from the business community, consumer groups, the executive branch, the Legislature and members of the general public.

It became clear through the SIAC hearing process that the Permanent Fund was being viewed as all things to all people. At a hearing held in November 1976, testimony called for investment in fish hatcheries, loans for utilities, housing loans and creation of a trust to save for the future.[6]

The SIAC, through the governor, introduced two bills to the 1977 legislative session. The first, HB 210, passed quickly. It was an interim measure outlining management of the Permanent Fund while the Legislature debated the long-term structure. HB 210 required the Commissioner of Revenue to invest the Permanent Fund in conservative investments. It was a holding pattern.

The second SIAC bill contained its plan for the long-term management structure. Although it did not pass, the bill showed the direction the Permanent Fund was headed at that time. The bill, HB 298, called for a 50-percent contribution rate, up from the 25 percent required by the Constitution. The money would be invested by percentages in differ-

ent types of investments; 40 percent in investment-grade securities; 30 percent in Alaska private industry where other capital from private entities was not available; and 30 percent in community development through municipalities, public corporations and construction. The management would be by a policy board appointed by the governor, and an investment committee, separate from the policy board, would make the specific investments. All income would go to the General Fund. Investments would be limited by application of the Prudent Investor Rule. No investment would be allowed where other private capital was available, and the Fund would not be allowed to manage any entity in which it had invested.

In his letter of introduction, Gov. Hammond stressed that HB 298 was not necessarily the final product, but only a vehicle for discussion.

The House of Representatives, meanwhile, had appointed a special committee to look into Permanent Fund management. Chaired by Rep. Clark Gruening, the committee received all bills introduced on the Permanent Fund. They also introduced one of their own, very similar to the SIAC bill, but with a higher contribution rate.

The Alaska House of Representatives takes the oath of office with Lt. Governor Lowell Thomas, Jr., presiding, at the start of the 1975 legislative session. The House, under the leadership of Rep, Hugh Malone (second from left), generated the Permanent Fund legislation that eventually made it to Governor Jay Hammond's desk.

Also of interest in the 1977 session was the introduction of Hammond's HB 525. This bill, which went nowhere, was the first to call for a cash distribution of Permanent Fund income to individual Alaskans. Called Alaska, Inc., the plan called for payments to registered voters of one share for every five years of residency. This would be paid for by 50 percent of the Fund's annual income.

Although none of the Permanent Fund bills introduced in 1977 passed, the discussion was well under way. That discussion was focusing on a combination of development and saving.

Public Hearings Guide Fund Design

During the interim between the 1977 and 1978 legislative sessions, the House Special Committee on the Permanent Fund took its hearings on the road around the state. The results of all those hearings were outlined in the committee's final report, "A Proposal for the Alaska Permanent Fund."

The final report gathered up all the testimony presented to the committee and divided it up by what the public, the consultants, and the committee proposed. It gives a good idea of where the Permanent Fund was headed in late 1977.

In summary, the public response to the hearings was worked into a general list of points for the committee to follow:

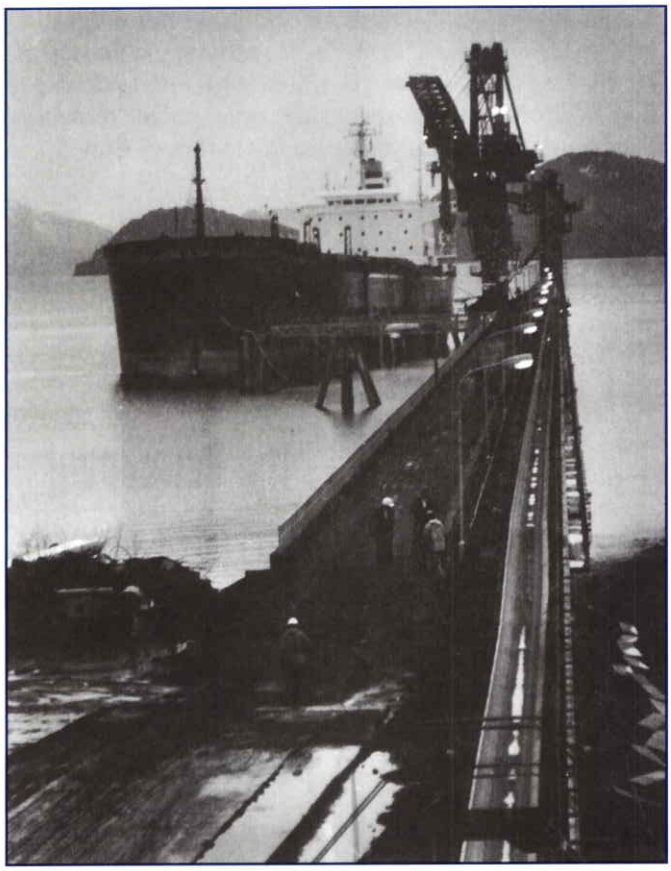
- The money in excess of current needs should be put into the Fund.
- This money should not be used for current expenditures.
- The investments should not be in areas where existing private financing was available.
- The income of the Permanent Fund should be used for the benefit of current and future Alaskans.
- The structure of the Permanent Fund should allow public accountability.
- However, political decision-making should take place where necessary. Appointed officials of the Permanent Fund should not make those types of decisions.

"The Permanent Fund was being viewed as all things to all people."

The consultants' positions were also collated into general points. Their positions became much more important later when serious legislative maneuvering took place. Essentially, the consultants agreed:

- Subsidizing, through cheap loans or bonds, industries or commercial enterprises was not a good idea for the Permanent Fund.
- If the project proposed was a viable one, then private financing entities would fund them.
- If private banks refused, then perhaps the project was not a good one.
- In that case, why should the state take the risk?

The most aggressive (and in conventional terms, imprudent) lending policy cannot, however, create an industry where resources, markets, skilled labor and other requisites are missing, and the Fund's managers should never become so "soft" as to finance enterprises whose promoters are not taking a substantial risk themselves, or which do not have convincing prospects of long-term viability.[7]



After months of debate, the Legislature decides that the Alaska Industrial Development and Export Authority, not the Alaska Permanent Fund Corporation, is the appropriate vehicle to help fund such economic development projects as the Idemitsu Corp. coal terminal in Seward.

The consultants, however, did feel that medium and small industries might benefit from Permanent Fund assistance where "institutional barriers" may exist. In this case, the barriers were defined as lack of knowledge, and distance. Lending in small towns or the Bush is exceptionally expensive; however, the cost of investigating and servicing small commercial, real estate and installment loans and lease purchase contracts and the like, and the costs of collection, foreclosure, repossession and resale can easily exceed the potential earnings from loan fees and interest. These excess cost burdens, together with unfamiliarity with local conditions, understandably make the statewide (Anchorage and Fairbanks) banks and other financial institutions reluctant to provide capital even for larger locally-owned development, such as resorts, hotels, apartment houses, fish processing plants, etc., and where they do make loans they are willing to finance a smaller portion of total investment.[8]

Fund Goals Become Clear

Based upon its hearings, the committee determined that the first two goals of the Permanent Fund were to be permanence and income production. These are in conflict in that investments that may earn a very high return are likely to be more risky than ones with a lower expected return. The goals must be balanced against each other. The additional goal was that part of the Permanent Fund be used for the short-term benefit of Alaskans. In effect, these required a trust concept for the principal of the Fund.

It also realized, however, that the Permanent Fund is only one of several financing vehicles available to the state and that it was unnecessary, as well as unwise, to try to design a Permanent Fund to do all things.[9]

The compromise the committee worked out was introduced in the 1978 session as HB 596. The legislation created two entities: The Alaska Permanent Fund Corporation and the Alaska Enterprise Investment Corporation. The former, receiving the bulk of the revenues, was to be severely restricted on the type of investments it could make. The ultimate goal of the Permanent Fund Corporation was to maintain safety of principal. The second entity, the Enterprise Corporation, was the answer to providing short-term benefit to Alaskans. It was to provide funds to "financially sound small- and medium-scale productive private enterprises and community development projects."

Two points must be made here. First, people began to realize that the Permanent Fund really wasn't that large of a part of state revenue. In FY 1978, contributions to the Alaska Permanent Fund totaled $50.4 million, while total unrestricted revenue to the state was $787.4 million. There was other money available to fund the miscellaneous projects people envisioned.

Second, in 1978, other entities began to be created to handle these assorted wants. The first real effort to do just this was a result of the House Special Committee's efforts. Many of the people testifying before the SIAC and the House Committee wanted to further renewable resource industries and break Alaska's dependency upon one nonrenewable source of revenue – oil. As a result, the House committee introduced legislation, which later passed, to create the Alaska Renewable Resources Corporation. The purpose of this corporation was to give grants and other financial assistance to "projects and programs that identify and demonstrate new products, markets and technologies in renewable resources."

During the interim, the Senate also had a Special Committee on the Permanent Fund working. In addition, the executive branch was still involved through the Division of Policy Development and Planning. The result of all this studying of the question was the introduction of several bills in the second session of the Tenth Alaska Legislature in 1978.

Delegates disagree on permanent fund

By ANDY WILLIAMS
Daily News Staff Writer

FAIRBANKS — For a supposed "motherhood" issue, the proposed constitutional amendment to establish a permanent fund drew considerable flak at a meeting of constitutional convention delegates here last weekend.

The fund drew support from members of the Hammond administration and legislators who proposed it as a means to save some of the revenue from development of oil and gas resources. The amendment on the Nov. 2 election ballot would revise the constitutional prohibition against dedicating funds

workshops at the meeting of delegates to the 1955-56 constitutional convention and an underlying topic of concern in many discussions during the three-day session.

IT WAS MOST roundly criticized during a workshop on the constitutional role of the executive Saturday. Participants said there were tremendous implications to establishing a government agency with the power to allocate large sums of money apart from the constitutional authorities of the legislature and the executive, and questioned whether the concept had been well thought out.

going to need it as much as we do," Warwick said.

A second workshop Saturday on finance and taxation included some supporters of the fund.

Rep. Steve Cowper, D-Fairbanks, and Commissioner of Revenue Sterling Gallagher said it was the only practical way of ensuring that oil and gas revenue was saved. Eric Wohlforth, former state commissioner of revenue and moderator of the panel, said it was "logical to extend the benefits of all revenue as long as possible."

BUT KATHERINE Nordale, a constitutional delegate from Fair-

Debate over the purpose of the Fund took three years to resolve.

1978-1980: Subsidized Loans vs. Free Trade

In a memo to two consultants dated September 2, 1977, a staff assistant to the House Finance Committee outlined the prevailing state of affairs:

> Where to invest the Permanent Fund seems to be the question of whether a developing economy (isolated, with leakage of an estimated 64 cents on the dollar, but mostly literate and skilled), based largely on a depleting resource (transfer payments from the oil and gas industry), and having few apparent options for some time should have a policy of government intervention. In short, a policy of loans at the going market or subsidized loans, or even subsidized infrastructure loans (which may be possible in some cases) versus a policy of free trade.[10]

The question of how the Permanent Fund should be invested had from the beginning centered on the development bank versus the trust. There were different approaches with each bill, but all of them took some form of one tack or the other. From 1978 to 1980, the development issue remained but instead, focused on the Permanent Fund earnings.

The major Permanent Fund management bills introduced in 1978 were to be the basis for three years of discussion. The main bills in 1978 were HB 596 and SB 429. In 1979 and 1980, SB 1 traveled through the legislative process, first encompassing the Senate's ideas and then the House's. It finally became a compromise bill in free conference[11] committee and was adopted by the Legislature.

"The committee determined that the first two goals of the Permanent Fund were to be permanence and income production."

Prudent Investor Rule to Guide Investments

All of the versions reflected the recognition on the part of legislators that the principal of the Permanent Fund should remain inviolate. It should be invested with an eye toward safety of principal first. The Prudent Investor Rule, well established in common law, was to guide the investments. The greatest danger of substantial erosion of the Permanent Fund principal is not (as suggested in a February 23, 1979 Permanent Fund policy memorandum of the Division of Policy Development and Planning) from a practice of making investments at less than market rates but rather from making investments entailing more than a reasonable risk. Generally, in the investment world the higher the risk, the higher the expected return.[12]

The statewide Dittman Poll, commissioned by the Alaska Senate in October 1977, revealed strong support for using the Permanent Fund as a source of capital to improve the state's commercial fishing industry and other businesses.

Agreement on the safety of principal was only the tip of the iceberg, however. The main differences between the House and Senate bills were the management structure and the use of the income.

Dividends or Loans? House, Senate Differ

The first difference was that the Senate wanted the state Department of Revenue to manage the Permanent Fund and its investments. In a report of the Senate Special Committee on the Permanent Fund issued in 1978, the main reasons cited for this stand were that the expertise was there and that there would be no conflict of interest since all the money in all the funds administered by Revenue belonged to the people of the state.

The House, however, saw a need for management independent from state government. The point: to insulate the Fund from politics, but keep it accountable to the public. Such a task was to be accomplished by the creation of a public corporation separated from established government agencies. The corporation would be under legislative oversight to assure that it would not become too independent.

The second difference, and the most hotly debated, was over the use of Permanent Fund income. Ideas for its use abounded, but three major ideas surfaced in the 1978 to 1980 debate.

The House Permanent Fund bill did nothing with the income stream, leaving it for later Legislatures. The income was to continue to flow into the state's General Fund, available for whatever uses the Legislature chose.

The governor supported wholeheartedly a proposal to give the money to Alaskans in the form of dividends. Some of his reasons were outlined in a February 14, 1980 memo to Hugh Malone:

> Benefits from oil wealth which belong to all Alaskans can be distributed in many ways: low-interest loans, tax relief, expanded government services. While these all may have merit, not all Alaskans are beneficiaries. This is why I have proposed a Permanent Fund dividend program which, compared to drastic income tax reduction or repeal, would:
>
> 1. Provide benefits to all Alaskans from the earnings of their resource wealth ...
> 4. Confine benefits to Alaskans ...
> 8. Equitably impact both rich and poor.
> 9. Retain the taxpayers' one remaining tie with, and consequent concern

for, government growth: How much it costs them.

10. Far less likely reduce federal revenue sharing to the state.
11. By contrast, maximize favorable impact upon the state's economy by keeping a far larger portion of the money to fund the programs here in Alaska.

The Senate had its own proposal for Permanent Fund income. The legislation was introduced by the Senate Special Committee, chaired by George Hohman of Bethel. It provided a vehicle to thoroughly revamp the state loan programs. Many programs would have been abolished and then restored in a centralized Alaska Loan Programs Fund. The purpose, in part to:

> " ... create moneys for small businesses at low interest affordable rates which could be used not only to help out existing small businesses, but to generate new businesses particularly in the area of renewable resources."

Permanent Fund Committee's Initial Plan: Do Nothing

JUNEAU (AP) —, The House Permanent Fund Committee yesterday unveiled the first draft of what it wants to do with income from the Alaska Permanent Fund — nothing.

Under the tentative House proposal, profits from investing the principal of the fund would be plowed right back into the fund for at least the immediate future.

"We just don't know what we want to do with the income from the fund yet," said Rep. Clark Gruening, D-Anchorage and chairman of the committee. "At least until the 1980s the fund isn't going to be that great anyway so we're talking about using it for the time being as a savings account."

However, the working draft does include a proposal for creation of an Alaska Development Bank to make more immediate use of income from the state's oil and gas wealth.

The development bank would have the same source of funding as the permanent fund but in a different amount. It would be financed by not less than 5 percent of state revenues from mineral lease bonuses and rentals and royalties until it has accumulated a balance of $100 million. The permanent fund gets at least 25 percent of such revenues with no upper limit.

The draft copy includes detailed provisions for the operation of the bank. But Gruening said the proposals were only intended to give the committee a starting point for discussion, and would be changed drastically in the weeks to come.

"One problem with this draft is that we don't really know what we want the development bank to do," Gruening said. "We really haven't approached what philosophy we want to use to decide what the money will be loaned for."

"Do we want provide the opportunity for lower interest rates longer-

Use of Fund income divided the Legislature for years.

The same memo also noted: "The Alaska economy is currently in a state of crisis, particularly in the area of small business."[13]

The idea of loans for Alaskans went back to the original permanent-fund-as-a-development-bank idea of 1975. In a 1978 memo, an aide to the House Finance Committee chairman outlined what the Enterprise Fund, mentioned earlier as part of HB 596, and a variant of the development bank idea, was to accomplish:

> The Enterprise Fund is to close the "capital gap" in Alaska, private and public. This gap is measured by economists as the amount of capital that would normally be provided by private markets but is not because of "institutional barriers" in the financial community as a whole. Such barriers include lack of information, lack of experience with particular kinds of investment, and racial and other bias. Local regulatory practice can be a barrier, but the effects are probably not great due to the relatively free flow of capital within and even between countries.
>
> A capital gap is not a sheer absence of funds. Money can usually be obtained at some price. Rather, the usual reason that funds are not forthcoming is that other areas, offering better returns and lesser risks, can pay more for capital and enjoy more investor confidence.
>
> The full scale of this gap in Alaska is not documented. However, the evidence is that the shortfall is in the millions, not billions, of dollars and is focused in rural Alaska, mainly in small and medium ventures. Elsewhere, there is no proof that large, attractive loans are being missed or rejected by the private capital markets (banks and their lines of credit, bond and money markets, and insurance companies).[14]

"The governor supported wholeheartedly a proposal to give the money to Alaskans in the form of dividends."

The House moved away from this stance in later Permanent Fund bills, but the Senate continued to feel that the Permanent Fund was the vehicle to cure the rural capital gap.

Criticism of Senate's Loan Plan

Opposition to the Senate bill is shown by the following excerpts:

The Governor: In any program increasing the dispersal of our oil wealth all Alaskans, not simply taxpayers, should be beneficiaries. We already have numerous programs selectively dispersing portions of our oil wealth in the form of expanded subsidized government programs and low interest loans. These go only to select Alaskans, not to all. The size of these selective "hidden dividends" can be substantial.

For example, take the case of someone who gets a $100,000 state loan of oil wealth at 9 1/2 percent interest. Yet, all other Alaskans who own just as much of that wealth as he could get about 15 1/2 percent return if their money were loaned at market rate. Therefore, the loan recipient is receiving a "dividend," or subsidy, of $6,000 in the first year alone. That subsidy or "dividend" would amount to an incredible $94,000 on a 30-year loan.

That "dividend" or subsidy is being paid from oil wealth owned by all Alaskans. We don't confine payment of such loan "dividends" to taxpayers only or demand that before we provide Alaskans with low-interest loans, we first eliminate the income tax. Why should a system which provides far more equitable benefits to all Alaskans, such as the Permanent Fund dividend concept, be subordinate to that consideration? It seems high time that any new means of dispersing oil wealth should provide that all Alaskans, even the non-taxpaying, housewife, student, unemployed or retired couple get a share.[15]

Rep. Terry Gardiner was among the legislators who championed using Permanent Fund revenues to aid the state's disadvantaged residents.

The House: What are the House objections to the Hohman bill? The primary objection is that it is concerned much more with the state's loan programs than the Permanent Fund, and that a free conference committee on the Permanent Fund is not the place to so drastically restructure the loan programs. SB 1 is extremely complex and, if implemented, would have far-reaching consequences for the state's economy and credit rating. Specific problems with the concept include: 1) the earnings of the Permanent Fund are put at risk; 2) consolidation of the loan programs does not solve the existing problem of access to them; 3) the programs would receive automatic funding without legislative review; 4) there is no method of prioritization and the different loan programs could not be judged separately on their merits; and 5) municipalities would be encouraged to issue unrestricted debt.[16]

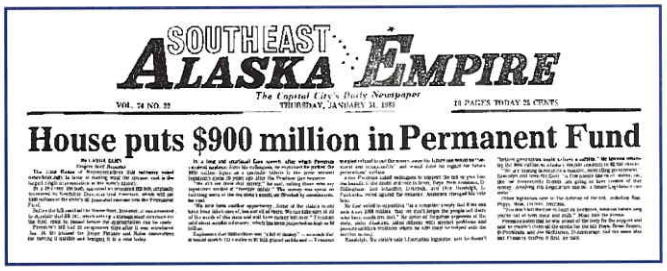
As can be seen, the problems with the loan fund approach basically were of three types: specific problems with the technical aspects of SB 1; general problems with the idea of subsidies to generate development; and questions whether the Permanent Fund was an appropriate place to fund such a program. While legislative votes on General Fund appropriations were held in the public eye, as envisioned by SB 1, decisions directing the use of the Permanent Fund income could have been made without public scrutiny.

It took three years, massive amounts of paperwork, numerous versions of various bills, and for the first time extensive use of professional financial and investment experts

and economists. But the Legislature ultimately adopted the House version without the Enterprise Fund that had been proposed in 1978. The final version required independent management through the Alaska Permanent Fund Corporation, secure investment of the principal in government and other high-grade securities, and left the income-use question unanswered.

Appropriations to the Fund and Dividends

At the same time the fight over management was going on, another important piece of legislation was introduced. This one proposed appropriating $900 million to the Alaska Permanent Fund, a symbolic amount recalling the $900 million received from the 1969 Prudhoe Bay lease sale. It passed, as did a later appropriation for $1.8 billion. The justification:


SOUTHEAST ALASKA EMPIRE

The Capital City's Daily Newspaper

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House puts $900 million in Permanent Fund

Over the years, special legislative appropriations have totaled $5.8 billion.

> The oil revenues currently being received by the state are in excess of what should be immediately spent, and depositing a portion of them in the Permanent Fund would be a wise and responsible move.[17]

There was another bill firmly supported by Hammond winding its path to passage in 1980. Earlier paragraphs have noted his emphasis on dividends for all Alaskans. The dividend distribution plan finally gained enough support to pass. In an article written for *The Alaska Journal* in 1983, two participants in the dividend battle outlined the major reasons for passage:

> ... As explained by Elmer Rasmuson, the Alaska Permanent Fund Corporation's first chairman, "The Permanent Fund began, chiefly, with a "negative" goal, to place part of the one-time oil wealth beyond the reach of day-to-day government spending.
>
> Some Alaskans, including then-Gov. Jay Hammond, came to favor direct distribution of a portion of the oil revenues as a check on government growth. Without such a check, asserted Hammond, government spending and lending would create a dependence which would bring a wrenching dislocation when the oil money ran out.
>
> Direct distribution, on the other hand, would give each citizen a personal stake in oil revenue and thus give Alaskans an incentive to oppose pork barrel spending and budgetary hyper-growth in general. Further, argued Hammond, if the distribution was paid in the form of annual dividends from the Permanent Fund's earnings, Alaskans would be more likely to fight raids on their savings account.[18]

"It seems high time that any new means of dispersing oil wealth should provide that all Alaskans...get a share."

Erickson and Groh further credited the economic concerns of equity and efficiency for the passage of the dividend program. The dividends would provide for equal distribution of the oil wealth. Loans, for example, did not, as only some could receive the benefits, and then at the expense of others. Efficiency involved the normative judgment that the people themselves should be able to choose how to spend the money, rather than have government do it.

Zobel Challenge Modifies Dividend Plan

The arguments in favor of the dividend distribution program prevailed. The legislation established a program giving every Alaska resident $50 for every year of residency since statehood in 1959. This graduated Permanent Fund dividend concept was to prevent migration to Alaska solely to collect the dividend check.

This law was promptly challenged on constitutional equal protection grounds by two Anchorage attorneys, Ron and Patricia Zobel. The case ended up before the United States Supreme Court. The dividend payments were held in limbo pending the Court's decision. The Court agreed with the challenge to the program and declared the program invalid.

Early plans to base Permanent Fund dividend size on length of Alaska residency were challenged by Ron and Patricia Zobel. The U.S. Supreme Court ruled in their favor, making equal dividends available to all Alaska residents.

Looking ahead to that possibility, in 1982 the Legislature passed another dividend plan to go into effect should the Court rule against the 1980 version. It called for equal payments to all six-month residents of the state. The first payment was to be $1,000, and all future annual payments were to be based on earnings of the Permanent Fund. That income was to be averaged on a five-year basis, and fifty percent of the average was to be divided among all eligible Alaskans.

When the Court struck down the 1980 plan, the 1982 version went into effect. On June 14, 1982, " ... the big computer in the State Office Building down the street from the capitol started up, and the first oversized blue-and-gold $1,000 checks rolled off the high-speed printer and into the mailbox."[19]

What is not so clear is the extent to which government investment can create self-sustaining non-government economic development. Nevertheless, the notion that government efforts can and should bring long-term prosperity still exerts a powerful grip on many Alaskans, particularly in the case of energy development.

Dividend distribution is of course also a way to inject money into the economy but it flies in the face of these traditional Alaska notions of development as well as the practices of other governments. All governments distribute benefits in a host of forms, but never before in the industrial world has a government mailed checks to all its residents simply because they lived there. Indeed, the only historical parallel to the Permanent Fund dividend distribution appears to be a recent program of the remote Malaysian state of Sabah, which, like Alaska, used windfall revenues collected from natural resource development to fund its per capita payments.[20]

Post-1980: Fund Grows, Management Evolves

After passage of the 1980 management legislation, the Permanent Fund continued to accrue mineral revenues as before, but now under the management of the Alaska Permanent Fund Corporation. Oversight was and is provided by the Legislative Budget and Audit Committee, but the Legislature as a whole has generally stayed away from the Fund. The exception was passage in 1982 of some non-controversial amendments to the 1980 Act. The legislation broadened the investments the Corporation was allowed to make, and more importantly, called for a certain percentage of the income to return to the Fund's principal to prevent inflation from eating it away over time.

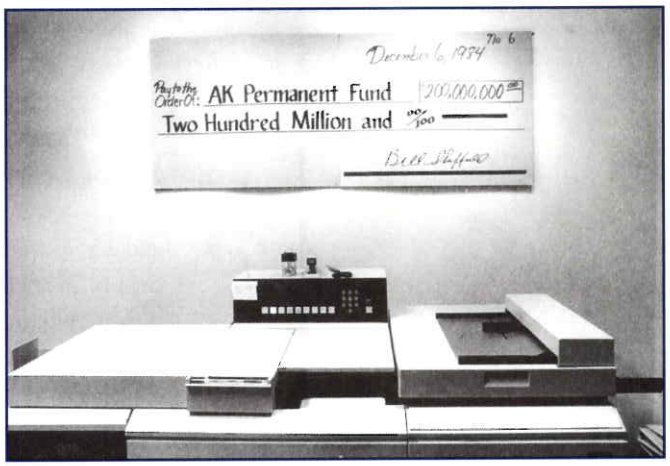
The Corporation itself has separated from the Department of Revenue, inhabiting offices in another building, hiring staff to manage and invest the Fund independently from other state funds, and managing its own operational budget. In its 1983 annual report the

Corporation reported net earnings of $471,125,000. The total Fund balance on June 30, 1983, was reported to be $4,375,036,000.

With over four billion dollars in the Permanent Fund, it was inevitable that the next question should arise: What exactly was this money for? By virtue of the thirty bills introduced during the 1983 legislative session having something to do with the Permanent Fund, it was clear that several members of the Legislature had some ideas as well.

Why is there a Permanent Fund? It was created for myriad reasons, not least of which was to keep it out of the immediate government spending stream. How to manage it was another question settled after lengthy debate.

What the Fund is and how it is being managed give some clues about what the Fund is for. But pressure continues to use the Fund in short-term ways now, or to save it to use in short-term ways in the future. It is up to the same people who decided to create the Fund and how to manage it, to decide its ultimate fate.



This oversized check, hanging on the wall of Permanent Fund Corporation offices in 1987, is a reminder of when Gov. Bill Sheffield paid off a $700 million bill to the Fund.

"This graduated Permanent Fund dividend concept was to prevent migration to Alaska solely to collect the dividend check."

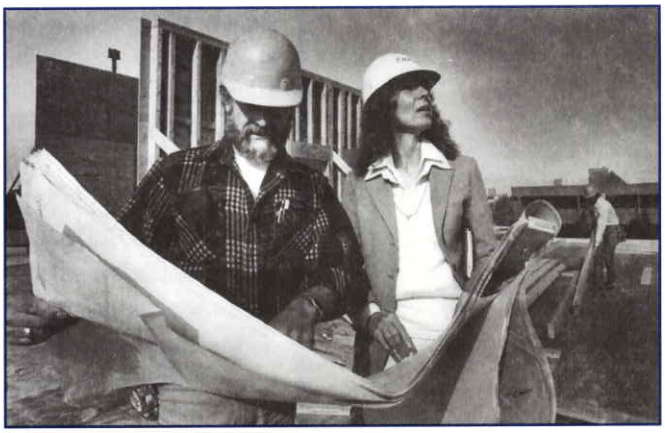
Footnotes

1. Alaska, Legislative Council and the Brookings Institution, "Statement of the Gamma Group: Seminar One," A Conference on the Future of Alaska (no place of publication, no date).
2. Robert A. Krantz, Jr., "Investment Management for Alaska's Second Decade," (October 4, 1969), p. 2.
3. Ibid., p. 3.
4. Throughout this text, the words "House Bill" are abbreviated as "HB," and the words "Senate Bill" as "SB."
5. Alaska, Department of Revenue, "Permanent Fund," *Alaska Revenue Journal*, vol. 1, no. 2 (October 1976): pp. 6-7.
6. Alaska, State Investment Advisory Committee, Hearing Minutes of November 5 and 6, 1976, (Anchorage, Alaska), pp. 2-9.
7. Arlon Tussing, "Economic Considerations in Establishment of Alaska's Permanent Fund," (Anchorage, Alaska: Institute for Social and Economic Research, July 7, 1977), p. 21.
8. Ibid., p. 17.
9. Alaska, House Special Committee on the Alaska Permanent Fund, "A Proposal ...," p. 7.
10. James B. Rhode, Aide to House Finance Chairman, to Barbara Bergman and Donald Gordon, Professors, Legislative Affairs Library files, September 2, 1977, p. 2.
11. "Free conference" is a type of committee composed of members from both the House and Senate. Its purpose is to resolve differences in House- and Senate-passed versions of a particular bill.
12. Alaska, House Special Permanent Fund Committee, Testimony of Clark Gruening, (March 30, 1979), pp. 10.
13. "Questions and Answers Concerning Alaska's Permanent Fund," 1979 or 1980, p. 6.
14. James B. Rhode, Aide, to Steve Cowper, Chairman of the House Finance Committee, Legislative Affairs Library files, March 8, 1978, p. 1.
15. Jay Hammond, Governor, to Hugh Malone, Representative, Legislative Affairs Library files, February 14, 1980, p. 3.
16. Hugh Malone, "The Alaska Permanent Fund and Management of the Alaska's Wealth," House Special Committee on the Permanent fund, Legislative Affairs Library files, March 5, 1980, p. 4.
17. Hugh Malone to *Homer News*, et. al., Press Release, Legislative Affairs Library files, January 31, 1980, p. 3.
18. Clifford John Groh and Gregg Erickson, "The Permanent Fund Dividend Program: A Noble Experiment," *The Alaska Journal*, vol. 13, no. 13 (Summer 1983), p. 142.
19. Ibid., p. 145.
20. Ibid., pp. 141-142.

Oil from the trans-Alaska pipeline is loaded onto supertankers at the Valdez terminal through massive booms.

The Permanent Fund Dividend Program: Alaska's "Noble Experiment"

By Clifford John Groh and Gregg Erickson



Alaskans were dreaming big in the 1970s, and with millions in new oil revenue filling the state treasury, no dream seemed unreachable.

"Both the Permanent Fund and the Permanent Fund dividend originated in the harvest of Alaska's tremendous oil wealth."

Clifford John Groh was a law student at the University of California at Berkeley, and Gregg Erickson an economic consultant in Juneau when they collaborated on this report, which first appeared in the Summer 1983 edition of Alaska Journal. *Longtime Alaskans, both Groh and Erickson were active in the effort to adopt the Permanent Fund dividend legislation.*

Last fall and winter virtually every Alaskan received their own spendable, savable, investable $1,000 share of Alaska's oil wealth – their Permanent Fund dividend. The more than 400,000 people who received these checks became part of one of the most remarkable social experiments in modern American history, testing whether a small slice of public resource revenues might benefit Alaska more in the hands of individual Alaskans than in the hands of their state government.

The dividends – and the Permanent Fund which generates them – stand apart from traditional American notions of government's role in society. The concept of the government distributing resource revenues in equal amounts, directly to all individuals, makes an astonishing end-run around usual debates about taxes and public spending.

The economic importance of the dividend program can be measured by all the retail promotions built around the annual distribution of the dividend.

Alaska's Tradition of Government Investment

Both the dividends and the Permanent Fund stand in particularly sharp contrast to the dominant Alaska ideology which holds that government investment is essential to build a stable, diversified and self-sustaining private economy. The vision of Alaska as a rich storehouse of resources waiting to be unlocked through government investment has a long history. In 1915, Anchorage's first newspaper saw the Alaska Railroad "and the proven and potential possibilities of the country that road will traverse and open up" as the key to a sparkling future for the newly established tent city.[1] The railroad did indeed assure Anchorage a future, but over the next two decades that future sparkled only dimly.

For Ernest Gruening, writing in 1954, the economic stagnation which characterized all of Alaska during that and several earlier periods was the direct result of government neglect, just as the upturn in the mid-1930s, the growth during World War II, and Alaska's "cold war" boom of the early fifties were the consequence of government attention.[2] In each case Gruening cites, political "neglect" meant less government spending – while attention meant more.

The critical economic impact of government spending in Alaska is clear. With the single exception of the 1974-77 pipeline construction period, economic good times in modern Alaska have also coincided with periods when government was pumping money into the state – disaster relief in 1964-65, state spending of oil lease bonus receipts in 1970-73, and state spending of Prudhoe Bay royalty and tax revenue in 1979-83.[3]

What is not so clear is the extent to which government investment can create self-sustaining non-government economic development.[4] Nonetheless, the notion that govern-

ment efforts can and should bring long-term prosperity still exerts a powerful grip on many Alaskans, particularly in the case of energy development. Many Alaska political leaders point to the building of dams in the Tennessee Valley and the Columbia River Basin as examples of how hydroelectric development can lower power costs, provide construction jobs, and attract industry. Just as plans for Rampart dam captured the imagination of Alaskans in the 1950s and 1960s, the proposed Susitna hydroelectric project has been hailed by many in the 1970s and 1980s as a major boom for the Railbelt region between Anchorage and Fairbanks.[5]

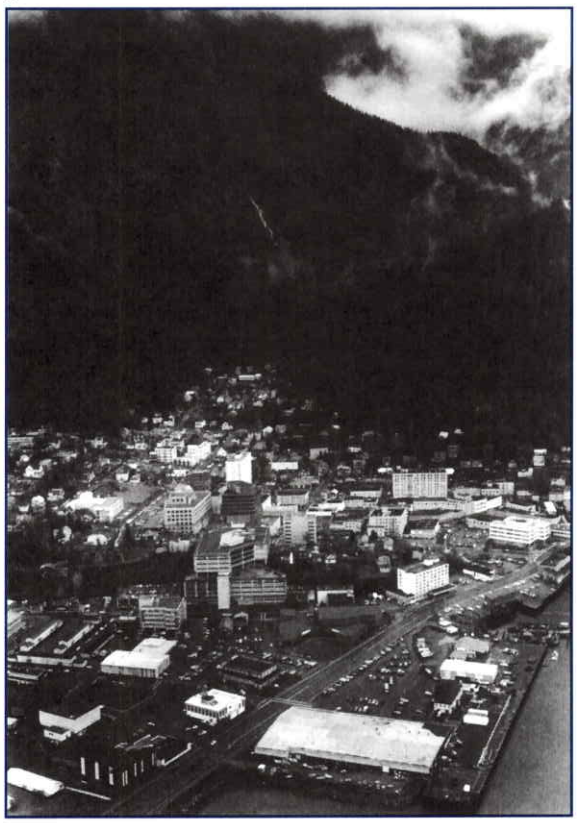
Government Dividends Almost Unique

Dividend distribution is of course also a way to inject money into the economy, but it flies in the face of these traditional Alaska notions of development as well as the practices of other governments. All governments distribute benefits in a host of forms, but indeed, the only historical parallel to the Permanent Fund dividend distribution appears to be a recent program of the remote Malaysian state of Sabah, which – like Alaska – used windfall revenues collected from natural resource development to fund its per capita payments.[6]

How it Happened

Both the Permanent Fund and the Permanent Fund dividends originated in the harvest of Alaska's tremendous oil wealth. The development of the vast Prudhoe Bay oil field on state-owned land allowed the state government to collect more than $12 billion in petroleum taxes and royalties in the decade from 1972 to 1982, with the expectation of an additional $140 billion or more by the year 2000.[7]

Exploding revenues produced exploding budgets. By 1982, Alaska was number one among the states in per capita expenditures ($88,500 per person), and was spending almost three times as much per Alaskan as the U.S. government was spending per American.[8]



The Alaska Permanent Fund Corporation is headquartered in Juneau, a tightly knit Southeast Alaska community that is a center of state, federal and borough government.

The first waves of the rising sea of oil money prompted Alaskans to create the Permanent Fund by a 1976 Constitutional amendment. By law, this public savings account receives at least 25 percent of all oil royalties – which works out to approximately 10 percent of the state's oil revenue in an average year.[9] As explained by Elmer Rasmuson, the Fund's first board chairman, "The Permanent Fund began, chiefly, with a 'negative' goal, to place part of the one-time oil wealth beyond the reach of day-to-day government spending."[10]

Hammond Supports Direct Dividends

Some Alaskans, including then-Gov. Jay Hammond, came to favor direct distribution of a portion of the oil revenues as a check on government growth. Without such a check, asserted Hammond, government spending and lending would create a dependence which would bring a wrenching dislocation when the oil money ran out. Direct distribution, on the other hand, would give each citizen a personal stake in oil revenue and thus give Alaskans an incentive to oppose pork barrel spending and budgetary hyper-growth in general. Further, argued Hammond, if the distribution was paid in the form of annual dividends from the Permanent Fund's earnings, Alaskans would be more likely to fight raids on their savings account.[11]

Some Alaskans supported direct distribution on the grounds of equity, contending

"Never before in the industrial world has a government mailed checks to all its residents simply because they lived there."

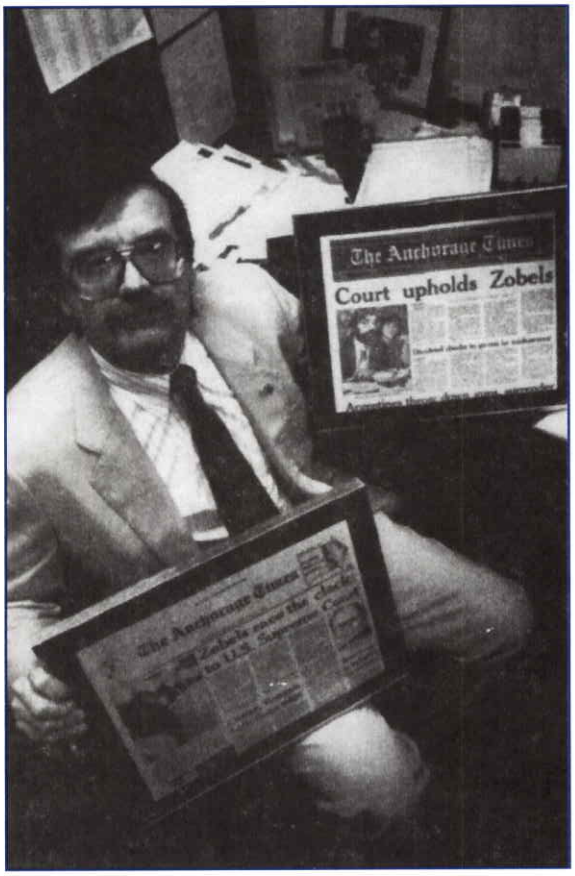
that "the powerful and connected are already benefiting from the state's wealth through special-interest appropriations, often arranged behind closed doors."[12] Many pointed to the state's heavily subsidized loan programs as the biggest example of inequitable benefit distribution. By 1981, some upper-income borrowers under the home loan program were receiving monthly subsidies larger than the payments made under the best-known federal welfare program, Aid for Families with Dependent Children.[13]

Others backed direct distribution primarily on economic grounds, arguing that individuals' use of a portion of the oil money would result in more efficiency and utility than the government's use.[14] Additionally, some favored the concept out of a libertarian fear that unrestrained government would eventually threaten individual freedom.[15]

After several years of advocacy, Hammond was able to engineer legislative passage of a Permanent Fund dividend distribution bill during the high revenue year of 1980. The legislation provided that the annual dividends would vary, increasing commensurate with length of residency.[16] Hammond contended this cumulative residency feature would "avoid the 'rip-off and run' syndrome which has so plagued Alaska."[17]

Zobels Challenge Residency Test

Many supported this "the longer you're here, the more you get" plan as a way to reward the contribution of longtime residents; this idea has a long lineage in Alaska history going back to the establishment of the Pioneers' Homes in 1913. Eligibility for the homes was restricted in recent years to Alaskans over 65 who had resided in the State for at least 10 years.[18] A related program, the Alaska longevity bonus, provides direct payments (currently $250 per month) to Alaskans over 65 who have resided in the State since 1959, the year Alaska became a state. Both programs reflected the notion that those who had "pioneered" Alaska should be given special benefits in their old age, and both enjoyed wide popularity in the State. However, Ronald and Patricia Zobel, two Anchorage lawyers, believed that all of the residency tests embodied in these programs were unconstitutional, and they filed suit against the dividend program.[19] In mid-1980, all payments were blocked pending resolution of the litigation, which ended up in the U.S. Supreme Court.



Ron and Patricia Zobel of Anchorage earned statewide enmity for their successful Supreme Court challenge to a plan giving larger Permanent Fund dividends to long-time Alaska residents.

Concern about the outcome of the Zobel litigation led the Hammond administration to introduce, in early 1982, another dividend bill, designed to take effect if the original legislation was struck down by the Court. In essence, this "backstop" bill provided that every six-month resident would get a dividend.[20]

The equal distribution scheme embodied in the "backstop" bill met with almost no enthusiasm in the Legislature. In February of 1982 it was estimated that there were less than 10 votes (out of 60 in the entire Legislature) for the proposal.[21] Some legislators feared that the equal direct distribution scheme proposed in the "backstop" bill would encourage in-migration to Alaska, plus touch off a negative reaction outside the State which would add fuel to a Congressional campaign to limit Alaska's oil revenues.[22]

Hammond Forces Vote on Dividend Plan

Neither did this proposal draw much attention from the public at large. The dividend legislation's universal impact gave no individual or group any special incentive to seek its passage. It proved difficult for the bill's supporters to motivate citizens to work for a bill whose benefits – while substantial to the average person – were distributed so widely. If the legislation passed, everyone would get a check; if it did not, no one would.

Hammond broke through this inertia by threatening to call a special session and veto funding for lawmakers' pet projects should the Legislature not pass the legislation. The governor underscored his commitment by personally testifying before a legislative subcommittee – although he strongly favored the original plan and hoped it would be upheld.[23]

Gov. Jay Hammond, as one of his last acts as governor, insisted that the Legislature pass a new Permanent Fund Dividend bill .

The political chaos produced by years of rapid budgetary growth helped the bill's passage in two ways. Some legislators came to agree with Hammond that the Legislature's track record showed that a portion of the oil money was better off in the hands of the people. The pressure of dealing with the cascade of petrodollars also fragmented the Legislature's attention span, and gave the governor extra room to maneuver and make deals to gain passage of his top priority.[24] Finally, the bill's passage was aided by the support of a tiny but committed core of diverse legislators and activists led by two former Speakers of the House.[25]

The "backstop" bill passed the Legislature with only two major changes from the governor's bill. Several provisions were inserted to ensure that no Alaskans would lose federal public assistance payments because of the receipt of dividends. After behind-the-scenes philosophical arguments about the trustworthiness of parents, the provisions instructing the State to hold on to minors' dividends until they turned 18 were replaced by a requirement that parents and guardians be allowed to collect dividends on behalf of minors.

Once on the floor, the legislation benefited from the governor's pressure, as well as from a perception that voting against distributing cash to residents could be politically dangerous – particularly in an election year. The bill passed easily in the waning hours of the session.

The Supreme Court ruled 8-1 against the original plan on June 14, 1982, less than two weeks after the session ended.[26] Hammond then signed the bill, although deeply disappointed that his original residency-based plan had been struck down.[27] Hours later, the big computer in the State Office Building down the street from the capitol started up, and the first oversized blue-and-gold $1,000 checks rolled off the high-speed printer and into the mailbox.

"Hammond broke through this inertia by threatening to call a special session and veto funding for lawmakers' pet projects."

Conclusion

Despite the novelty of Permanent Fund dividends and the publicity surrounding the $1,000 first-year distribution, Alaska still spends most of its oil revenue in traditional ways. Adding the $120 million earmarked for 1983 dividends – which will be about $300 per Alaskan – to the approximately $3 billion state budget would increase state expenditures by less than 5 percent.

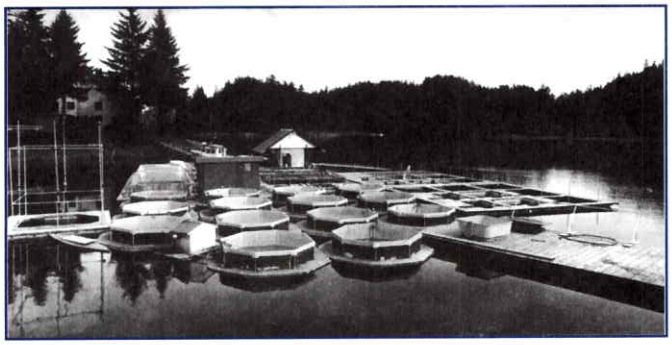
The verdict is still out on Permanent Fund dividends. The program may be seen as an equitable and efficient strategy which both challenges the decision-making capacities of

all citizens and encourages responsibility in unusual conditions of collective wealth. Or history may record the distribution as a wasteful and immoral giveaway of public assets to private greed. What is clear is that America's federalist system has again allowed a state to serve as a laboratory for decidedly different ideas.

The authors gratefully acknowledge the assistance of the following individuals: J. Rhode, T. Gardiner, H. Malone, M. Barker, M. Carey, L. Kramer, M. Wittow, D. Randolph, D. Niedermeyer, N. Lord, S. Dale, H. Fisher, G. M. Doogan, T. Singer, B. Rogers, J. Field, and J. Matson.

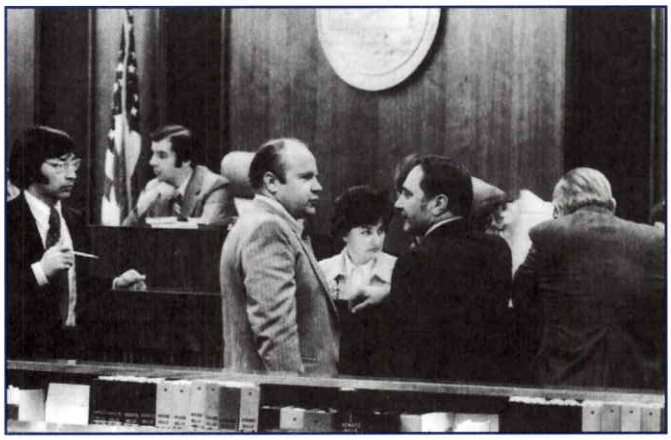
Footnotes

1. *Cook Inlet Pioneer* and *Knik News*, August 21, 1915, p. 3.
2. Ernest Gruening, *The State of Alaska* (New York: Random House 1954), pp. 157-306.
3. George W. Rogers, "The Alaska Economy in the 1960s," in Gordon S. Harrison (ed.), Alaska Public Policy: Current Problems and Issues (Fairbanks: University of Alaska, 1971). Linda Leask (ed.), "Prices and Incomes – Alaska and the U.S. 1967-1980," in Alaska Review of Social and Economic Conditions, June 1981, Gregg Erickson and Thomas O. Singer, "State Spending and the Alaska Economy," paper presented at the Conference on Alaska's Budget Process: The Agenda for Change, Anchorage, Alaska, December 4, 1982.
4. Alaska Permanent Fund Corporation, The Trustee Papers (Anchorage: 1982). (Hereafter this is cited as The Trustee Papers.)
5. *Anchorage Daily News*, January 12, 1983, p. 1.
6. Malcolm Gillis, "The Effects of in-State Investment: Lessons From Oil-Fired Development in Other Parts of the World." in The Trustee Papers, p. 41. Endowed with timber and oil resources, Sabah has made annual cash payments of almost $50 per capita, which is about 5 percent of Sabah's annual per capita income. Alaska's $1,000 payment was just over 6 percent of the State's 1982 estimated per capita personal income.
7. Alaska Department of Revenue. Revenue Sources. Quarterly Update, September, 1982, pp. 7, 10; Alaska Department of Revenue, Petroleum Production Revenue Forecast, December 1980, p. 10.
8. Between FY 1977 and FY 1982 the State's general fund expenditures increased by 235 percent; per capita expenditures adjusted for inflation increased by 159 percent. Milt Barker, "Memorandum to the Hon. Al Adams," August 6, 1982, table 1. Adjustments for inflation and population were calculated from data in Barker, supra., and The Hammond Almanac 1983 (Maplewood. N.J.: Hammond Almanac, Inc., 1982), pp. 186. 244.
9. Alaska Constitution. Article IX. Section 15; and Ch. 18 SLA 1980.
10. *Anchorage Daily News*, June 26, 1982, p. A-13.
11. Gov. Jay Hammond, "Farewell Address," November 29, 1982 (photocopied), pp. 8-18; *Anchorage Daily News*, February 7, 1982, p. A-13.
12. *Anchorage Daily News*, July 10, 1982. p. G-3.
13. Terry Gardiner and Ford (Clifford John) Groh. Alaska's Rainbow of Opportunity, 1981 photocopied), p. 27.



The state-run commercial fish hatcheries, like this installation at Little Port Walter in Southeast Alaska, were a product of Alaskans' desires to see oil wealth support economic activities based on renewable resources. (1987)

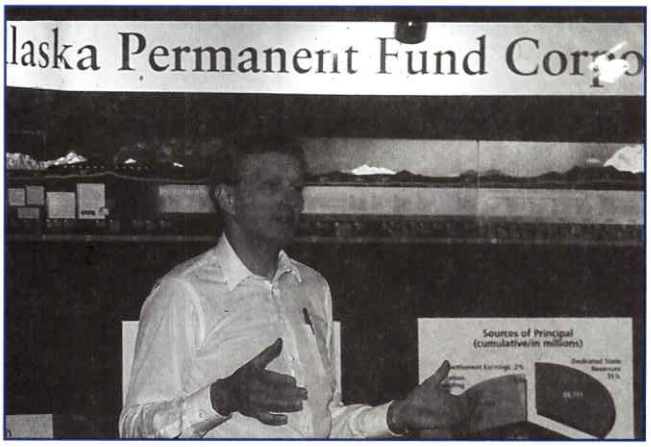
14. Richard B. Coffman, "Capital Shortage, Public vs. Private Allocation of Capital, and Alternative Ownership Systems for Alaska's Oil Wealth," in The Trustee Papers, pp. 23-26; and Donald Gordon, "The Problems of Wealth," ibid., pp. 4-6.
15. Dick Randolph, the Libertarian candidate for governor in the 1982 election, frequently touched on this theme.
16. Adults who had resided in Alaska for 21 years or more would receive $1,050 in the program's first year, others would get $50 for each year of residency (Ch. 21 SLA 1980).
17. "Statement by Governor Jay S. Hammond on Supreme Court Decision" (no date), (photocopied), pp. 2-3.
18. Ch. 25 SLA 1913; and Ch. 44 SLA 1915.
19. Zobel vs. Williams, U.S., 102 S.Ct. 2309.72 L.Ed.2d 672 (1982). The Zobels also filed and won a similar suit in the State courts against a related program which rebated State income taxes on the basis of residency.
20. Under this "backstop" plan, the per capita payments in the program's first year would be $1,000, a figure chosen because it would consume almost all of the money appropriated up to then to fund the old plan; after the first year, the amount of the annual dividend was to be calculated by dividing the number of eligible applicants into half of the Permanent Fund's interest earnings. (The other half of the income would be retained by the Fund so as to keep up its earning power in the face of inflation.)
21. Brian Rogers to Gregg Erickson, February 13, 1983.
22. Ibid.
23. "Statement by Governor Jay S. Hammond on Supreme Court Decision," note 17, supra.
24. See Richard A. Fineberg, "Chaos in the Capital: The Budget System in Crisis" (Anchorage: Alaska Public Interest Research Group, 1982).
25. The uniqueness of the direct distribution issue made nonsense of traditional political alignments, as shown by the coalition of the Republican Hammond with moderate to liberal Democrats Malone and Gardiner, as well as the nation's first Libertarian legislator, Rep. Dick Randolph of Fairbanks.
26. Zobel vs. Williams, note 19, supra.
27. Hammond, note 17. supra.



Alaska's Senate taking an at-ease during the 1973 session. Seated is Senate President Terry Miller (R-Fairbanks). At left is Willie Hensley (D-Kotzebue), Jay Kerttula (D-Palmer), Bill Ray (D-Juneau) and Ron Rettig (R-Anchorage), with his back turned.

"The verdict is still out on Permanent Fund Dividends."

Alaska's Permanent Fund Legislative History, Intent and Operations



Peter McDowell, one of the original Fund Trustees, reminisces about the origins of the Permanent Fund Corporation during the Corporation's 1996 Annual Meeting

"The objective of the Fund was to earn the highest possible return with low risk to the principal."

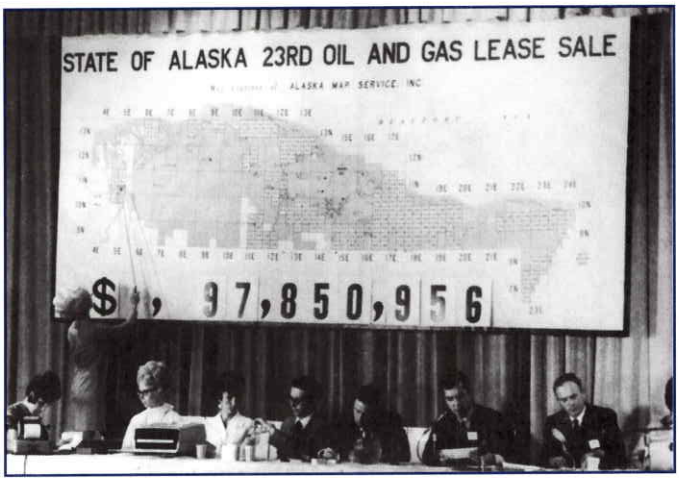
The Rural Research Agency, an agency of the Alaska State Legislature, was directed to examine the legislative history, intent, and subsequent implementation of the legislation which created the Alaska Permanent Fund Corporation (APFC). The Agency produced this report, which was first published in January 1986, then abridged and edited for the Trustee Papers Vol. 5.

Executive Summary

Introduction

The 1976 Constitutional Amendment (Article IX, Section 15) created the Permanent Fund and provides the fundamental directives for contributions and earnings of the Fund. The Constitution:

1) allows the creation of a dedicated fund;
2) directs a minimum level of mineral resource revenue contributions to the principal of the Fund; and
3) directs that all earnings be deposited to the General Fund unless otherwise provided by law.



The 1969 Prudhoe Bay lease sale netted the State about $900 million in bonus bids.

Issues in The Development of the Permanent Fund

Three major issues arose in the development of legislation to manage the Permanent Fund:

1) the objectives of the Fund;
2) fiscal issues; and
3) organization and management of the Fund.

Legislation enacted in 1980 stated the final choice of objectives as:

1) the Corporation should provide a means of conserving a portion of the State's revenues from mineral resources to benefit all generations of Alaskans;
2) the Corporation's goal should be to maintain safety of principal while maximizing total return; and
3) the Corporation should be used as a savings device managed to allow the maximum use of disposable income from the Corporation for purposes designated by law.

A "trust" was created to be managed by the Alaska Permanent Fund Corporation with a Board of Trustees to provide policy guidance. The management direction was conservative and placed paramount importance on "safety of principal." The objective of the Fund was to earn the highest possible return with low risk to the principal.

Other objectives considered and rejected were social and economic. The social objective had few advocates, other than Gov. Jay Hammond, who proposed Alaska, Inc., the precursor to the Permanent Fund Dividend program. The economic development objective was not chosen because the consensus was reached that:

1) lack of available capital was not the reason for limited economic development in Alaska;

2) that "soft" loans were very risky; and

3) loans were a subsidy to a select few people.

Members of the Senate had proposed bills utilizing the Permanent Fund principal for an economic development bank. Those bills were defeated for the above reasons and because they would have caused fundamental and major changes in responsibility among various state departments.

The state Constitution requires a minimum of 25 percent of selected mineral resource revenues be placed in the Permanent Fund. Subsequent legislation increased this to 50 percent. Analysis by administrative and legislative legal counsel concluded that once money was placed in the body of the Permanent Fund principal it could not be withdrawn without a Constitutional amendment. Inflation-proofing was considered but not included in the 1980 legislation. Legal opinions suggested that the Trustees must consider inflation in making investment decisions. However, the Legislature was under no obligation to consider additional inflation-proofing such as is now done.

The Trustees were directed by the Legislature to use the "institutional prudent investor rule" in guiding their investment decisions. Therefore the criteria by which the Permanent Fund Corporation management should be evaluated is based upon the concepts of diversity, total portfolio strategy, and assessment of risk. The Corporation should not be judged on individual investment decisions.

The major focus of the 1980 legislation was the management and organization of the Permanent Fund Corporation. The public clearly wanted a politically neutral Fund and the opportunity to participate in policy development. The Legislature and the executive were concerned about oversight and mechanisms for control of the Fund. The Trustees are gubernatorial appointees who submit the budget of the Corporation to the Legislature through the executive budget proposal. Legislative oversight is accomplished through the Legislative Budget and Audit Committee (LBA). Initially the LBA Committee was to have this responsibility for three years; then an assessment as to the need for a separate standing committee was to be made. This assessment never occurred.

Fund battle looms before lawmakers

The Alaska Permanent Fund is one of the most volitile issues in the state. Fund "raiders" would consider spending the money now; "defenders" want to build the fund as a hedge against declining oil revenues.

By ANN CONY and JOHN LINDBACK
Daily News reporters

JUNEAU – With oil prices falling and anticipated state revenues shrinking, defenders of Alaska's $6.2 billion permanent fund are bracing themselves for potential raids by legislators who want more state-funded construction projects.

"There's no question about it," said Rep. Mike Szymanski, D-Anchorage, a member of the House Finance Committee. "The mood of the legislature is to look for any available revenue that can be used."

Politicians who fashion themselves as guardians of the public savings account, such as Szymanski and Rep. Jim Duncan, D-Juneau, fear the fund's $557 million in interest earnings held in the so-called undistributed income

Fiscal Structure of the Permanent Fund

In the Fund's first decade, management of the Permanent Fund was directed by three pieces of legislation:

1) Chapter 6 SLA 1977 – effective March 23, 1977.

2) Chapter 18 SLA 1980 – all but one section became effective April 9, 1980.

3) Chapter 81 SLA 1982 – effective July 1, 1982.

4) Chapter 23 SLA 1986.

5) Chapter 83 SLA 1986.

Initial legislation permitted an investment list that included only fixed-income securities such as notes, bonds or bills guaranteed by the Federal Government, debt of federally insured financial institutions and corporate investment-grade securities. Under interim management, all earnings from the investment of the Permanent Fund were deposited in the General Fund per the Constitution.

The 1980 Permanent Fund Act is the basis for current management of the Fund. The Joint Committee Report stated that SB 161 was concerned with "the single most important question at this time – the management of the Fund's principal" and that the legislation addressed three areas: safety of principal, accountability and legislative oversight.

It placed management of the Permanent Fund under the Alaska Permanent Fund Corporation (APFC) and its Board of Trustees. Future nonrenewable mineral resource revenues would be subject to a 50 percent contribution rate rather than the past rate of 25 percent. Fixed-income securities remained the only type of investments permitted. Legislation passed in 1980 made a number of changes to the Permanent Fund earnings

"The Trustees were directed by the Legislature to use the 'institutional prudent investor rule' in guiding their investment decisions."

distribution scheme. From FY 1980 through FY 1982, annual income was divided between:

1) Dividend Fund – received one-half of the amount of income available for distribution (the five-year moving average of net income).

2) General Fund – received the remaining half of the amount of income available for disbursement (based on the Constitutional provision for income not otherwise spent by the Legislature).

3) Undistributed Income Account – since annual income was (and always has been) larger than income available for disbursement, a retained earnings type of account was created containing the difference between earnings and distributions each year. (Note: In 1986, this account was renamed the Earnings Reserve Account.)

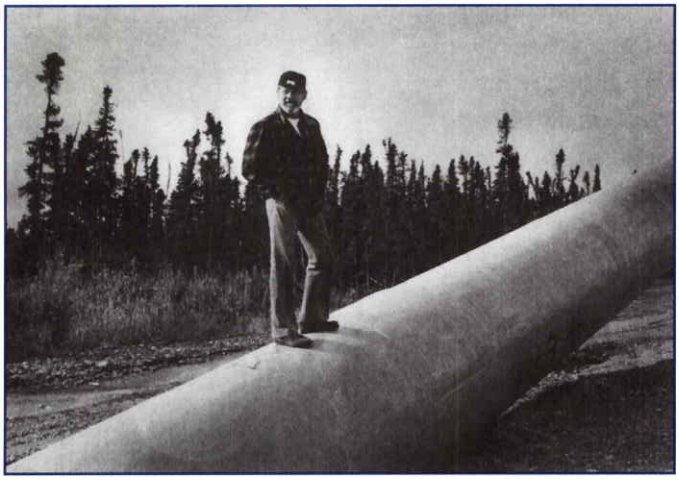
The 1980 Permanent Fund Act created the "undistributed income account," but it failed to define the account or mandate any management or investment guidelines. A letter of intent that accompanied the legislation also did not discuss the creation or objective of this account.

The 1982 Amendments addressed three major issues:

1) Composition of the Board of Trustees – changed to four public members with four-year terms, and two members of the administration.

2) Permissible Investments – the list of allowable investments types was expanded to include domestic stock (common and preferred) and selected types of real estate. Asset allocation was also changed to accommodate these new investment types.

3) Inflation-Proofing – a portion of annual earnings was henceforth to be reinvested in the principal to offset the effects of inflation.



Known as Alaska's Bush-rat governor, Gov. Jay Hammond is widely seen as the father of the Permanent Fund dividend program.

Conclusions

1) The Permanent Fund was established with a set of principles which have been significant in its success. These principles, such as the Prudent Investor Rule, flexibility of Trustees in investment decisions, insulation (but not isolation) from political activity, and accountability to the Legislature, have been followed and should continue to be adhered to. Deviation from these principals, such as disinvestment, may harm the future financial success of the Fund.

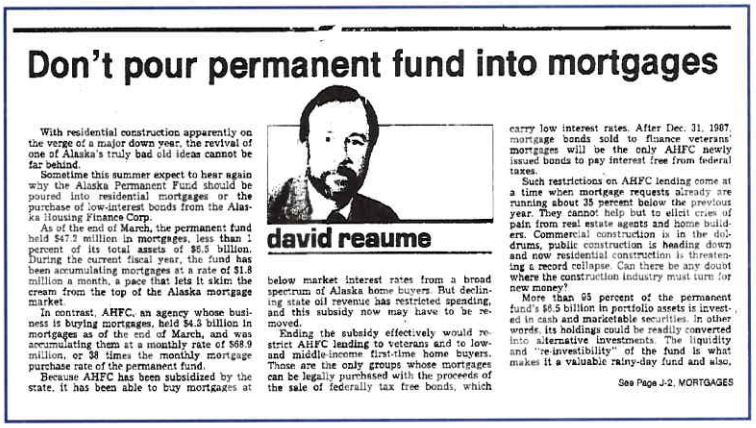
2) Flexibility of investments should be expanded to include foreign stocks. (Note: This authority was provided by the Legislature in 1989.)

3) A major portion of the earnings of the Permanent Fund are designated for inflation-proofing. How adequately the principal is protected from the impact of inflation is influenced by the methods used to determine the amount reinvested. Inflation-proofing will soon become the major source of new revenues for the Permanent Fund.

4) The other program funded from Permanent Fund earnings is the Dividend Program. This program has disproportionately raised the incomes of low-income Alaska families many of whom live in rural Alaska. In addition economists have compared the effect of the Permanent Fund Dividend to expenditures in the capital and operating budgets and have concluded that it is the most effective way to encourage economic activity in Alaska.

5) Since it is unlikely that the Permanent Fund will continue to earn real rates of return at the current level (because the current situation is historically unusual and allows higher than normal returns on fixed income investments) and since the possibility of increasing inflation exists, the Legislature eventually may have to choose between the Dividend program and inflation-proofing. It is unlikely under the existing distribution scheme that large amounts of money will ever be available to the General Fund for appropriation.

6) The Undistributed Income Account's original purpose and legislative history is vague. However, this account, since renamed the Earnings Reserve Account, is comprised of the earnings of the Permanent Fund, and the Constitution is very clear that these earnings are to be deposited to the General Fund and subject to appropriation unless otherwise designated by the Legislature. Under the current law, appropriating the Earnings Reserve Account is clearly within the legal options of the Legislature and is consistent with the intent of the Permanent Fund.



Don't pour permanent fund into mortgages

With residential construction apparently on the verge of a major down year, the revival of one of Alaska's truly bad old ideas cannot be far behind.

Sometime this summer expect to hear again why the Alaska Permanent Fund should be poured into residential mortgages or the purchase of low-interest bonds from the Alaska Housing Finance Corp.

As of the end of March, the permanent fund held $47.2 million in mortgages, less than 1 percent of its total assets of $6.5 billion. During the current fiscal year, the fund has been accumulating mortgages at a rate of $1.8 million a month, a pace that lets it skim the cream from the top of the Alaska mortgage market.

In contrast, AHFC, an agency whose business is buying mortgages, held $4.3 billion in mortgages as of the end of March, and was accumulating them at a monthly rate of $68.9 million, or 38 times the monthly mortgage purchase rate of the permanent fund.

Because AHFC has been subsidized by the state, it has been able to buy mortgages at below market interest rates from a broad spectrum of Alaska home buyers. But declining state oil revenue has restricted spending, and this subsidy now may have to be removed.

Ending the subsidy effectively would restrict AHFC lending to veterans and to low- and middle-income first-time home buyers. Those are the only groups whose mortgages can be legally purchased with the proceeds of the sale of federally tax free bonds, which carry low interest rates. After Dec. 31, 1987, mortgage bonds sold to finance veterans' mortgages will be the only AHFC newly issued bonds to pay interest free from federal taxes.

Such restrictions on AHFC lending come at a time when mortgage requests already are running about 25 percent below the previous year. They cannot help but to elicit cries of pain from real estate agents and home builders. Commercial construction is in the doldrums, public construction is heading down and now residential construction is threatening a record collapse. Can there be any doubt where the construction industry must turn for new money?

More than 95 percent of the permanent fund's $6.5 billion in portfolio assets is invested in cash and marketable securities. In other words, its holdings could be readily converted into alternative investments. The liquidity and "re-investibility" of the fund is what makes it a valuable rainy-day fund and also,

david reaume

See Page J-2, MORTGAGES

Ideas about how to use the Fund ranged from mega-capital projects to mortgages.

"The Permanent Fund was established with a set of principles which have been significant in its success."

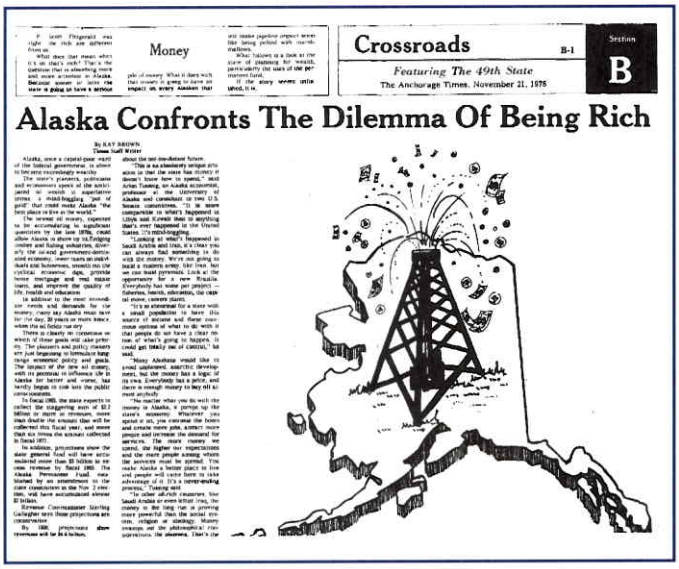
Chapter One: Introduction

The Alaska Permanent Fund was approved by the citizens of Alaska nearly two decades ago when they overwhelmingly passed a Constitutional amendment allowing a dedicated fund to be created. The principal of the Permanent Fund now exceeds funds such as the Rockefeller Foundation, the Ford Foundation, and the J. Paul Getty Trust. This report examines whether the Permanent Fund has fulfilled the public and legislative objectives for which it was created in 1976. It describes the historical legislation that guided the development of the Fund's investment strategy and discusses the Fund's fiscal structure. Finally, the report examines the future of the Permanent Fund and the options Alaskans now have as a result of the Permanent Fund.

The history of the Permanent Fund is complex with many different groups involved in the development of the legislation and an equal number of ideas about the objectives and management of the Permanent Fund. At various times, two to thirty-five bills have been before the Legislature regarding the Alaska Permanent Fund Corporation (APFC). This paper has been designed to focus on the major historical themes related to current legislative issues regarding the Permanent Fund:

1) the objectives or purpose of the Permanent Fund;
2) the management of the fund; and
3) the disposition of the earnings of the fund.

The discussion emphasizes those objectives considered during the development of the Permanent Fund which are likely to be reconsidered with a declining revenue base for the State of Alaska: the Permanent Fund as an economic development tool, as a fiscal savings account, or as a social mediator. Arguments for and against each objective are presented and an explanation of why the fiscal objective was chosen. Issues such as "inflation-proofing" and disposition of earnings are discussed. Comparisons are made between legislative intent and existing operations on topics such as accountability, investment strategy, legislative oversight and the Earnings Reserve Account. Alternative scenarios for the future Permanent Fund earnings are presented.



Money

Crossroads B-1

Featuring The 49th State

The Anchorage Times, November 21, 1976

Section B

Alaska Confronts The Dilemma Of Being Rich

By KAY BROWN
Times Staff Writer

In 1976, Alaskans voted by a margin of two to one to save a portion of their North Slope oil dollars.

History of Concept

In 1976 the public was very optimistic about the financial future of Alaska. Total revenues anticipated to accrue by 1985 to the State's Treasury from oil royalties and taxes were as high as $8.6 billion without any additional discoveries of new oil fields. At the same time, there was concern about the growth in government spending and the economic future of Alaska once the oil revenues declined. The state's population had just experienced the effects of a construction boom as a result of the $900 million bonus payment for Prudhoe Bay and the construction of the trans-Alaska oil pipeline. A mechanism to slow or to dampen the "boom and bust cycle" the Alaska economy was experiencing was desired by the citizens. Among Alaskans, the general consensus was that the "operation of the fund would have the effect of reducing the immediate fiscal impact of oil and gas income and a stretching out and smoothing of its long-term impact" (Tussing 1977). The public embraced the concept by a margin of two to one when they approved the Constitutional amendment. The vote represented broad support of liberal and conservative factions in Alaska society.

The idea of saving a part of the windfall oil revenues appeared to arise simultaneously in the early 1970's among the financial community, the general public, and the Legislature. In a speech before the Alaska Chamber of Commerce in 1969 the concept was presented by a member of the financial community, Robert Krantz, as a "perpetual fund" from which the Legislature would appropriate and use the earnings. The Legislature heard similar proposals from a seminar they had sponsored on the "Future of Alaska" conducted under the auspices of the Brookings Institute. During the 1970 legislative session, Gov. Keith Miller introduced legislation which would have set up an appropriated reserve of money for a "resources permanent fund." The legislation passed the Senate but not the House. In 1975 legislation (CSHB 324 am S) was introduced and passed by the Legislature creating a Permanent Fund but this time Gov. Hammond vetoed the legislation, citing the Alaska Constitution which prohibited dedicated funds and proposing the Constitutional amendment (SSHJR 39) which the voters approved in 1976.

Gov. Keith Miller had originally proposed that 50 percent of non-tax mineral royalties and revenue be deposited in a permanent fund, reflecting conservative estimates of revenue totals.

The Constitutional Amendment

The Constitutional amendment permitted the existence of a dedicated fund which had been forbidden previously. It also set the minimum amount and sources of the revenues from which the Permanent Fund was to be created. The amendment is reproduced below:

> Section 15. ALASKA PERMANENT FUND. At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.

The Constitutional amendment represented a compromise between the Senate and the House in the types of revenues and amount of revenues allocated. The revenues dedicated to the Permanent Fund were those revenues which the State received as a result of its status as a landowner or because of its relationship to the Federal Government. The House had wanted to include severance taxes but the Senate argued that taxes were assessed for the operations of government, not to create, in essence, a profit. The compromise between the governor, House, and Senate was designed to exclude the severance tax, but to raise the minimum contribution from 10 percent to 25 percent of the allowable revenues. In effect, either bill allocated 10 percent to 11 percent of the State's mineral revenues to the Permanent Fund.

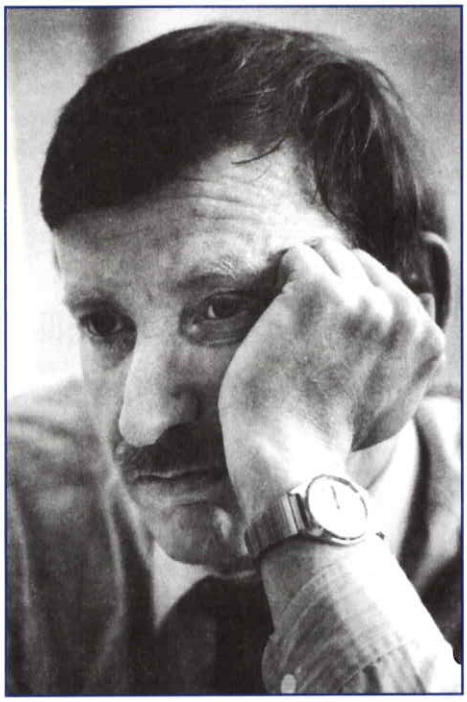
Although the Constitutional amendment did give a conservative direction to the Fund, it did not set up the management structure, the allowable income-producing investments for the Fund, or designate how the earnings would be used when deposited in the General Fund. These issues were to be decided with subsequent legislation. Table 1 summarizes the steps creating the Alaska Permanent Fund.

"All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law."

Table 1. Chronological Sequence of Permanent Fund Events

1969	Concept of a savings account first proposed by Krantz before the Alaska State Chamber of Commerce.
1970	Gov. Miller introduces first bill, which is defeated in House of Representatives.
1975	Permanent Fund bill passes Legislature and is vetoed by Governor Hammond for Constitutional reasons.
1976	Voters approve Constitutional amendment.
1977	HB 210 – provides for interim management of the Permanent Fund, and passes in March. September Anchorage Symposium by House Permanent Fund Committee on Objectives of Permanent Fund.
1980	SB 161 – creates the Alaska Permanent Fund Corporation.
1982	SB 684 – amendments to the 1980 Permanent Fund Act.

Chapter Two: Issues in the Development of the Permanent Fund Concept



Jim Rhode, an aide to the chairman of the House Finance Committee was one of the earliest and most eloquent supporters of the Permanent Fund.

Three major issues or questions arose during the development of the Permanent Fund which were either addressed in the Constitutional amendment and or clarified in subsequent legislation. The issues are:

1) What are the objectives of creating a Permanent Fund?
2) What are the financial concerns related to creating a Permanent Fund?
3) How was the Permanent Fund going to be managed?

To determine the answers to these issues the House and Senate established special Permanent Fund Committees, contracted with many financial consultants, and commissioned polls and surveys to determine public opinion. The Hammond Administration, through the Alaska Growth Policy Council and the State Investment Advisory Council, solicited public input.

Objectives of the Fund

The objectives proposed for the Permanent Fund were many; some were very broad while others were very specific. The possibilities were described categorically as social, economic and fiscal. Examples of social objectives would be to use the Fund to promote programs with an emphasis on changing social conditions such as the redistribution of wealth through the negative income tax, to subsidize low-income families, to correct regional economic differences, or to support educational programs. Economic objectives were described as those which would promote economic diversification and development. Proposals for subsidized loan programs, large infrastructure programs to build hydroelectric dams, railroads, and ports, or the development of industrial parks can be categorized under the economic objectives. The fiscal objective centered upon the idea of the Fund as a "savings account" which would be managed very conservatively, primarily

investments in high-grade low-risk securities, or would be used to reduce state debt. Each objective had advocates who advanced specific legislation for Fund objectives and management. The various groups involved in the development of the Permanent Fund are summarized in Table 2.

Table 2. Groups Involved in the Development of the Permanent Fund Legislation

State Investment Advisory Council (SIAC). Membership was expanded and directed by Gov. Hammond to develop a Permanent Fund proposal. Membership included academic specialists, private enterprise representatives, the Departments of Commerce and Economic Development, Revenue, and the Division of Policy Planning and Development.	Initially stressed the idea of Permanent Fund as an Economic Development Bank.
Alaska Growth Policy Council and the Public Forum were established by Gov. Hammond to determine opinions on future development of the State.	Had no position on Permanent Fund, but provided mechanism for public input regarding the Permanent Fund.
Division of Policy Development and Planning (DPDP). Directed by Gov. Hammond to provide policy coordination and guidance between the various departments.	Coordinated and developed analysis of various positions. Appeared to be pro fiscal objective.
Alaska State Senate.	Sen. Hohman developed loan program revisions to be funded by the Permanent Fund.
Alaska State House of Representatives Permanent Fund Committee. Seven members specifically working on Permanent Fund Legislation from 1976 until passage of management bill in 1980.	Developed the fiscal concepts which were eventually included in the management sections of the bill. Conducted many of the public seminars and provided information booklets.
Commonwealth North. Business lobby group.	Advocated use for infrastructure development.
Alaska Chamber of Commerce.	Advocated loan programs for businesses.

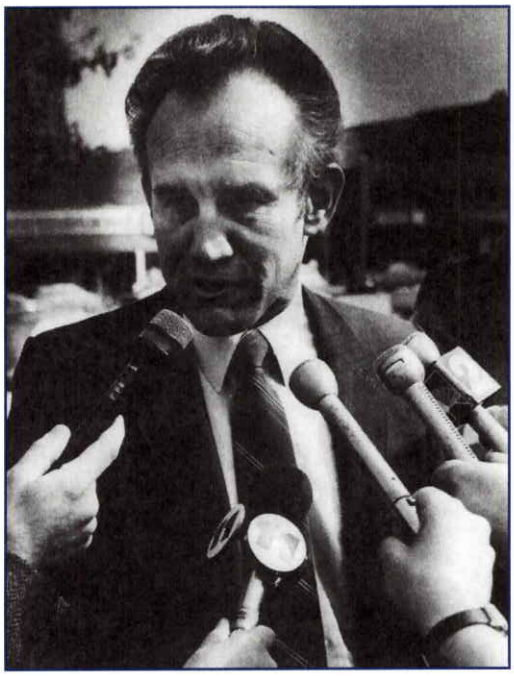
"The fiscal objective centered upon the idea of the fund as a 'savings account' which would be managed very conservatively..."

Economic Development Objective

Proponents of the economic development or diversification objective included numerous and powerful special interest lobbies. Special interest groups saw the Permanent Fund as a development bank which could finance projects. For example, the power utility organizations promoted the concept of using the fund for hydroelectric development. Suggestions were made that the Permanent Fund finance the Alaska Natural Gas Transportation System, and Alaska Railroad extension into the interior of Alaska, community development banks and so forth. The Permanent Fund became the "wishing well" for all of these interests and more.

The main proponents in the State Government for the economic solutions were the State Investment Advisory Council (SIAC), the Department of Revenue, the Department of Commerce and Economic Development, and the Senate. Gov. Hammond had requested that SIAC take the lead role in developing legislation concerning the management of the Permanent Fund. Membership in SIAC was expanded and included representatives from the Departments of Commerce and Economic Development, Revenue, and Administration, agricultural representatives, members of the financial or banking communities, resource development interests, and representatives from the Native community.

SIAC considered the following objectives for the Permanent Fund; the development of a loan program, loan subsidies, securing or guaranteeing State industrial development bonds, and a development bank. The Council hired White, Weld & Co. as consultants to examine the possibilities. Kenneth Butler, vice-president for White Weld, summarized the possibilities SIAC examined:



Distributing a portion of state resource revenue directly to citizens held strong appeal to Rep. Dick Randolph, Fairbanks, the nation's first Libertarian state legislator.

"... the assets of the Permanent Fund can be used in a great variety of ways and combination of ways within the structure of the tax-exempt market to maximize its effectiveness and impact on solving the needs of Alaska and achieving its economic goals. Briefly stated, some of the opportunities are: 1) direct guarantee of debt, 2) make-up of revenue shortfall, 3) loans to projects or political subdivisions, 4) combination financing with public utilities or private industry, 5) industrial development financing, 6) pledge of specific assets and/or income of the Fund for certain projects, and 7) others." It is important to understand that these initial efforts focused on using the entire body or principal of the Permanent Fund for loans and development activities, however, as discussion continued the focus shifted to the earnings. For example, in 1981 after the Permanent Fund had been established, business groups such as the Business Round Table advocated the use of the earnings for infrastructure development as opposed to the Permanent Fund Dividend Program."

The Department of Revenue had conceived a similar breakdown of the possible Permanent Fund objectives. Commissioner of Revenue Sterling Gallagher stated the possible objectives for the Permanent Fund as economic diversification, community development or a savings account. Two additional possibilities were considered in October, 1977, using the Permanent Fund as a mechanism for revenue-sharing with municipal governments, or as a control on state spending.

By the time Permanent Fund legislation was enacted in 1980, several concepts concerning economic development had emerged from the process. Important among these were that economic intervention activities had little chance of succeeding, that the likelihood of loss of the body of the Permanent Fund was high, the size of the Permanent Fund would be inadequate for large infrastructure projects, and that economic development would encourage immigration and worsen the state's taxable base.

PUBLIC PERCEPTIONS

Two perceptions influenced public opinion among Alaskans in the mid 1970s:

1) Alaska economic development was being hindered by a lack of capital; and

2) Alaska lifestyles based on renewable resources such as fish and timber should be promoted.

Members of the public initially perceived the Permanent Fund as an economic development tool by a margin of 4-1 (Dittman 1976). The Dittman Poll conducted for the Alaska State Senate in October of 1977 concluded that the top five of twenty-two options for the use of Permanent Fund earnings had an economic orientation. They were:

1) loans for renewable resource development (fisheries and timber);

2) loans for farming and agricultural development;

3) loans for senior-citizen housing programs;

4) loans for large-scale electrical power development (hydro-electric/geothermal); and

5) loans for small business development.

Similarly, an Alaska Chamber of Commerce questionnaire showed that Chamber members wanted the Permanent Fund to be invested in high-grade stocks (43 percent) and be used for loan programs or development projects. The public wanted to apply the same criteria used by private institutions such as banks for loans in any development lending program. Overall small-business owners and the public conceived of the Permanent Fund as a tool for economic diversification.

Oil money funded state loan programs benefiting Alaska's traditional private industries, including financing for commercial fishing vessels like this Prince William Sound seiner.

RURAL PERSPECTIVES

Rural residents, in polls and at public hearings, supported the economic development uses of the Permanent Fund. They were more inclined to use the Permanent Fund principal as well as the earnings immediately than urban residents (29 percent vs 22 percent) and were less supportive of loan programs (38 percent vs 62 percent). In the Dittman Survey, rural residents said they were capital-short and would participate in and benefit from loan programs. They wanted these programs to be administered by the state as opposed to private banks. During a Symposium on Permanent Fund objectives, housing loan program needs were presented as an example of the type of programs rural residents envisioned for Permanent fund dollars. Jamie Love of the Alaska Public Research Group said, "It's very difficult for people living in rural Alaska to provide housing through conventional or their own resources." He advocated rural loan programs funded by the Permanent Fund.

With more information, village and Native corporate leaders' support of the economic objective modified somewhat between 1976 and 1977. For example, the "savings account approach" was recommended by Alaska Public Forum participants in Dillingham in the fall of 1977. However, money for renewable resources was a close second. In Wainwright that fall, participants in the Alaska Public Forum recommended the money be used for immediate infrastructure needs such as an airport terminal, with investment in renewable resources a close second. Opinion among Native Corporation leaders was that the Permanent Fund had "great potential value in meeting rural area needs." Native Corporate representatives envisioned the Permanent Fund as a bank similar to the Economic Development Administration, the Federal Housing Administration, and State

"Rural residents, in polls and at public hearings, supported the economic development uses of the Permanent Fund."

loan programs. Specifically these leaders saw a need for loans for projects involving fisheries and minerals development. Overall, the rural people still envisioned the Permanent Fund as an economic development bank.

CONSULTANT RECOMMENDATIONS

Consultants were very influential and numerous during the development of the Permanent Fund. Table 3 lists the main consultants who were involved.

Table 3. Consultants Used in Developing the Permanent Fund Legislation

Alaska Pacific Bank	Robert Richards worked with SIAC, produced Permanent Fund position paper in the "Alaska Series."
Arthur D. Little	Financial consultants contracted by SIAC to examine State loan programs and recommend changes.
Baily, Donahue, and Kasson, Inc.	Political consultants who were contracted by SIAC to study attitudes about goals of Permanent Fund and level of awareness in 1977.
Debevoise & Plimpton	Legal firm contracted by Legislative Budget and Audit to determine the implications of the Prudent Investor Rule.
Dittman Research Associates	Market and public opinion research firm contracted by Senate Permanent Fund Committee to do "Results of Personal Hearing-in-the-Home Program concerning the Alaska Permanent Fund."
Beldon Daniels	Regional planner, from Department of City and Regional Planning, Harvard University and Counsel for Community Development contracted by House Permanent Fund Committee to write two issue papers on the development of the Permanent Fund.
Robert J. Dupere	Questionnaire research firm contracted by Senate Permanent Fund Committee to do business opinion poll about Permanent Fund.
Fidelity International, Inc.	Financial consultants on bill drafts to Legislative Affairs Agency Legal Division.
Milton Friedman	Nobel Prize winning conservative economist from the University of Chicago. Met with both SIAC and House Permanent Fund Committee members.
Institute of Social and Economic Research	University of Alaska research group contracted by the House Permanent Fund Committee to analyze different contributions, needs, and economic scenarios regarding the Permanent Fund.
Kidder, Peabody and Co.	Financial consultants contracted by House Permanent Fund Committee to provide advice on Permanent Fund structure, recommend other advisors such as Robert Blixt of Minnesota Board of Investments.
Price Waterhouse & Co.	Financial advisors contracted by House Permanent Fund Committee to examine the organizational structure of the Permanent Fund as a development bank, criteria for integrity, oversight, and boards.

The economic objective was examined thoroughly by consultants and their recommendations demonstrated some consensus in the ability of the Permanent Fund to promote economic diversification, alleviate the rural capital shortage, and about participation in soft loan programs.

Rural people believed a capital shortage existed because of the difficulties they were having in obtaining loans. Coffman and Fry studied the problem and concluded that structural problems, rather than a lack of dollars, were causing the shortage (Coffman and Fry N.D. and Coffman 1982). The structural problems cited were a lack of investment opportunity, land title problems, insurance difficulties, lack of supporting infrastructure, lack of information and expertise, seasonal nature of business opportunities, the high costs of goods and services, and the low personal incomes of rural Alaskans. Alaska economist Arlon Tussing had come to a similar conclusion and noted that the private market appeared to be fulfilling the capital needs of Alaskans (Tussing 1977). In his opinion, the costs of borrowing money in rural Alaska reflected the actual higher cost of lending in those areas. He did qualify his findings by suggesting that a state program in one area, loans to small- and medium-scale enterprises in small and rural communities, might fill a specific capital shortage. The overall conclusion by these consultants was that private lending institutions were providing adequate money and that an infusion of Permanent Fund dollars would replace rather than supplement the available lending pool.

As the headquarters for trans-Alaska pipeline construction – and a favored R&R spot for pipeline workers – Fairbanks became Alaska's boomtown of the 1970s. (1974)

The ability of the Permanent Fund to create new industries and/or to promote existing industries was seriously questioned by consultants. Beldon Daniels repeatedly stressed the need to develop realistic expectations concerning the Permanent Fund's ability to foster economic diversity. He noted that a coherent statewide policy on expenditures, taxes, and administrative regulation was needed to encourage private capital investments. Tussing agreed with Daniels, as have subsequent consultants. Tussing said, "It appears that a reduction of existing barriers to capital mobility and improving information flows would not necessarily accelerate the rate of development in Alaska fisheries, agriculture, or tourist industries, for example or in rural Alaska generally." In the Trustee Papers #1, Peden argues that investments in education, identifying specific industries that suit the region, and providing a cooperative government business atmosphere were more important than massive infusion of public capital to encourage economic diversification.

Concern for the potential inflationary results of Permanent Fund investments in Alaska was expressed by several consultants. International development specialist Malcolm Gillis argues in the Trustee Papers #1 that large infusions of money into small economies have caused inflation and socio-economic dislocation rather than economic diversification. This type of dislocation had been labeled in 1977 as "The Dutch Disease" when Holland experienced rising unemployment and lowered industrial productivity as a result of petrochemical revenues. The anticipated magnitude of the Permanent Fund in comparison to other pools of money in the State caused Daniels to comment:

> "Alaska's economy with its $4.5 billion in personal income is simply not large enough to be able to absorb significant in-state investments by the $4 billion Permanent Fund. Further, opportunities for making sound investments are relatively narrow. There are real limits on the ability of public fund investments to "force feed" sound, new economic activity in Alaska ...
>
> Alaska's second unique problem arises from its relatively small capital market. The Permanent Fund currently towers over all other financial sources in Alaska. If even 25 percent of the Permanent Fund were invested within the state, that portion of the Fund would be the fifth largest financial source in Alaska."

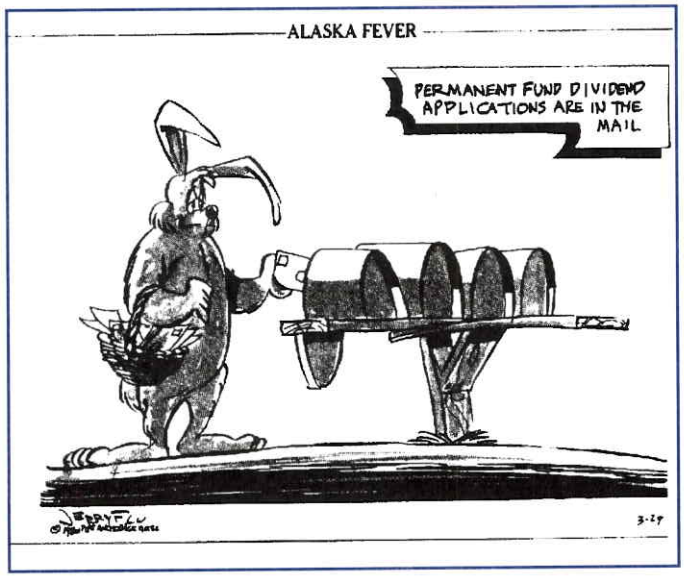
"The ability of the Permanent Fund to create new industries and/or to promote existing industries was seriously questioned by consultants."

The potential use of the Permanent Fund for loan programs raised the issues of subsidies and market rates of return on Permanent Fund dollars. The Permanent Fund had been conceived by proponents such as Gov. Jay Hammond as a way to benefit all Alaskans. Arrow summarizes the consensus in the Trustee Papers #1, noting that low-interest loans or below-market-rate loan subsidies are similar to any other public good and that "subsidies benefit small groups, doing nothing for future generations, and possibly doing nothing for present-day Alaskans." The conservative economists, Gordon and Friedman, recommended that direct payments rather than social-welfare programs or loan programs would provide the greatest benefit for individual Alaskans. Finally, nearly all of the consultants agreed that if the Permanent Fund provided loans at below-market rates or at higher risk than the commercial banks, an erosion of the principal of the Fund would occur. The consultants agreed with White Weld's conclusion that "soft-loan" programs do not belong in a "legacy public or private."

In summary, the consultants were useful to the public and the Legislature. Consultants emphasized the relative small size of the Permanent Fund to the overall state budget and economy. They introduced caution in expectations of what the Fund could achieve in terms of economic diversification and pointed out that other economic problems besides capital shortages were the factors hindering Alaska's economic development. Finally, they discussed the two major ways in which the principal of the Fund could be lost:

1) if investments were too cautious resulting in real rates of return below inflation; and
2) if investments were too risky resulting in loss of the capital.

Social and Community Welfare Objectives



Annual Permanent Fund Dividend checks help create a powerful advocacy group for the Fund.

Proponents of the social welfare objective concentrated on the disposition of the earnings of the Permanent Fund as opposed to the principal. Proponents of the social welfare objective also advocated an investment strategy to eliminate or balance specific inequities in economic, social, physical, or political parameters of the state. Alaska Pacific Bank analyst Richards gave examples of programs which promoted income redistribution or tax relief as possibilities for social objectives for the Permanent Fund. Proponents of the community welfare objective advocated investment in municipalities and community development to provide for the health, education, social, and public facility needs of Alaska communities.

GOV. HAMMOND'S RECOMMENDATION: ALASKA, INC:

The most serious advocate of social welfare goals was Gov. Jay Hammond. His proposal concentrated on the earnings of the Fund and was developed as a piece of legislation separate from legislation mandating management of the fund. Hammond wanted to develop a Fund which would benefit all Alaskans and to develop a public constituency which would protect the fund. Although the governor suggested and considered many options such as low-interest loans, tax relief, and increasing government services, he settled upon Alaska, Inc., which became the Permanent Fund Dividend program. His reasoning was that:

> "In any program increasing the dispersal of our oil wealth all Alaskans, not simply taxpayers, should be beneficiaries. We already have numerous programs selectively dispersing portions of our oil wealth in the form of expanded subsidized government programs and low-interest loans."

Hammond did not give up social welfare objectives once the Permanent Fund legislation passed in 1980. For example, in 1981 he was proposing that earnings be allocated between the dividend program and a "municipal" dividend program.

CONSULTANT RECOMMENDATIONS

Consultants were very influential in the formulation of objectives for the Permanent Fund. It appeared that Hammond was taking the advice of consultants such as Friedman. Friedman, in a meeting with members of the Administration and representatives from the Legislature, recommended to the State that the general public would receive the greatest benefits through some kind of direct ownership shares or distribution. Consideration of the Permanent Fund as a vehicle for social reform centered on the concept of the Fund as an economic bank and was most actively pursued during the first stages of the debate. Beldon Daniels, when considering the Permanent Fund as an economic bank, recommended a strategy which attempted to "minimize the rates of increase in economic disparity among regions and demographic groups within Alaska." Daniels did not believe that the Permanent Fund could do much in changing the social situation in Alaska.

The rapid influx of wealth from Prudhoe Bay oil brought rapid improvements to community infrastructure, including Skyview High School in Soldotna. (1987)

The other major recommendation was to advise against any kind of social objectives for the Permanent Fund. The reason for this recommendation was the inability to account for or measure the social performance of the Fund as succinctly as through financial criteria. The idea was to keep the Fund relatively "pure" in objectives and to allow the earnings to go back to the General Fund where the legislative process could respond to social needs and allocate funds more effectively. The Trustees (the governing board of the Permanent Fund) have taken these recommendations very seriously, as noted in former Trustee Dr. George Roger's testimony before the Alaska State Legislature.

Despite the diverse background and philosophies of the participants, the consensus that emerged was that the fundamental goal of the Fund was providing high quality savings and stability of income. The conclusion was that the Fund performance was most readily measured by financial standards, and that economic, social and political goals were best carried out and best judged in the open forum of regular government, that is, the ongoing democratic political process.

PUBLIC PERCEPTIONS

The public supported inclusion of many of the social welfare objectives for the Permanent Fund in proposed Fund loan programs. Housing loan programs and weatherization loans are two examples of loans with social objectives. There was also a quality-of-life component to some of the letters and testimony before the House Permanent Fund Committee with suggestions that the Permanent Fund be used for cultural events, art, and historic preservation.

Tax relief was another suggestion. No organized public groups appeared to actively push the social welfare objectives.

"Friedman recommended to the State that the general public would receive the greatest benefits through some kind of direct ownership shares or distribution."

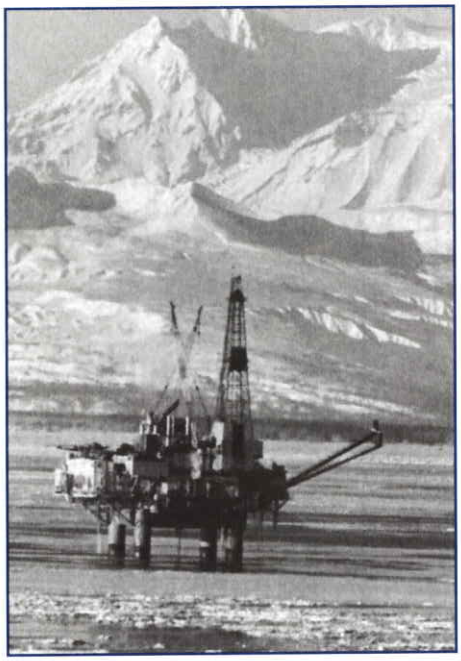
Fiscal or "Savings Account" Objective

Advocates of the fiscal objective or "savings account" in the mid 1970s foresaw the time 20-25 years in the future when oil revenues would decline. Proponents of this objective wanted to smooth out the income flow to the state. The banking community was among the first and strongest advocates of this objective. Other advocates wanted to limit the amount of money available for resource development or expanding government services. The Fund was envisioned as a "trust" similar to pension funds or government reserves. These types of funds are usually invested in lower risk securities with subsequently lower rates of return. The security of the principal is the foremost concern of trusts. At first, the fiscal objective was an element of the economic and social objectives proposed for the Fund but evolved into a singular objective: a "trust" which was a safe depository for the public's money.

At the conclusion of three years of debate and public hearings, the Legislature chose very clearly the "fiscal objective" as appropriate for the Permanent Fund. The Free Conference Committee Report on the Permanent Fund Management Bill SB 161 (May 4, 1979) said, " ... it is to be an inviolate trust which, in the words of this bill, conserves ... a portion of the state's revenues from mineral resources to benefit all generations of Alaskans ... "

However, in so choosing, the Legislature recognized concerns and needs that proponents of the other objectives were trying to accomplish by providing separate legislative solutions.

CURRENT VS. FUTURE NEEDS, ARGUMENTS AGAINST THE FISCAL OBJECTIVE



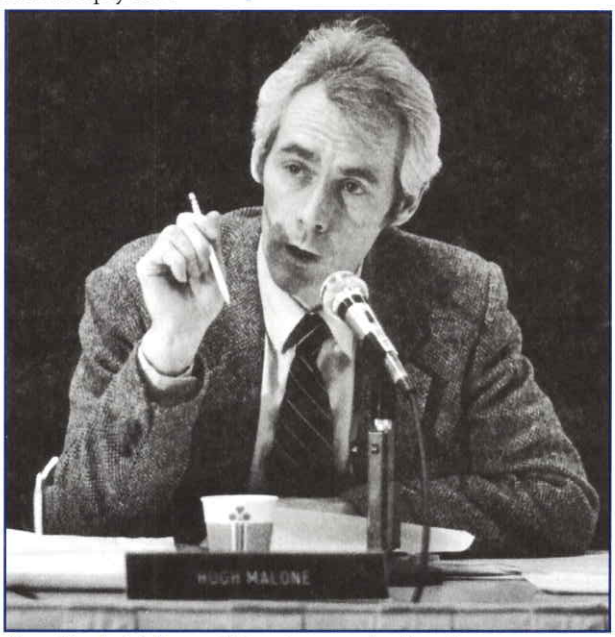
Oil production in Cook Inlet provided the first wave of petro dollars to the state.

A major argument against the fiscal objective was the overriding current needs of the people of Alaska, particularly rural people. Many argued that the State of Alaska had been granted lands to produce revenues for the development of infrastructure such as roads, sewers, and schools. The purpose of these grants were to "catch up" with other regions of the United States. Rural legislators supported this concept, as did rural people. Sen. Hohman from Bethel argued that a lasting economic structure should be developed with the Permanent Fund money instead of exporting the money out of the State. Hohman's comment about SB 161 which set up the Permanent Fund as it now exists was that it was "the charter for the Great Capital Exporting Company." The Dittman Poll showed a 2:1 margin of rural support for municipal bonding programs. In addition to rural people, some conservatives opposed the fiscal objectives. In a newspaper article, Libertarian Tom Fink clearly stated the conservative viewpoint that these revenues should be used immediately to pay off existing debts, develop infrastructure, and to reduce taxes.

Proponents of the fiscal objective countered these arguments with statements comparing the size of the Fund to general revenues and argued that other programs were available to fulfill those needs. For example, Rep. Hugh Malone, in arguing for the House version of the Permanent Fund, said, "The passage of the House Bill would not preclude aiding the state's economy in other ways as well. Loan programs, capital projects, tax repeals or refunds all these can be taken care of through the General Fund." One member noted that, "At least until the 1980's the Fund isn't going to be that great anyway so we're talking about using it for the time being as a savings account." Rep. Malone concluded the argument that the Permanent Fund should remain singular in orientation by stating:

"Although the voters made it clear in 1976 that they wanted a Permanent Fund which was permanent, expectations concerning the Fund's role were unrealistically high. People came to believe that the Fund could save oil money safely for the future, return benefits to Alaskans now, and diversify and expand the State's economy.

In reality, the amount of money being deposited into the Fund is simply not enough to provide all things for all people ... In short I'm opposed to using the Permanent Fund to fulfill those functions (loan programs) which properly belong to the General Fund."



Rep. Hugh Malone of Kenai wrote the first Permanent Fund bill that passed in 1975.

None of the proponents suggested that the Fund earnings not be used for fulfilling current needs once they were placed in the General Fund. There is however a very clear distinction made by the proponents of the fiscal objective between the earnings and the principal of the Fund. These are two distinct levels of funding. The principal monies generated by the Constitutional mandate, were expected to be $3 billion to $4 billion while the earnings were expected to be a small percentage of that figure.

The House Special Committee on the Permanent Fund provided three principles for financial goals for the Fund:

1) permanence of the principal is the primary purpose;
2) investments should be income producing at market rates of return; and
3) a portion should be used to benefit current Alaskans if investments are secure and income-producing.

In testimony before the Free Conference Committee on March 30, 1977, Rep. Clark Gruening again restated this distinction when he reiterated the five principles that the public hearing process had provided. Three of those principles are pertinent to this discussion:

"First, the Permanent Fund should serve as a safe depository for mineral revenues and not used for current expenditures; . . .

Third, where there are sound investments in Alaska the Permanent Fund should make them without duplicating financial services already available; and

Fourth, money earned by the Permanent Fund investments (the earnings or income) should be used for the benefit of current and future Alaskans; ..."

The House Committee recognized the immediate public desire for sufficient funds to encourage renewable resource and energy development, in their brochure "A Proposal for the Alaska Permanent Fund." Rep. Gruening stated in Kotzebue at the Permanent Fund Hearings that the Alaska Renewable Resources development program was an additional program in which 5 percent of mineral revenues were being allocated to address resource development capital needs.

CONSULTANT RECOMMENDATIONS

The consultants made several recommendations regarding the fiscal objectives for the Permanent Fund. The first recommendation was to split the trust portion of the Permanent Fund from the development bank. A trust fund and an economic development bank have distinct objectives and different measures of success.

Development banks were considered to be "direct, aggressive, and high risk" forms of government intervention. The second recommendation was to use financial indicators

"Although the voters made it clear in 1976 that they wanted a Permanent Fund which was permanent, expectations concerning the Fund's role were unrealistically high."

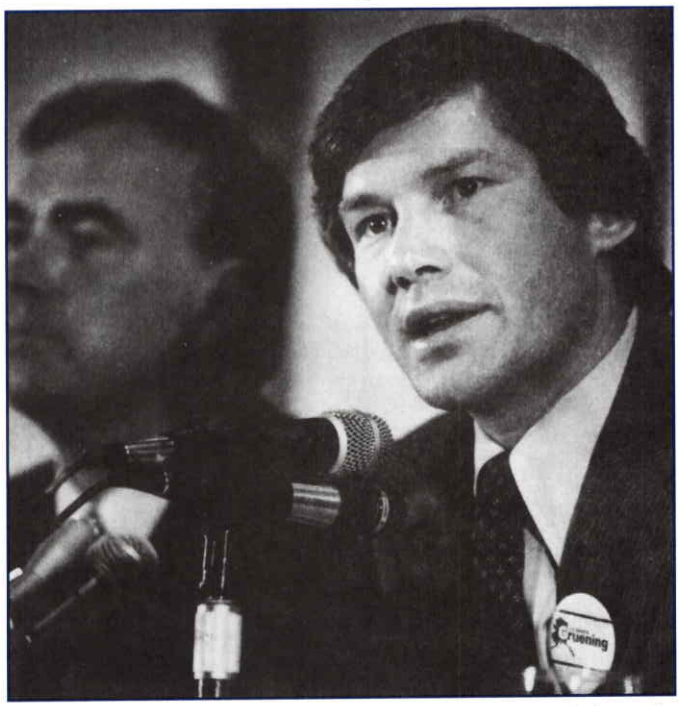
such as a national bond index or stock index to judge the Fund, as opposed to social measures. These measures would be nationally recognized indicators of rates of return for similar investment funds. The public and the Legislature, by using these measures, would have a clear understanding of the success or failure of the Permanent Fund managers. Finally, the consultants recommended the adoption of the "Prudent Investor Rule" which imposes diversity in types of investments and requires investments on a broad geographic base.

FISCAL ISSUES

As stated earlier, the fiscal objective was chosen by the Legislature and encapsulated in SB 161. Once the fiscal objective was decided upon, the Legislature considered these fiscal issues:

1) increases in the size of the Permanent Fund through additional appropriations;
2) the stability of the Fund; and
3) investment policy for the Fund.

The Amount of Money to be Placed in the Fund



Seeking to reconcile plans to make the Permanent Fund the cash cow for all state needs, the House appointed a special committee in 1977, chaired by Rep. Clark Gruening, to consider all Fund legislation.

The Constitutional amendment requires that at least 25 percent of mineral revenues, royalties, bonuses, etc. be contributed to the Permanent Fund. The amount of money to be placed in the Permanent Fund had been an issue when the Constitutional amendment was written. The proposals ranged historically from 10 percent to 100 percent of the various categories of revenues. Variation in the amounts proposed depended upon the use of the Fund being considered, upon the revenue projection for the State used, and philosophical concerns of the individual proponent.

Gov. Miller had originally proposed 50 percent of the non-tax mineral royalties and revenues. Gov. Hammond revised the figure downward to 10 percent and then upwards to 25 percent when more conservative estimates of total State revenues were made. He concluded that the 25 percent level would allow sufficient money for the General Fund and a sizable enough contribution to build the Permanent Fund. Later he again revised his suggestion increasing the contribution to 75 percent and proposed the inclusions of land sales.

Advocates of the economic development bank supported more generous contributions to the Permanent Fund. The Senate proposed a 100 percent contribution when advocating SB 1 which would have restructured loan programs and created essentially the development bank type of Permanent Fund. In 1977 the SIAC bill, HB 298, had a 50 percent contribution rate, 40 percent which would be dedicated to investment grade securities, 30 percent to private industry and small business loans, and 30 percent to community development. SIAC had considered a proposal to dedicate 100 percent of the funds but revised it downward when revenue projections indicated it would force the State into deficit spending. The House bill placed 30 percent of revenues excluding bonuses into the Permanent Fund. All bonus revenues were to be contributed to the Permanent Fund to reduce the motivation to sell leases to balance the budget. The House

bill also allocated 5 percent of the revenues to the Alaska Renewable Resources Corporation and 2 percent to the Alaska Native Fund until it was paid off.

In addition to the required revenue contributions to the Permanent Fund, the Legislature may also appropriate money to the Permanent Fund in excess of the 25 percent requirement. There was a $900 million dollar appropriation in 1980 (SCS CSHB 509) and a second $1.8 billion dollar appropriation in 1981 (FCCSB 1). The total appropriations, $2.7 billion, were deposited in increments, the last deposit being made in 1985 to complete the amount. These appropriations were not without controversy. Several Senators, Hohman from Bethel and Sumner from Anchorage, expressed serious concern that current needs such as employment and loan programs were not being given appropriate funding and consideration. (Note: The legislature also appropriated $1.24 billion from the Earnings Reserve Account in 1986.)

horage Daily News Saturday, July 23, 1983

Permanent fund board to study new investments

By STEVE SEPLOCHA
Daily News business editor

The Alaska Permanent Fund Corp. board of trustees Friday appointed a subcommittee to study whether, and how, the board might invest up to 10 percent of the $4.5 billion fund in income property over the next three years.

project. Another area being explored is a 50-50 joint venture program where the board would invest in established properties such as office buildings and shopping centers.

The board also agreed to begin a public information program to explain what the

At first, the Fund's investments were restricted to the most secure financial instruments.

The Stability of the Fund

How "permanent" was the Fund to be? Whether the Legislature could use the principal of the Fund created as a result of Constitutionally dedicated revenues and the additional $2.7 billion appropriated to the principal was a question many asked during the debate over the management structure of the Permanent Fund. Legal opinions on the subject have never been tested in the Alaska State Court System. In response to Rep. Clark Gruening's question on the implication of "permanent," the Legal Services Division of Legislative Affairs responded:

> There can be no legitimate question that the objective is preservation of that portion as capital for the long-term use of the state and its people and prevention of uses which are expedient in the short term but which would dissipate the capital of the Fund. The paramount consideration must be the probable safety of the capital of the Fund to be invested.
>
> The term "permanent" as used three times in the body of the amendment and in the title of the Fund would be read in the normal sense of that word since that reading is consistent with the context of the amendment, with the legislative and public discussion of the amendment, and with the understanding that the voters would be presumed to have in approving the amendment.

This opinion was restated in an internal memorandum to Billy Berrier from Joseph A. Guthrie, lawyers for the Legislature, in which a further conclusion was drawn that the term "at least" suggested that the Constitutional amendment foresaw additional deposits to Permanent Fund. The Legislature's legal advice was backed by the Administration's lawyers as well:

> Appropriations made to the Permanent Fund by law may not be withdrawn even though they are in excess of the amount required by the Constitution. Only the income of the Fund is available from the Fund. Of course, a standing appropriation could be repealed, and if so, no further money would go into the Fund from it.

The Department of Law made even stronger statements in a letter to Clark Gruening about the trust aspects of the Permanent Fund:

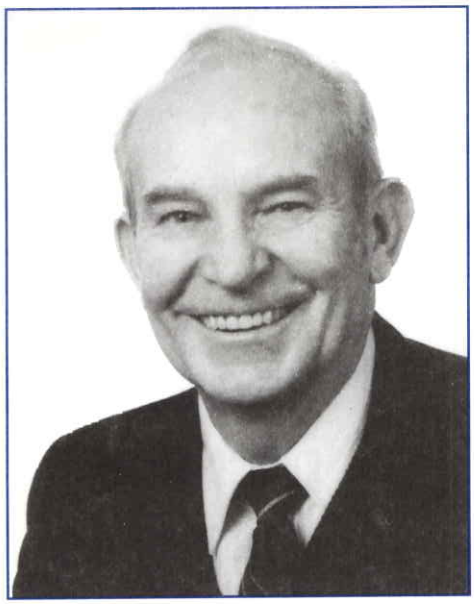
"There was a $900 million dollar appropriation in 1980...and a second $1.8 billion dollar appropriation in 1981..."

We are dealing with a peculiar – perhaps unique – quasi-trust. Unlike most trusts, the principal may not be reached whatever, either now or in the future. No one has a future right to the principal. Instead, the principal is to be invested in perpetuity to produce income. Only the income from investments may be reached. Absent still another Constitutional amendment, we see no way around this result. A Permanent Fund was intended, and a Permanent Fund appears to have been achieved. Accordingly, we doubt very much that any money appropriated to the Permanent Fund may subsequently – without a Constitutional amendment – be withdrawn.

The conclusion is that, unless the Courts decide that the Permanent Fund is not a trust, the principal will not be available for appropriation by the Legislature or for use by the Executive Branch unless a Constitutional change is enacted.

Inflation-Proofing

Concern about inflation was one of the first issues expressed in 1976 and continues to be an issue in 1985. Commissioner Motley of the Department of Commerce and Economic Development in a presentation to SIAC suggested that the Fund would be worth half its original amount in purchasing power by 1985 if some form of inflation-proofing were not enacted. The Division of Policy Development and Planning noted that a major issue arising during the summer of 1979 was inflation- proofing and that the governor should consider reinvestment of earnings in the Fund for inflation-proofing. The Trustees maintain that inflation-proofing was an original priority of the Permanent Fund – legislation which was unintentionally overlooked when the legislation was enacted. However, the authors have noted several instances where inflation-proofing was discussed by legislators, the advisory committee, and the executive branch and it seems unlikely that policy makers overlooked the issue when creating the management structure in 1980. Inflation-proofing became a serious concern of the Trustees in 1981. In 1982, Gov. Hammond proposed allocating an amount equal to 50 percent of net income to inflation-proof the Fund. The present method for calculating inflation-proofing was introduced as an amendment in 1982 to CSSSB 684 on the floor of the Senate.



Oral Freeman was one of the Fund's strongest supporters and served as chair of the Board of Trustees from 1986-89 and 1991-93.

Daniels stated inflation posed a real problem for funds invested in relatively safe savings account types of securities. He noted that between 1965 and 1975 small funds, while doubling nominal values, actually lost in real values. An example may help illustrate the potential effects of inflation: five percent inflation over 20 years can decrease the real purchasing power of a trust by two thirds (Montana Legislative Council 1984).

The Permanent Fund earnings did not exceed national inflation indices between the years 1978 and 1980. This erosion of the Fund's purchasing power could be even more serious if the inflation of government services such as infrastructure development is considered since inflation for these services is higher. The ability of the Permanent Fund during those years to provide earnings for the General Fund declined although inflation was offset by required additional deposits from mineral revenues.

Various legal opinions suggest that the Permanent Fund Trustees are required to consider and account for inflation-proofing in their investments because of the "trust" nature of the fund and because of the Prudent Investor Rule. The Legislature was not required to directly inflation-proof the Fund as is now done, but is constrained to allowing only "income-producing investments." The following are samples of the relevant opinions:

"The creation of the Permanent Fund did not legally obligate the Legislature to keep the income of the Fund abreast of inflation. There almost certainly is an implied obligation to manage as a prudent person, which means that reasonable efforts to make profitable investments with an eye towards inflation are probably a legal requirement."

A second opinion is presented below:

" ... the Alaska Supreme Court will treat the Permanent Fund as a trust or quasi-trust, and as a general rule, apply trust responsibilities in determining its administrators' duties.

"There can be no question that a trustee must take into consideration the trend of prices and the cost of living, the prospect of inflation or deflation. RESTATEMENT (SECOND) OF TRUSTS 2d 227, Comment e (1959). To do otherwise would hardly be the conduct of a man of prudence. Accordingly, the Fund managers will have to take inflation (or deflation) into account in making and changing investments, if – as we believe – the Fund constitutes a trust."

From left, Norman Gorsuch, Steve Cowper, George Rogers, Robert Heath and Byron Mallott discuss ways to protect the permanent fund from inflation

Fund panel moves to fight inflation

by Anette Taylor
Times Business Writer

The Alaska Permanent Fund Corporation Friday decided to use the Consumer Price Index as the indicator to make the permanent fund "inflation-proof."

The CPI will be used to determine how much money should be reinvested in the fund as a hedge against inflation.

Also Friday, the board elected Steve Cowper, a former state legislator and candidate for governor, as chairman. Trustee Arnold Espe was re-elected vice chairman. Executive director David Rose, was reappointed secretary-treasurer.

The inflation-proofing index, which was 6.1 percent as of December 1982, ultimately will affect the annual dividend paid each resident of the state because the amount is based on a percentage of what is available for distribution.

The permanent fund is made up of oil lease bonuses and other petroleum revenue as well as general fund appropriations. The fund totals more than $4.5 billion.

The principal cannot be spent, but investment earnings — currently estimated at about $1.25 million a day — are at the disposal of the legislature.

Ninety percent of the fund is invested in U.S. government bonds, bills and notes. The remaining money primarily is invested in Alaska housing mortgages and certificates of deposits with Alaskan banks.

The board adopted objectives regarding investments in real estate, including preservation, consistent long-term rate of return and potential for capital appreciation. A subcommittee was established to study how the board should spend money allocated for common stock investments.

In other action, the board directed Rose to suggest to state officials that money the state has promised the fund be offset by money the permanent fund owes the state.

The legislature appropriated $1.8 billion to the permanent fund and has paid all but $800 million. The permanent fund owes the state approximately $110 million in interest money for the general fund and an additional $110 million for dividends to state residents.

" The case has been strongly made for inflation-proofing as a significant policy, and in that regard, I have not seen any wavering on the part of the trustees." – Former Trustee Byron I. Mallott

Two alternatives to inflation-proofing exist.

1) Increasing the risk and theoretically the rates of return on investments; and

2) Placing some of the earnings back into the principal.

Daniels recommended a strategy of investing a small portion of the Fund in venture capital which has a higher risk. "Venture capital investment is a sound strategy for a small portion of the Alaska Permanent Fund. Such investments can fulfill the prudential obligations of the Fund while providing it with extremely high returns." The Legislature chose a combination of both strategies, expanding allowable investments and committing a part of the earnings to inflation-proofing in 1982. The statute reads:

> Sec. 37.13.145. DISPOSITION OF INCOME. At the end of each fiscal year, an amount sufficient to offset the effect of inflation on principal of the Alaska permanent fund during that year, as measured by a nationally recognized index, shall be transferred from net income as defined in AS 37.13.140, excluding income on the undistributed income account in the Alaska permanent fund, to the principal of the Alaska permanent fund for reinvestment.

Inflation-proofing, while protecting the future earning power of the Fund, limits the revenues available from the earnings for expenditure by returning sizable portions of the earnings to the principal of the Fund.

The Prudent Investor Rule

The Legislature has inserted the "Prudent Investor Rule" into the statutes concerning the management of all of Alaska's various retirement funds and the Permanent Fund. Since the 1800s this concept has been established by law, regulation and through court decisions. There is no single statement of specific actions directed by the Prudent Investor Rule but a process and application of fiscal management concepts is required. It is a rule commonly applied to people responsible for managing or investing someone else's money.

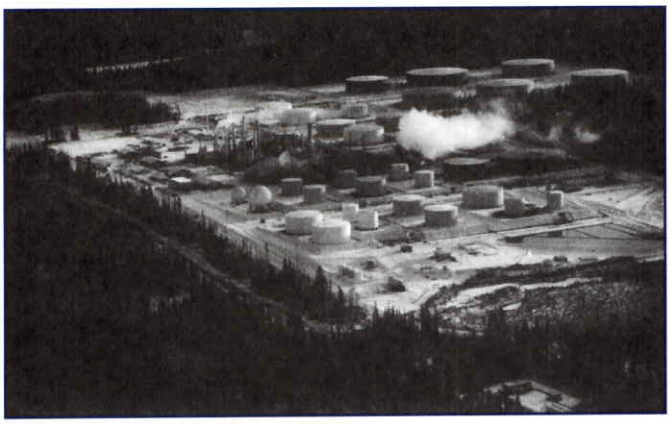
"The Permanent Fund earnings did not exceed national inflation indices between the years 1978 and 1980."

Many public funds, such as those in Wisconsin and Montana, apply the Prudent Investor Rule.

The Prudent Investor Rule was required by AS 37.13.120, the statute directing the management of the Permanent Fund. It reads:

> Sec. 37.13.120. INVESTMENT RESPONSIBILITIES OF THE BOARD.
> (a) The Prudent Investor Rule shall be applied by the board in the management and investment of Alaska Permanent Fund assets. The Prudent Investor Rule as applied to investments of the Corporation means that in making investments the board shall exercise the judgment an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it not in regard to speculation but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income.

This statute clearly states that the Trustees are to use the institutional or modern interpretation of the rule. Debevoise and Plimpton analyzed the implications of the Prudent Investor Rule for the management of the Permanent Fund for the Legislative Budget and Audit Committee. They concluded that the prudent investor's decisions should be judged on these criteria:



Discovery of oil in Cook Inlet led to construction of refineries in Kenai, like the Tesoro Refinery

1) The procedures of making the investment decisions. Was the decision based upon the best available knowledge at the time of the decision? Would that decision have been made by others of equal knowledge and responsibility? Is the decision process documented?
2) The "total" portfolio as opposed to individual investments. Does the investment significantly affect the risk components of the entire portfolio? The level of risk in individual investments is not as important as overall risk. This criteria recognizes the possibility that some investments may lose money; i.e. capital is always at risk.
3) Is the portfolio adequately diversified? Does that diversification include both type of investments and geography?
4) Liquidity – are the goals and cash flow needs of the eventual recipients of the trust being considered? This criterion may become more of an issue with the Permanent Fund if the earnings are used for programs of an ongoing nature.

Former Commissioner of Alaska Department of Revenue and Permanent Fund Trustee, Thomas K. Williams, in a series of memoranda to the Trustees, suggested that the statutory direction of the Permanent Fund raised diversification to a level equal to the requirement not to invest in imprudent, i.e., too risky, investments.

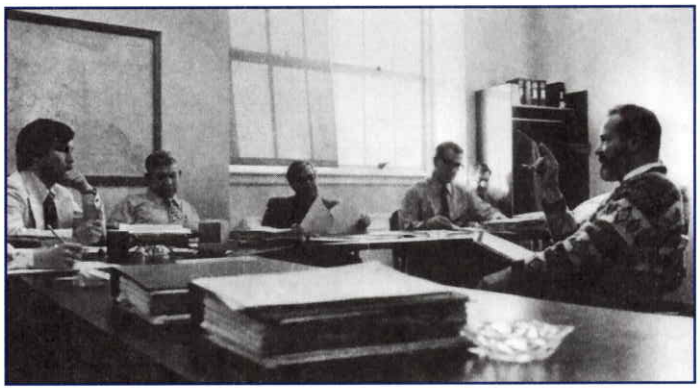
A final aspect of the Prudent Investor Rule is the neutrality of the investment decisions – social and political decisions are not to enter into the investment strategy. Debevoise & Plimpton are very clear on this point:

> The Prudent Investor Rule directly addresses the traditional financial questions confronting a trustee ... "Social investing" deals with a variety of practices and proposed practices which circumscribe or direct the investment manager's choice of investments. For example, some have suggested that it is appropriate

to instruct an investment manager not to invest in companies which operate in certain areas of the world, or manufacture certain products, or have adopted certain policies toward union organization, plant closings, or the like ...

These practices are sharp departures from the politically neutral paradigm of the investment process. They raise questions under both the duty of loyalty and the duty of prudence ...

Moreover, if the pursuit of social goals involves any sacrifice of current return (at equivalent levels of risk), then it will be undoubtedly argued that the trustees have violated both the rule of prudence and, in the case of the Alaska Funds, the specific language of the statutes (which requires maximization of income in the case of the Permanent Fund, for example).



Jay Hammond testified before members of the Senate Resources Committee in 1974, including Chairman John Sackett, Bob Palmer, John Rader and Lowell Thomas.

It appears that disinvestment of stocks of companies involved in business activities in South Africa as proposed in Senate Concurrent Resolution 14 (introduced in 1985) and in an *Anchorage Daily News* editorial last year would not comply with the Prudent Investor Rule. The Debevoise and Plimpton Memorandum suggested that investments which were of an equal return rate but would require extra administration, development, and monitoring would probably violate the Prudent Investor Rule as well. Maximization of financial returns and safety of principal are the only concerns the Trustees of the Permanent Fund are to address under the Prudent Investor Rule.

ORGANIZATION AND MANAGEMENT ISSUES

In developing the management structure of the Permanent Fund there was a considerable amount of concern about creating an entity without public controls. These issues centered around how control would be achieved, who would control the Fund, and how to provide adequate oversight without politicizing the Fund. The management issues represented critical differences between the Senate and House concepts of the Permanent Fund. SB 161 which became the bill setting up Permanent Fund Management reflects subsequent compromises.

Constitutional and Public Concerns

The delegates to Alaska's Constitutional Convention had opposed dedicated funds because their review had shown that such funds became unresponsive to changing needs. Many of the original delegates subsequently expressed concerns about the management structure and organization of the Permanent Fund at their 20-year reunion in Fairbanks. The Constitutional argument was that the Permanent Fund could establish a "fourth estate" which was outside the legislative process and would provide great powers to the executive. At the time these comments were made, the Permanent Fund was still being considered as a development bank administered by the Department of Revenue. Katherine Nordale, a delegate to the Constitutional Convention, expressed these concerns in a letter to the Permanent Fund Committee:

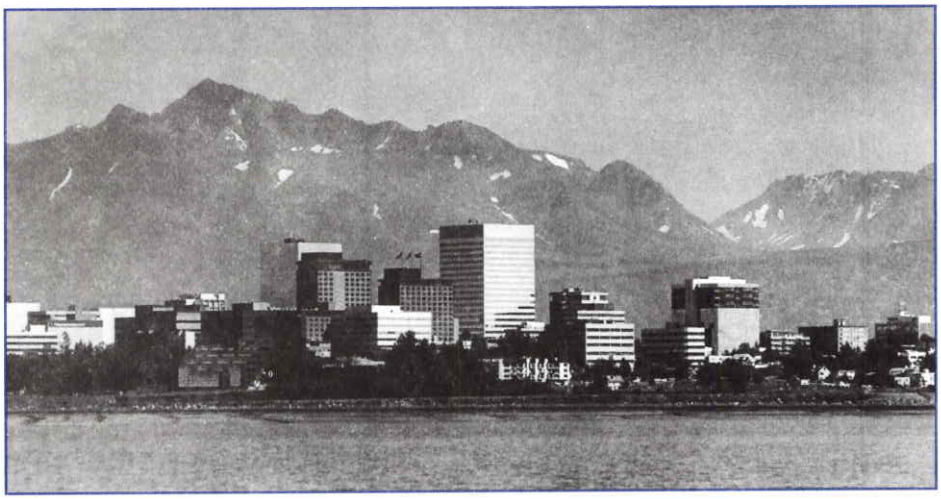
"Inflation-proofing...limits the revenues available from the earnings...by returning sizable portions... to the principal of the Fund."

"... present on that occasion (the 20 -year reunion) was John Bebout, who was a consultant at the Alaska Constitutional Convention.

" ... A provision in many state Constitutions permitting the dedication of funds, or not specifically prohibiting it, had proved disastrous. Hence, the Alaska delegates became convinced that our new state should not fall into that error. However, it has done so through amendment.

" ... I seized the opportunity in 1976 to ask John Bebout what he thought of the proposed Constitutional amendment establishing the Permanent Fund. He replied immediately, 'You are establishing a Fourth branch of government!' It was a shock. The more one ponders his comment, the more one realizes that he voiced a very serious problem facing Alaska. Great power attaches to the control of so large a sum of money. Unless it is managed very carefully and vigilant scrutiny is exercised every step of the way, the people of Alaska may reap little benefit, but millionaires may be created to the detriment of the general welfare of Alaska."

Newspaper editors echoed the Constitutional Delegates' concerns. For example, *The Anchorage Times*, in three separate editorials, discussed the possibility of the Permanent Fund being controlled by a group of men that would have influence beyond that of the State's governors, national companies, and banks. These editorials also expressed concern about the Fund's effect upon the economy of the State of Alaska. The extent to which this concern was felt can be deduced from the terms used in the editorials, news articles, and testimony such as: "Frankenstein in the state establishment," "henchmen," a "new class of men of great, quiet power" and "creating an economic and political monster." Likewise political candidates foresaw that whoever controlled the Permanent Fund, for example, the governor, would have great additional influence.



The Anchorage skyline sprouted office buildings at a dizzying pace in the early 1980s as businesses rushed to take advantage of the oil-fired boom.

Public Concerns

The public expressed a slightly different concern. They were more concerned with the "political use" of the Fund than they appeared to fear misuse of the Fund by the investment managers. Clark Gruening stated, "The day-to-day management of the Permanent Fund should be insulated from politics but the management should be accountable to the public in matters of policy and performance" as one of the five principals distilled from the public hearings. For example, Kenai participants in the Public Forum sessions on the Permanent Fund strongly recommended that the management be removed from the political arena. They also recommended that the Permanent Fund Board include some "financial wizards, some professionals, and also some just regular people like us." It is clear from such records that the public wanted to be involved in the policy-making aspects of the Permanent Fund.

Rural Concerns

Rural leaders were concerned that the Fund would be "wired into the bureaucracy" and were opposed to this idea. Reasoning that the Permanent Fund should be free of agency administration but answerable to the public, they recommended specific changes in HB 596 and found the Senate version of the fund more in concurrence with expressed needs. HB 596 was the management bill introduced into the Alaska State Legislature by the House Permanent Fund Committee. Native Corporation leaders wanted the Permanent Fund removed from the political spectrum as well. Rural and urban views did not appear to be significantly different on the desire to depoliticize the Permanent Fund.

Annual dividend checks provided vital cash income to many Alaskans seeking to live out their dreams of life on the Last Frontier.

Legislative Action

The House specifically addressed the issues of accountability to the public and to the Legislature in their proposed legislation. It recommended that accountability to the public be achieved through a board which would be appointed by the governor and confirmed by the Legislature (confirmation was latter dropped for Constitutional reasons). The House also included a requirement for "plain English" annual reporting of the Corporation's activities in the legislation. Legislative intent clearly was to involve the public in Permanent Fund oversight. Gov. Hammond was also very specific that his intentions in developing the dividend program from Permanent Fund earnings was a way of ensuring public involvement by means of a vested constituency for the Permanent Fund.

To whom the Permanent Fund would be required to report annual activities was an issue between the executive and legislative branches of government. Testimony by Speaker of the House Hugh Malone confirmed that the Legislature foresaw active oversight of the Permanent Fund Corporation through the budget review process by both the executive and the Legislature. These intentions were a result of consultants' recommendations which specifically noted that budget review and annual reporting requirements were two of the most effective ways that public enterprises could be held accountable. The annual reporting requirements were viewed as a preventive measure which would keep an agency on track with legislative intent while budget control was regarded as a punitive response. Daniels recommended both budget control and annual reporting requirements for effective public control.

When the Permanent Fund was being considered as a development bank or loan program by the Senate through SB 1, the Fund was to be placed in the Department of Revenue. When SB 1 was defeated, the Administration proposed, through amendment, executive branch oversight. Comments by individual members of the House Permanent Fund Committee were even more direct about the proposed amendments submitted by the Department of Revenue to HB 596. The Department of Revenue proposals would have placed the Fund under the control of the Commissioner of Revenue.

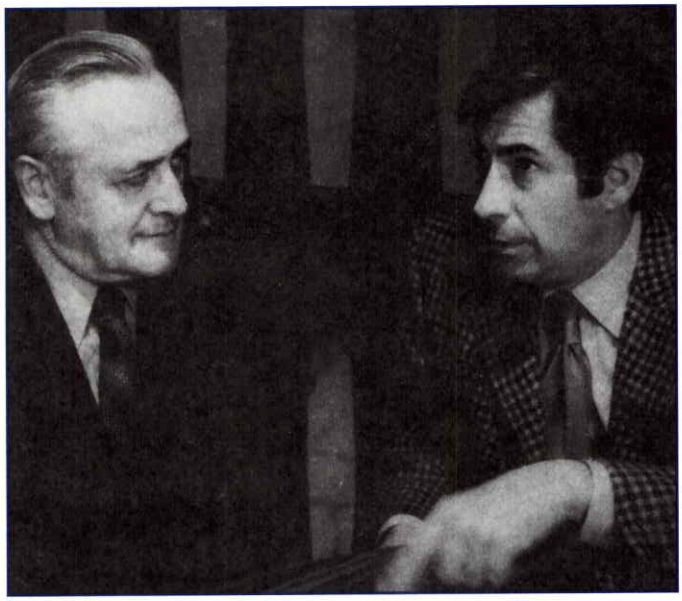
The committee decided to create management structures independent of the executive and legislative branches on the basis of public testimony and consultant advice. The public expressed repeatedly its preference for a Permanent Fund free from any taint of political pressures in its investment decisions. The committee's consultants gave similar advice, pointing to worldwide examples of investment funds that failed due to political pressure. To inject employees of the executive into the management of the Permanent Fund would be to fly in the face of both public wishes and sound management principles.

"The public wanted to be involved in the policy making aspects of the Permanent Fund."

The House and the Senate eventually compromised and the Permanent Fund was placed outside of the Department of Revenue. However, the Commissioner of Revenue is a Trustee, the Legislative Budget and Audit Committee retains oversight responsibilities, and an annual "plain English" report is required. The House clearly stated that if the Legislative Budget and Audit Committee did not provide adequate oversight, a special Permanent Fund Committee providing Legislative oversight should be set up.

Political neutrality of the Fund was achieved by the design of the management structure of the Permanent Fund with budgetary, policy, and investment decision responsibilities carefully delegated to a state Corporation separate from the executive and the legislative branches. The Free Conference Committee Report, May 4, 1979, summarizes the accountability and neutrality issues:

> It was the aim of the Committee to establish a management system for the Alaska Permanent Fund which would be protected from political influences but, at the same time, responsive to changes in State policy and accountable to the people through their elected officials. In short, the aim was insulation without isolation. It was agreed that the best way of achieving these ends was not to place the management within the Department of Revenue, but to create a public corporation distinct from State government.
>
> Accountability in policy and investments were achieved by providing a clear, legal list of allowable investments and budgetary review and oversight. The Fund does not receive any earnings to pay for its operating costs, unlike other similar funds, but must go through the executive budgetary process. These criteria were a direct result of the desire of the legislative body to maintain accountability.



Gov. Bill Egan and Sen. Mike Gravel looked out for Alaska's interests as the new oil age dawned.

Chapter Three: Fiscal Structure of the Permanent Fund

Several topics are considered in describing the fiscal structure of the Alaska Permanent Fund. They include historical state revenues and spending, management and investment strategies employed by the Alaska Permanent Fund Corporation (APFC) and distribution of Fund earnings.

HISTORICAL PERSPECTIVE
State Revenues

Prior to the Constitutional amendment that required deposits to the Permanent Fund, all mineral resource revenues were placed in the General Fund and were available for appropriation by the Legislature. Revenues related to petroleum production have represented a significant portion of Alaska's unrestricted revenues since Statehood. In FY 1959, the state received about 12 percent of unrestricted revenues from Federal revenue sharing rents and royalties from oil and gas leases. Revenues from bonuses and rents from state lease sales began in FY 1960. Oil and gas severance taxes and royalties from lease sales began contributing to revenues in FY 1962 and FY 1965 respectively. Petroleum-related revenues as a percentage of the General Fund unrestricted revenues fluctuated, but gener-

ally increased from FY 1959 through FY 1969. In FY 1970 the State received over $900 million in bonus payments from the 1969 Prudhoe Bay lease sale. In that fiscal year about 88 percent of the General Fund unrestricted revenues were from petroleum related revenues.

The contribution of petroleum revenues to unrestricted revenues peaked in FY 1980 at 90 percent and has since declined gradually to an estimated 84 percent in FY 1985. The declining contribution of petroleum revenues to total state revenues is expected to continue in the future. By FY 2000 petroleum related revenues are expected to represent about 70 percent of the General Fund unrestricted revenues.

Bidders on Alaska's early North Slope oil leases anticipated big returns. Competition among oil companies ran high.

State Spending

In a 1981 memorandum, Legislative Finance fiscal analyst Milt Barker summarized historical capital and operating budgets in both actual dollars and in values adjusted for Anchorage-based inflation rates over time. The memorandum reported that from FY 1961 to FY 1982 the total state budget, in nominal dollars, increased from about $46 million to over $3.6 billion. In terms of values adjusted for Anchorage inflation rates, there was a 70-percent increase in total budget from FY 1970 to FY 1971, but the greatest increase was experienced in FY 1981 (149 percent above the previous fiscal year). The Alaska Permanent Fund developed out of concern that benefits from the sale of Alaska's nonrenewable resources would not be available to future residents.

MANAGEMENT AND INVESTMENT OF THE PERMANENT FUND PRINCIPAL

Interim Management Under the Department of Revenue

Under HB 210 (Ch 6 SLA 1977), the Department of Revenue managed the Permanent Fund from March 1977 through April 1980. The legislation allowed investment in a very restricted list of government and corporate securities and the letter of intent that accompanied HB 210 expressly excluded investments in common stocks. In 1977, when assets of the Permanent Fund first became available for investment, the portfolio assembled by Department of Revenue managers consisted of short-, intermediate- and long-term debt securities. The national economy had entered a period of increasing inflation rates that greatly influenced the ability of investments to earn real returns. This phenomenon led many investors out of the long-term bond market and into shorter-term government securities. Given the inflation trends of the time, long-term investments no longer offered adequate returns. Short-term fixed-income securities had the flexibility to adjust to the unpredictable economic conditions. Under these circumstances, managers recognized that the fixed rate of return offered by the long-term bonds could have locked Permanent Fund assets into unprofitable investments. Maturities of less than four years were the goal in FY 1978 and by June 30, 1980 the average life of marketable securities was just over three years.

"From FY 1961 to FY 1982 the total state budget, in nominal dollars, increased from about $46 million to over $3.6 billion."

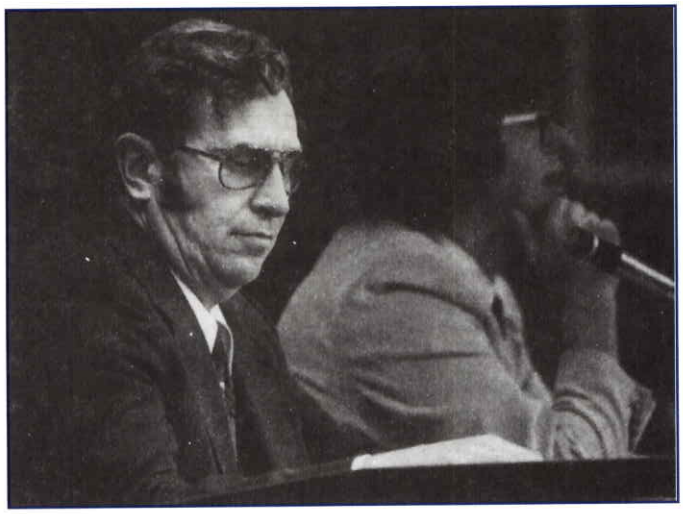
The 1980 Permanent Fund Legislation

Pursuant to AS 37.13.040, management of the assets, investments and earnings of the Alaska Permanent Fund were transferred from the interim authority of the Department of Revenue to the Alaska Permanent Fund Corporation effective April 1980. The Board of Trustees were given wide latitude on the organization of the Corporation and chose to make the gradual transition as the roles of the corporate staff and investment managers developed. Full control of all assets and investments was achieved with the transfer of the mortgage portfolio in April 1983.

Under the direction of the Board of Trustees and through guidelines set up by the statutes, the corporate staff is responsible for the management and investment of the Permanent Fund assets. As outlined in AS 37.13.020 (Sec 5 Ch 18 SLA 1980) the mission of the Corporation is to:

1) ... provide a means of conserving a portion of the State's revenues from mineral resources to benefit all generations of Alaskans;
2) ... maintain safety of principal while maximizing total return; and
3) ... be used as a savings device managed to allow the maximum use of disposable income from the Corporation for purposes designated by law.

AS 37.13.120 directed that the Prudent Investor Rule guide the investment decision of the Trustees. This section also mandated that investments be diversified and be made only in income-producing instruments. The original legislation allowed for a very limited diversity, however, because it permitted investments only in fixed-income or debt securities. One of the first resolutions passed by the Trustees in 1980 set a maximum four-year maturity on new investments. By the end of FY 1981, the inflation rate (CPI) was 13.52 percent and the average life of marketable securities was 13 months. Maturities on the Corporation's new investments in marketable securities were limited to three months or less.



Senate President Clem Tillion and Speaker of the House Terry Gardiner guided passage of the 1980 bill that created the Alaska Permanent Fund Corporation.

The 1982 Amendments

Although the 1980 Permanent Fund Act provides much of the basis for the current management scheme, the 1982 amendments resulted in major refinements. This legislation (Sec 5 Ch 81 SLA 1982) changed the makeup of the Board of Trustees, expanded the list of permitted investments, changed asset allocation guidelines, more clearly defined income and provided for inflation-proofing.

Permitted Investments

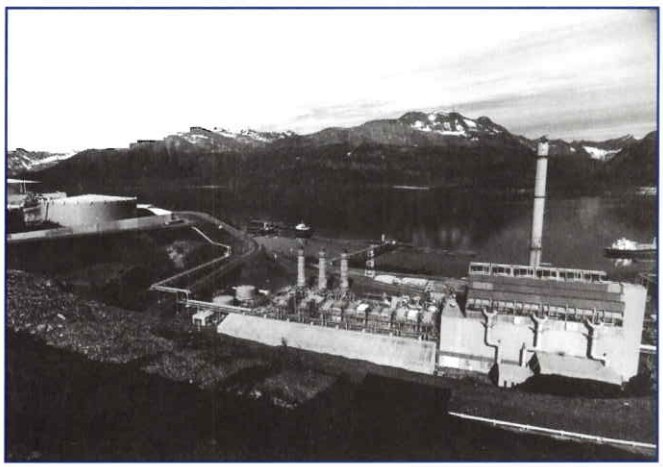
Concern about both long-term earnings and the diversification of the Fund assets resulted in additions to the list of permissible investments in 1982. This legislation gave the Corporation authority to invest in corporate stocks, notes secured by mortgages on commercial real estate, real estate equity and securities issued by foreign branches of U.S. banks denominated in dollars. These changes allowed the addition of equity-based investments (stocks and real estate) to a portfolio that had previously been invested only in fixed-income securities.

In testimony before the Trustees on March 20, 1981, George Russell Jr., of the financial consultants Frank Russell Company, Inc., made some interesting remarks about the

role of fixed-income securities in a portfolio. His testimony summarizes the opinion of many experts who supported the expansion of permitted investments to include equities. He told the Trustees that "(f)ixed-income management should not be viewed as being able to achieve long-term returns that are competitive with equities." Analysis of historical returns indicated that fixed-income securities did not perform against inflation as well as did equities.

The statute was also amended in 1982 to exclude unrealized gains and losses from the computation of net income. Changes in the value of investments would not affect the calculation of income available for distribution. This clarification was necessary to comply with Generally Accepted Accounting Principles (GAAP) which were adopted as a standard for the Corporation by the same amendment.

There were several pieces of legislation passed in 1986 which affected the Permanent Fund:



North Slope crude arrives at the Valdez Marine Terminal following a six-day journey down the trans-Alaska pipeline.

Ch 25 SLA 1986 (HB 28): This legislation appropriated the unexpended and unobligated balance of the undistributed income account to the principal of the Permanent Fund. The appropriation was contingent upon the passage of legislation that amended provisions relating to averaging income and the undistributed income account. Ch 28 SLA 1986, discussed below, provided for the necessary changes required in this legislation. $1.26 billion was transferred from the undistributed income account to the Fund principal on July 1, 1986.

Ch 28 SLA 1986 (SB 346): Amended AS 37.13.140. The method for calculating income available for distribution at the end of each fiscal year was changed from a five-year moving average of net income to 21 percent of the net income for the last five years. This is not a significant change because the previous method of taking the average resulted in income available for distribution equaling 20 percent of the net income for the last five years. This change was made to accommodate the requirements of Ch 25 SLA 1986 described above.

A second result of this bill, also to accommodate Ch 25 SLA 1986, was changing the name of the undistributed income to the earnings reserve account. The Trustees have used this name since 1984 (Resolution 84-12).

This bill also amended AS 37.13.145. The basis for inflation-proofing was changed from a "nationally recognized index" to the change in the calendar year average United States consumer price index for all urban consumers. This is also consistent with procedures approved by the Trustees in 1983 (Resolution 83-7).

Ch 83 SLA 1986 (SB 233): This legislation added obligations of the state or instrumentalities of the state rated at least "A" to the list of collateral that can be used to secure certificates of deposit. According to the Alaska Permanent Fund Corporation (APFC) Annual Report this legislation contributed to a 50 percent expansion of the in-state investment program.

Ch 53 SLA 1986 (HB 491): This legislation created the National Petroleum Reserve Alaska (NPRA) special revenue fund (AS 37.25.040.) The state share of federal mineral revenues from oil and gas development on the NPRA since December 12, 1980 will be deposited to this account (except that already spent through General Fund appropriations before June 9, 1984.) Under federal law this money was to be made available to communities impacted by NPRA oil and gas development. In the past, 50 percent of this revenue was deposited into the Permanent Fund as prescribed by AS 37.13.010. The other 50 percent was available for appropriation by the Legislature. Under HB 491 the revenues would

"Concern about both long-term earnings and the diversification of the Fund assets resulted in additions to the list of permissible investments in 1982."

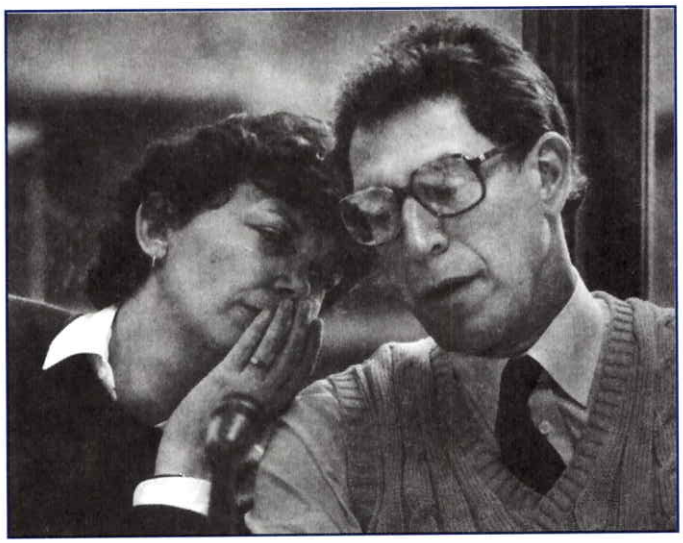
first be made available for appropriation to communities impacted by oil and gas development. At the end of each year, 50 percent of the funds in the NPRA revenue fund that had not been appropriated would be deposited into the Permanent Fund. All NPRA funds previously deposited into the Permanent Fund must be returned to the NPRA special revenue fund.

Target Rate of Return

As managers of a public trust, the Permanent Fund Trustees are directed to pursue a conservative investment strategy, one that does not subject the trust to unreasonable levels of risk. The Trustees must balance an acceptable level of risk with the necessity of earning a certain rate of return. In a resolution approved on March 30, 1983, the Trustees resolved to pursue "an investment policy which offers the highest possible investment yield commensurate with minimal risk." The Trustees have stated that they wish to manage the fund on a "risk-averse basis" with the objective of achieving a 3-percent real rate of return over time.

In 1982 Thomas K. Williams (then Commissioner of Revenue and a Trustee) discussed the Board's responsibility to determine a target rate of return and an acceptable level of risk. Williams used the following example to illustrate the importance of achieving a consistent rate of return:

> ... consistent performance gets one farther than variable performance having the same average level: for example, a consistent, four percent real rate of return over ten years equals (1.04) or 1.4802 times the original amount; in contrast, a performance of zero percent for five years and eight percent the other five equals (1.00) 5 or 1.4693 times the original amount. The simple element of consistency adds an extra 2.32 percent (0.4802 divided by 0.4593 equals 1.0232) in this example.



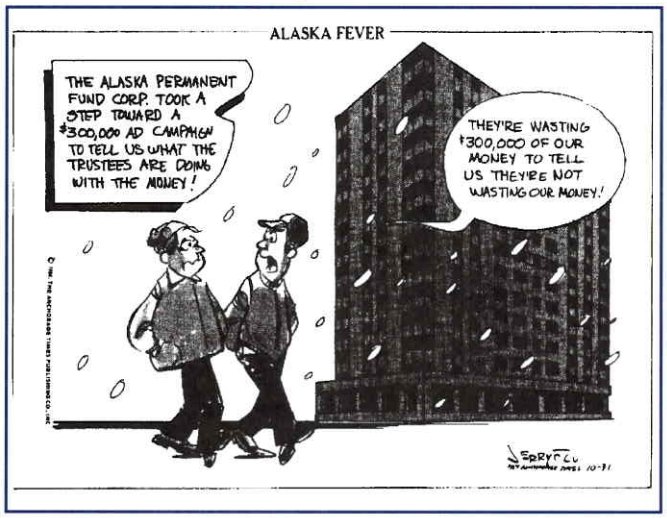
Susan Burke advised attorney Avrum Gross at a Senate State Affairs Committee meeting in 1985. As Attorney General, he argued the state's case on the Permanent Fund Dividend case in the U.S. Supreme Court.

In addition to the possibility of long-run returns being adversely affected, variable return rates are also undesirable for other reasons. Income available for distribution to the Dividend Fund is based on the five-year average earnings of the Fund. As earnings fluctuate so does the amount of dividends. Also, variable earnings could cause either large deposits to the Earnings Reserve Account in years of high earnings and withdrawals from this account in low income years. The ERA can be used to supplement annual earnings to pay dividends and inflation-proofing.

Williams noted that although the Trustees may want to set a low target rate of return to address the variability issue, the rate should not be set so low that it could easily be exceeded. Management would then appear too successful when, in fact, their target rate was too easily achievable. On July 22, 1983, the Trustees set a 3-percent target rate of return for Permanent Fund investments. (Note: In 1996 the Trustees increased the target to 4 percent.)

The 1982 amendments did not alter the original language in AS 37.13.120 which described the investment responsibilities of the Board of Trustees. Subsection (c) still mandated that "(t)he board shall maintain a reasonable diversification among investments unless under the circumstances it is clearly prudent not to do so." Risk, which is most often defined as variability or volatility in the rate of return over time, can be reduced by

diversification. There are two ways this technique can be applied to reduce the risk levels of a portfolio; diversification among markets and diversification within markets. Diversification among markets is achieved by the Permanent Fund Corporation through the allocation of assets between different types of investments. Appointing equity managers (stock investors) with different investment styles and expertise is an example of how the Corporation diversifies within markets.



EARNINGS FROM INVESTMENT OF THE PERMANENT FUND

Two bills passed during the 1980 legislative session organized the Alaska Permanent Fund Corporation and provided for the distribution of some of the Fund earnings. Free Conference Committee Substitute for SB 161 (Sec 5 Ch 18 SLA 1980), which created the Alaska Permanent Fund Corporation, was primarily concerned with directing management of the principal. The Free Conference Committee Report accompanying this legislation left "the separate question of how to use the Fund earnings to separate legislation." However, the bill did more clearly define both annual income from investment of the Fund principal and the amount of earnings that could be distributed. Income was defined as "the annual interest of the Corporation," which is obviously intended to mean the annual interest earnings from investment of Permanent Fund assets. Since all previous interest earnings had been transferred to the General Fund, annual interest of the Corporation was earned through investment of the Fund principal only. The 1980 version of AS 37.13.140 distinguished annual income from income available for disbursement by defining it as the lesser of "the latest fiscal years' income or the average annual current income for the past five fiscal years ..." In other words, as long as the current year's income was greater than the previous year's income, distributable earnings would be an average of the annual income for the last five fiscal years. Prior to this, all interest income for the current fiscal year was considered available for distribution and was deposited in the General Fund.

The General Fund

Legislation passed in 1980 resulted in a new income distribution scheme. By distinguishing between annual income and income available for distribution, the Legislature provided for a portion of annual earnings to be divided between the General Fund and the newly created Dividend Fund. Because annual income has been greater than income distributed, the 1980 Permanent Fund legislation also created retained earnings account which was later designated the Undistributed Income Account.

The General Fund continued to receive a portion of earnings under the Constitution clause until subsequent legislation (SB 684) provided for the distribution of all Permanent Fund income. The Constitution requires that income available for distribution which had not been appropriated by the Legislature be deposited in the General Fund. The final deposit to the General Fund was made in fiscal year 1983 under Ch 81 SLA 1982.

"As managers of a public trust, the Permanent Fund Trustees are directed to pursue a conservative investment strategy."

The Dividend Fund

Within a week of the passage of legislation that created the Permanent Fund Corporation, Free Conference Committee Substitute for SB 122 (Sec 1 Ch 21 SLA 1980) was signed by the governor. This legislation provided for the distribution of some of the Fund earnings through the Permanent Fund Dividend Program. Although repealed and reenacted in 1982, this act directed the distribution of Permanent Fund income for fiscal years 1981 and 1982. The Dividend Fund, which was a separate fund in the state Treasury, was established to pay Permanent Fund dividends. The amount transferred to the Dividend Fund from the Permanent Fund is 50 percent of the income available for distribution which is deducted from annual earnings of the current fiscal year. In the absence of any language to the contrary, the statute has been interpreted to allow payment to the Dividend Fund from net income of both the principal and the Earnings Reserve Account.

The 1980 legislation only provided for the use of half of the annual income. The remaining half of income available for distribution was deposited in the General Fund per the Constitution. The 1982 amendments resulted in AS 43.23.050(b) directing that "... 50 percent of the income of the Alaska permanent fund earned during the fiscal year ending on June 30 of the current year and available for distribution" be transferred to the Dividend Fund. The Dividend Fund has received one half of distributable income since FY 1980. The Department of Law has advised that interest earned on the Dividend Fund once it was transferred to the Department of Revenue should be returned to the General Fund rather than be added to the Dividend Fund.

Transfers of Permanent Fund earnings to the Dividend Fund have been made by legislative appropriation. Several times the Department of Law has provided opinions on whether the transfer of Permanent Fund earnings without appropriation would violate that Constitutional prohibition of dedicated funds. Attorney General Norman Gorsuch advised that, although a transfer without appropriation could be defended, it had not been tested in court. The Dividend Fund and reinvestment of earnings were both specifically mentioned in the Joint Chairman's report that accompanied CSSS HJR 39 (proposing Constitutional amendment). The Attorney General advised that transfers to the Dividend Fund be done by appropriation and that AS 43.23.045 (which discusses the transfer) be clarified. Gorsuch stated that "the interpretation ... which I find to be most reasonable and compatible with the Constitutional prohibition against dedications is that the Legislature may provide by law for the income to remain in the permanent fund (either through reinvestment as principal or retention in an Undistributed Income Account) without appropriation, but may not transfer income to another fund or authorize it to be spent without an appropriation."

1996 Fund Trustees Wilson Condon, left, and Clark Gruening both played major roles during the 1980s that shaped the Fund's policy.

The Undistributed Income Account (Earnings Reserve Account)

Under the 1980 legislation, a portion of income available for distribution (as determined by the five-year moving average) was transferred to the Dividend Fund and the General Fund. The balance of annual earnings was held in a retained earnings account which, although part of the Permanent Fund, was distinct from the principal. This distribution scheme was followed until the 1982 amendments were enacted. Although created by the 1980 legislation, this retained earnings was not officially addressed until the 1982 amendments redefined income and referred to the "undistributed income account in the Permanent Fund." (It was renamed the Earnings Reserve Account in 1986.)

The 1982 Amendments

Distribution of the Permanent Fund earnings were further directed by the 1982 amendments to the Permanent Fund legislation. The passage of the final version of SB 684 (Ch 81 SLA 1982) repealed and re-enacted AS 37.13.140 defining income, and added section 37.13.145 which provided for the distribution of income. The text of these sections is reproduced below:

Rose cautious about fund's future

by John Knowlton
Times Business Writer

The $6.6 billion Alaska Permanent Fund is one of the largest, fastest-growing funds in the nation and the board that manages it has achieved the goals set out when the savings account was established in 1976, a fund spokesman said Monday.

But David Rose, executive director of the Alaska Permanent Fund Corp., cautioned that the fund may not be large enough to cover revenue shortfalls expected in the 1990s when the Prudhoe Bay revenues decline.

"We have been reasonably successful in meeting those early goals and aspirations and we have been reasonably successful in creating a long-term, long-lasting institution," Rose told the Anchorage Chamber of Commerce.

But he emphasized that "it is an early success — a beginning — there is still a long road to travel. And that road has many perils."

The permanent fund was established in 1976 when voters overwhelmingly approved a constitutional amendment which set aside 25 percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue-sharing payments and bonuses. The legislature increased the dedication to 50 percent for all oil fields discovered after 1979.

The fund now is the largest income producer in the state, aside from the petroleum industry, and by 1987 will produce more income for the state than it will receive from oil revenues.

"The citizens of our state have, in effect, created a new industry — one

See Fund, page C-5

Fund trustees OK office buy

by Larry Persily
Times Juneau Bureau

Juneau — Alaska Permanent Fund Corp. trustees have approved an $11 million commitment to finance an office building in Wichita, Kan.

Meeting in Juneau late last week, trustees approved a participating mortgage commitment for the Wichita project, said Jim Kelly, research and liaison officer for the permanent fund.

Total financing for the building is expected to be about $27 million, with the Alaska Permanent Fund

See Office, page C-5

Dave Rose served as the first executive director of the Alaska Permanent Fund Corporation.

> Sec. 37.13.140. Income. Net income of the Corporation must be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses. Income available for distribution equals the average net income of the Corporation for the last five fiscal years, including the fiscal year just ended, but may not exceed net income of the Corporation for the fiscal year just ended plus the balance in the undistributed income account described in AS 37.13.145.
>
> Sec. 37.13.145. Disposition of income. At the end of each fiscal year, an amount sufficient to offset the effect of inflation on principal of the Alaska permanent fund during that year, as measured by a nationally recognized index, shall be transferred from net income as defined in AS 37.13.140, excluding income on the undistributed income account in the Alaska permanent fund, to the principal of the Alaska permanent fund for reinvestment. The balance of the net income as defined in AS 37.13.140 shall be transferred to the undistributed income account in the Alaska permanent fund. Money in the undistributed income account shall be invested in investments authorized under AS 37.13.120. Income from the investment of the undistributed income account shall be treated as an addition to that account.

The major effects of the 1982 legislation can be summarized as follows:

1) Net income of the Corporation includes earnings on investment of both the principal and the UIA.

2) The portion of net income from investment of the principal that can be distributed is equal to the lesser of average income of the Corporation (principal plus UIA) for the past five years OR current income of the Corporation plus the balance of the UIA. This protects the Permanent Fund Corporation from having to distribute excessive earnings during years of declining returns.

3) Provided for a portion of net income from investment of the principal to be reinvested for inflation-proofing. Income from investment of the UIA cannot be used for inflation-proofing.

4) Balance of net income from investment of principal that is not distributed is transferred to the UIA.

5) UIA is invested under the same guidelines as the principal, with earnings on investment returned to that account.

Prior to these amendments the annual income of the Corporation had been divided between the Dividend Fund and the General Fund. The new legislation took advantage of the Constitutional clause that allowed the Legislature to provide for the disposition of income.

"The Dividend Fund has received one half of distributable income since FY 1980."

Different interpretations of the legislative intent regarding the disposition of the Undistributed Income Account have become an issue of increasing importance. This account was created by the 1980 Permanent Fund Act but was not specifically addressed in the legislation or the letter of intent. The 1982 amendments defined deposits to the Undistributed Income Account and directed that it would be invested in the same manner as the principal. Further definition of legislative intent, such as a letter of intent defining the purpose and use of this account, was not a part of the legislation. However, in a transmittal letter that accompanied Sponsor Substitute for SB 684, Gov. Jay Hammond stated that "(m)oney in the undistributed income account will be invested by the Corporation until it is transferred to the dividend fund or appropriated by the legislature."

In the absence of clear legislative direction, the Trustees have stated their interpretation of legislative intent with regard to this account. In a resolution approved on September 21, 1984, the Trustees designated the Undistributed Income Account "as a reserve to offset the future impact of inflation on the principal of the Permanent Fund and for the future payment of dividends." In this resolution, the Trustees stated that the Legislature had defined the Undistributed Income Account "as a reserve to insure a stable source of income from which dividend payments and other distributions appropriated by the Legislature can be made." The Permanent Fund Corporation looks to this account to provide funds necessary to make up any future shortfalls in dividend or inflation-proofing. The Legislature has, to the authors' knowledge, never explicitly defined the Undistributed Income Account as a reserve account. Possibly what the Trustees are referring to is a statement in the Joint Committee Report on SB 161 which stated that "the amount of income available for disbursement will be determined on an averaging basis; this insures a relatively steady income flow." In the resolution defining the UIA, the Trustees do confirm that the undistributed income is available for appropriation by the Legislature.

Affirmations of this can be also be found in Trustee meeting minutes and in various corporate memorandums. All legislation, from the Constitution to the statutory guidelines, as well as the resolutions of the Permanent Fund Trustees, have asserted that the use of the Fund income is for the Legislature to decide. The Undistributed Income Account is accumulated income and therefore is available for appropriation.

House hopes to lock up $400 million in fund

by Bruce Scandling
Associated Press

Juneau — House lawmakers sent a measure to the Senate Friday that would shift $400 million into the Alaska Permanent Fund and "remove the temptation" to spend it on construction projects.

The measure — originally introduced by Juneau Democrat Jim Duncan — would take $400 million from the so-called undistributed income account and deposit it into the principal of the fund.

By law, the legislature cannot spend money that has been dedicated to the principal of the permanent fund.

Under Duncan's bill, another $331 million would remain in the undistributed income account as a hedge against the future effects of inflation on the permanent fund.

The $400 million deposit would increase the principal of the fund to $6.8 billion.

The undistributed income account is comprised of yearly

"sends a signal" to Alaskans that lawmakers are concerned enough about the future to put away as much money as possible before oil production starts a steady decline projected to begin in the early 1990s.

He said it is tempting for lawmakers — especially in a year of budget-cutting — to look toward the undistributed income to help pay for projects around the state.

"What we are doing is removing that temptation," Duncan said. "I think we have to get the message across that we don't have the ability we did three or four years ago (to pay for projects)."

Anchorage Republican Walt Furnace voted for the measure, but questioned whether saving money now is necessarily the best state policy.

"A dollar today is worth more than it is worth tomorrow," Furnace said.

He said many Alaska communities still need basic facilities like roads, sewers, docks and harbors — and suggested it might be best to pay for those projects now.

The measure — which prompted speeches by a dozen House lawmakers — was altered by one significant amendment.

House Majority Leader Don Clocksin, D-Anchorage, drafted an amendment changing the title of the bill to include the $400 million figure.

That means Senate lawmakers, in their consideration of the proposal, would have to draft an entirely new bill to increase or reduce the deposit to the permanent fund.

Legislators hotly debated whether "undistributed" income should be used for state projects or deposited in the Fund's principal.

Inflation-Proofing the Fund

The Legislature, through the 1982 amendments, provided for reinvestment of income to help maintain the principal's earning capabilities. The legislation required that a nationally recognized index of inflation be used to determine the amount reinvested. The Trustees were responsible for determining how to inflation-proof the Fund.

In deciding which nationally recognized index of inflation to use, the choice was narrowed to the Consumer Price Index for all Urban Consumers (CPI) or the Gross National Product Implicit Price Deflator (GNP Deflator). In recommending the CPI to the Trustees, Dave Rose defined and differentiated between the two indexes. The CPI measures the price change in a specific group of consumer goods with respect to a base year. Among the advantages cited by Rose were that the CPI is the most accurate measure of price changes and is widely recognized as a measure of inflation. Rose also listed several disadvantages of this measure. It assumes that consumption patterns are constant, it treats

housing as an annual consumption good and it overrates luxuries and underrates necessities.

The GNP Deflator measures changes in prices, as does the CPI, but it also considers changes in the national output. The CPI deals with consumers only but the GNP Deflator includes consumers, businesses and government output. Rose stated that, although the GNP Deflator was a more "comprehensive measure of trends in the national economy," it had several disadvantages. In combining changes in prices with changes in output, this measure underestimates price changes. Also, the public is much more aware of the CPI as a measure of inflation. Thomas K. Williams, however, recommended that the GNP Deflator be adopted by the Trustees as the index of inflation. He believed that the CPI was not an appropriate measure of impact of inflation on the Fund. "The Permanent Fund is not a consumer exposed to inflation, it is an investor exposed to inflation. An index designed to measure the effects on consumers' buying power is not necessarily one that fits the situation of the Permanent Fund."

Sen. George Hohman (second on the right) fought hard to use the Permanent Fund as an economic stimulator.

On July 22, 1983 the Trustees adopted the calendar year average CPI for all urban consumers as the index with which to measure the impact of inflation on the Fund. As stated in this resolution, their goals were to accurately measure the impact of inflation on the Fund and to choose a representative measure of inflation. The choice of which index to use is important because it is the primary factor in determining both the amount reinvested in the principal and the real rate of return. The calendar year average CPI is an index measuring the average change in prices from January through December of the previous calendar year. Apparently the Trustees chose to use the calendar year average because information on the inflation rate being used was required during the legislative session.

There are several effects of using the calendar year average CPI. In both the inflation-proofing amount and the real rate of return, one factor (CPI) is based on calendar year numbers, and the second factor (either the principal balance or the nominal rate of return) is based on fiscal year numbers. The current measure of inflation lags six months behind the other two factors. If inflation is increasing, then the calendar year CPI will be less than the fiscal year CPI, resulting in insufficient deposits to the principal. If, on the other hand, inflation is decreasing (calendar year CPI is greater than fiscal year CPI), the amount reinvested in the principal will be more than would have been necessary. The real rate of return, the difference between the nominal return and the inflation rate, is supposed to reflect the earnings rate without the effect of inflation. Under the current procedure, if the calendar year CPI is less than fiscal year CPI then the real rate of return published by the APFC is higher than if using the fiscal year CPI for calculations. Thus, subtracting the calendar year inflation rate from the fiscal year nominal return rate does not accurately determine the real rate of return.

"The Trustees were responsible for determining how to inflation-proof the Fund."

Table 4 compares the fiscal year CPI with the prior calendar year to illustrate the results of the current procedure. Values for FY 1978 through FY 1985 include both years when the calendar year CPI is larger and vice versa.

Table 4. Fiscal and Prior Calendar Year CPI and the Results of the Procedure on Real Rate of Return and Inflation-Proofing Amounts.

Fiscal Year	Fiscal Year CPI	Prior Calendar Year CPI	Result of Using Real Rate of Return	Calendar Year Inflation Proof Amount
1978	6.72 %	6.49%	higher	lower
1979	9.39	7.65	higher	lower
1980	13.31	11.27	higher	lower
1981	11.56	13.51	lower	higher
1982	8.67	10.35	lower	higher
1983	4.30	6.10	lower	higher
1984	3.69	3.22	higher	lower
1985	3.89	4.26	lower	higher

The calendar year CPI is the index actually used by the APFC to calculate inflation-proofing amounts and real return rates for the corresponding fiscal year. Table 4 illustrates that the most serious impact of using the calendar year CPI would be during periods of rapidly increasing inflation rates (FY 1978-80) because the six month lag period would prevent the timely reinvestment of earnings. The information presented in Table 4 is for comparison purposes only, there are many other factors in the procedures used to determine return rates and inflation-proofing amounts which will influence the respective values. The intent of this discussion is not to estimate the precise amount of money involved in the different procedures but, rather, to point out that it is philosophically more correct to use the fiscal year CPI in calculating the impact of inflation on other fiscal year based values.

Once the CPI was chosen as an index, the next issue facing the Trustees was identification of which Fund balance should be inflation-proofed. The debate centered around using the average principal balance throughout the year or the balance at the end of the fiscal year. The Trustees chose to define the end-of-the-year balance as the "principal balance" for the purpose of inflation-proofing. In reviewing this resolution, Assistant Attorney General Laura L. Davis commented on the use of the end-of-the-year principal balance. "As long as the principal is growing, it may overcompensate somewhat for the effect of inflation on the principal during the year ... (a) more precise figure could be obtained by using an average monthly principal balance or using a sum of monthly computations." In support of the Trustees' action, Davis stated that inflation-proofing based on the end-of-the-year principal balance met the requirements of the law. The Trustees were not required to "minimize" the amount reinvested for inflation-proofing. Because the Fund's principal balance is increasing each year, the end-of-the-year balance has always been greater than the average balance. Applying the CPI to the end-of-the-year principal balance has resulted in the maximum reinvested for inflation-proofing.

Chapter Four: Conclusions

The Alaska Department of Revenue projects that earnings from investment of the Permanent Fund will exceed General Fund unrestricted revenues within ten years. Permanent Fund earnings continue to increase at a modest but steady rate, thus it is the

declining General Fund revenues that will be most influential in reversing this relationship. Changes in the policy concerning the Permanent Fund will surely be debated as the State seeks solutions to revenue shortfalls. In evaluating future policy changes, it is important to consider the principles by which the Permanent Fund was established and the role that these principals have had in the successful achievement of Fund objectives.

In creating the Permanent Fund Corporation, the Legislature set forth the following objectives:

1) to provide a savings account for all generations;
2) to protect the principal of the fund while maximizing returns; and
3) to conserve mineral revenue wealth and produce disposable income the purpose of which would be designated by law.

The Permanent Fund principal represents the successful creation of a savings account. The principal is made up of dedicated mineral resource revenues, special appropriations, citizens' contributions, and reinvestment of earnings to protect against inflation. The objectives of safeguarding principal, maximizing returns and providing disposable income have been commendably accomplished by the Trustees and the Corporation staff.

Evidence that oil wealth was fueling an expansion of state government came in the 1974 completion of the new State Office Building.

The Permanent Fund organization and management structure was the result of thorough policy debates. A wide range of participants were involved in this policy discussion from the general public to internationally recognized economists and planners. It is important to consider the guidelines and directions that evolved from these debates because they can be directly linked to the success of the Permanent Fund.

The law mandates the use of the Prudent Investor Rule for an institutional or expert investor to guide management decisions. Within that context, the Trustees are given great flexibility regarding asset allocation when developing investment strategies. These two guidelines clearly state the Legislature's definition of purpose and general direction for the Fund: protection of principal and management by a discrete non-political body. Closely tied to these issues is the Permanent Fund Corporation's accountability to the legislature and to the public. Two other important policy guidelines include the requirement that investments produce income and reinvestment of earnings to offset the impact of inflation on the Fund. The importance of these particular issues and their relevance to future policy decisions are discussed below.

The Prudent Investor Rule

AS 37.13.120(a) requires that the Prudent Investor Rule guide the management of the Permanent Fund. The Prudent Investor Rule clearly places the fiduciary responsibilities for investment policy upon the Trustees. It requires that the process of investment decisions be documented and that certain criteria be considered before investment decisions are made. A body of information and legal opinion exists by which the actions of the Trustees can be judged. Inclusion of the Prudent Investor Rule ensures that the Permanent Fund principle will be protected and wisely invested. Under the Prudent Investor Rule, the Trustees and staff can consider only financial returns and safety of the principal when making investments.

Other states, Montana, for example, have cited the use of the Prudent Investor Rule by Alaska as a model to follow in changing their statutory investment requirements. The funds examined which have social requirements have not achieved a return on invest-

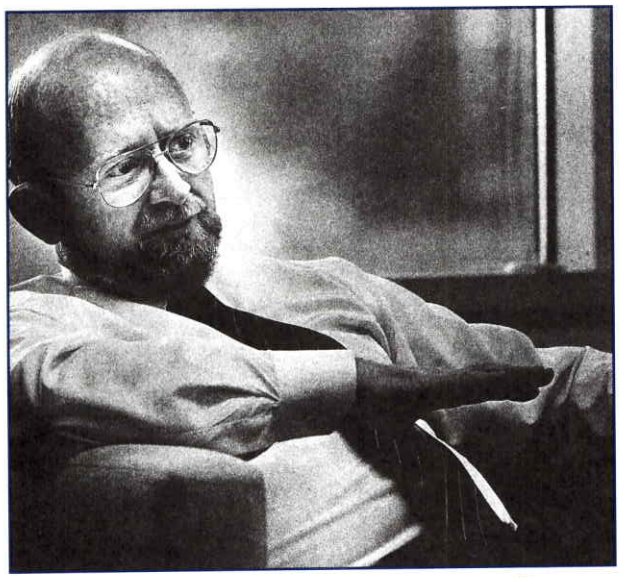
"The Permanent Fund organization and management structure was the result of thorough policy debates."

ments comparable to that of the Alaska Permanent Fund. Abandoning the Prudent Investor Rule to allow for social investment (such as dis-investment in South Africa) may have far greater consequences than that immediate action. The guidelines developed under the Prudent Investor Rule have withstood the test of time and have resulted in safe and profitable management of trust funds the Alaska Permanent Fund should continue to operate under these guidelines.

Flexibility in Management Decisions

The Alaska Permanent Fund list of allowable investments is somewhat less restrictive than most State retirement funds and substantially more conservative than many private corporate pension funds. The Trustees have chosen a very conservative investment strategy. Other funds, with different asset allocation schemes, may seem to achieve higher. returns, but volatility of return must also be considered. Policy makers should be aware that higher rates of return engender higher risk and over a time period may not result in better overall performance. The Legislature should encourage the Permanent Fund Corporation to continue their emphasis on stable, predictable revenues rather than higher, more risky return rates.

The Prudent Investor Rule requires Permanent Fund managers to diversify their portfolios to protect the trust against unnecessary risk. Directions which would specify a minimum amount of in-state investments would violate the ability of the Corporation to fully diversify. Examination of other State funds support this belief. Nearly all of them had very low percentages of direct in-state investment. Diversity protects the stability of the fund's earning stream. No manager will make good investment decisions all the time. Diversification of a portfolio provides a more stable earning stream and protects the Fund from loss in one investment type. Rather than identifying whether each investment decision has been "good or bad," the performance of the Permanent Fund Corporation should be assessed based on whether the portfolio, as a whole, is achieving acceptable returns while being adequately protected against risk. The Permanent Fund is systematically diversifying its portfolio through allocation of assets between investment types and within specific markets.



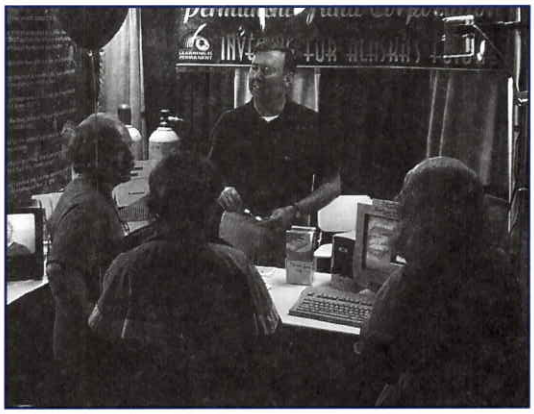
Permanent Fund Corporation Executive Director Dave Rose testified on the fund before the House Judiciary committee in 1987.

The flexibility necessary to continue this management approach should be supported by policy makers. Current law allows the Trustees to allocate assets among fixed-income instruments, stock or real estate within certain broad guidelines. This law gives the Trustees and management the flexibility to respond to changing economic conditions. The ability of the Trustees to adjust the maturities of their fixed income investments in response to changes in inflation rates has been very important in achieving the high returns of recent years. A number of other funds have experienced substantial losses due to their large allocations to stock investments.

Both stock and bond markets are becoming increasingly international. International and domestic markets often are countercyclical, international markets showing high returns when the domestic markets are low and vice versa. Even the more conservative public trust funds included foreign markets on their list of allowable investments. Expanding allowable investments may provide more opportunities for the Permanent Fund Corporation to fulfill its mandates. Allowing investment in foreign stock and bond markets may increase Permanent Fund returns as well as give the Trustees more opportunities for portfolio diversification.

Accountability

Accountability to the Legislature and to the public is an important legal responsibility of the Permanent Fund Corporation. It appears that the staff and Trustees have been very responsive to this mandate. This paper contains a few minor suggestions as to how accountability might be improved. They include increased documentation of policy debate by the Trustees and the addition of a summary of detailed holdings to the annual report.



As part of APFC's public accountability mandate, staff, including Chief Financial Officer Peter Bushre, answer questions at various Alaska fairs.

Accountability, however, implies that those to whom the Fund reports have certain responsibilities as well. These responsibilities include systematically developing the ability to evaluate both the information being provided by the Fund and its financial performance. The Legislature should acquire the expertise to develop the criteria by which the Permanent Fund should be judged as well as to contract and interpret a performance analysis. Performance must be measured over a period of time long enough to adequately judge the success or failure of management. Suggestions have been made in the paper concerning the development of measures such as time-weighted rates of return, measures which accurately consider objectives of the funds, and the need for annual, three, and five-year comparisons. Performance analysis and audits conducted by outside parties protect the Fund, the Trustees, and the public. They also build the understanding needed by policy makers to address the issues which will affect the fund in the future. The Permanent Fund is the only State fund examined that did not have an audit separate from the management audit performed each year. The Legislative Budget and Audit Committee should consider establishing a continuing evaluation program which includes periodic independent audits and performance analysis on an annual, three-year, and five-year basis. Legislative staff, with appropriate expertise, should evaluate the Permanent Fund performance analysis on behalf of the Legislature.

Fiscal vs. Economic Development Objectives

Maximizing the return of the investment and allowing the legislative process to determine social and economic development objectives with the earnings is a clear historical decision. The unsuccessful Alaska Renewable Resources Corporation, which was created at the same time as the Permanent Fund, illustrates the wisdom of this decision. The advice of the consultants at the time of the creation of the Permanent Fund – that other factors besides lack of capital affect economic development – is still true. Equally important is the advice that a development bank with soft loans will not protect the principal of the Permanent Fund. Requirements that the Alaska Permanent Fund be involved in economic development activity such as infrastructure development or Alaska business loans at below market interest rate are likely to result in a loss of real earning power of the principal of the Fund.

Inflation-Proofing the Principal

The Legislature has directed that Permanent Fund annual earnings be used to inflation-proof the principal. Although the Trustees are required to consider inflation in their investment decisions, the legal opinions suggest that the legislature is not required to provide additional inflation-proofing dollars. Without inflation-proofing, assuming a 5-percent inflation rate, the real earning power of the Permanent Fund would be reduced by half in 20 years. As early as FY 1987, inflation-proofing could be the largest source of contributions to the Permanent Fund. To determine the amount reinvested for inflation-

"The Permanent Fund is systematically diversifying its portfolio through allocation of assets between investment types and within specific markets."

proofing, the Trustees have chosen to apply the calendar year average Consumer Price Index to the fiscal year end principal balance. This choice may result in either over- or under-compensating for inflation, depending on the relationship between calendar and fiscal year averages and the growth of the principal throughout the year. Because the Dividend Program is the priority in earnings distribution, it is possible that, in the future, there will be insufficient earnings to fully inflation-proof the principal. The Dividend Program, a direct cash payment, has significantly increased the incomes of low-income persons, many of whom live in rural Alaska. It has also had a positive economic effect on the economic well-being of the State greater than the same level of expenditures by the capital or operating budgets .

What course could the Permanent Fund Corporation take if, in the future, earnings and the Earnings Reserve Account are insufficient to fund both the Dividend Program and inflation-proofing? Inflation-proofing is a program created by law, the consequences of which will have significant impact on the real earning power of the Permanent Fund and on the amount of dollars available to the General Fund. The Dividend Program is a popular and effective way to use Permanent Fund earnings to benefit Alaskans, especially low-income Alaskans, and to enhance economic activity in the State.

During development of the original Permanent Fund legislation, Clark Gruening stated that committee members began to realize that the Permanent Fund would not be able to provide all things for all people. Similarly, the earnings of the Permanent Fund will not be the sole solution to the decline in State revenues. The ability of the Permanent Fund management to maintain the level of success they have been achieving will hinge on the choices made and direction given by future Legislatures.

Former Trustee and current Executive Director Byron I. Mallott helped shape the early policy of the Fund, while Grace Schaible, former Attorney General and 1995-97 Trustee Chair, continues to play an important role in determining future Board policy.