

## **Petroleum and the Future of the Alaska Economy**

Scott Goldsmith  
Professor of Economics  
Institute of Social and Economic Research (ISER)  
University of Alaska Anchorage

Resource Development Council  
December 8, 2009

(First, some clarifications—It is not Thursday and the Alaska economy has not gone “into the tank” to quote an unidentified source in the ADN)

For the first time in 22 years the economy did not grow this year and we will end it with fewer jobs than we had in January.

The job loss so far has been modest—perhaps 1 percent, particularly in relation to the rest of the nation. Only 8 of the 369 metropolitan areas of the US have posted employment gains thru October of this year (BEA) and many report losses upwards of 8 percent.

Here in Alaska the job loss has been concentrated in tourism, transportation, and petroleum, but inevitably the slowdown has been spreading out to other industries including construction, retail trade, services, and local government. Some sectors however have held steady, like state government, or continued to grow, like health care.

Our losses could have been much greater. We did not have a housing bubble like Nevada. We do not have a large heavy manufacturing sector like

Michigan. And unlike California with a \$16 billion hole in its state budget, we have a large state fiscal surplus.

With the surprise announcement of the drop in the unemployment rate last week—from 10.2 to 10 %, some analysts are saying the national economy has hit bottom and is starting a recovery—albeit slowly.

I think talk of a recovery at this stage is primarily a strategy to bolster consumer confidence. If we can get consumers, who account for 70% of GNP, to believe that the economy is getting better, they will open their wallets, start to spend again, and presto, the economy WILL get better.

I have no problem with that strategy, but realistically, I don't think we are out of the woods yet, and I expect to hear more bad economic news sprinkled in with the good next year.

The Alaska economy will continue to contract next year. We know tourist visits will be down. Major oil companies have announced reductions in their capital budgets. Consumers are cautious and have less cash from a smaller PFD this year. Many support businesses are going into the new year with weakened balance sheets.

But the economy eventually will recover from the effects of the national recession. The tourists will come back (although we will have to work at getting our share of the market), the Fedex jets will return full from the far east, consumers will regain confidence and start spending.

But what kind of economy will we return to after the national recession has become history. Will we get back on that trajectory that brought us 22 years of uninterrupted growth?

Maybe. We have always been lucky and our good luck might continue. Perhaps we will be blest with a natural disaster to give the economy a boost. We seem to be overdue for one. Maybe the oil price will jump to \$200 a barrel. Use your imagination

But lets not deceive ourselves into thinking that just because we were born on 3<sup>rd</sup> base, we hit a triple.

A better strategy than relying on luck is to take stock of what we have, and actively work to build on our strengths.

So I want to take you the first step and describe what drives our economy. That will shed light on how the economy got to where it is today, and where it could potentially go in the future.

What drives our economy are those activities that bring new money into Alaska. It is this new money that accounts for all the jobs, all the payroll, and all the other income of Alaskans.

The picture is quite simple. I call it the 1/3 rule of thumb. Some have likened it to a 3 legged stool.

About 1/3 of jobs and income can be traced back to the production of our traditional natural resource industries, those depicted on the state seal,-- fishing, mining, timber, as well as tourism, air cargo, and retirees.

1/3 can be traced to the dollars flowing into Alaska from the federal government. And 1/3 of jobs and income depend on the petroleum industry.

What about the construction industry, the banking sector, health care, the university, or the many other industries that employ most of us in this room?

It's not that these sectors are unimportant for the economy, but rather that if you work in one of these industries, your job would not exist without an inflow of dollars from one of these drivers.

To take one example, if you work for a bank, roughly 1/3 of your coworkers have jobs because of our traditional resources, 1/3 because of the federal government, and 1/3 because of petroleum. The health of the banking industry ultimately depends on the health of those economic drivers.

So lets look at each leg.

Traditional industries—particularly mining and tourism--have posted some impressive gains in recent years. Unfortunately among other challenges they have a size disadvantage. In spite of healthy growth, they still make a very modest contribution the overall size of the economy—about 14% of income comes from tourism and mining.

Looking back over the last 22 years, only a fraction of the growth can be traced to these sectors. It is a mistake to think, as many have done, that the economy was diversifying and “moving beyond” dependence on oil. In reality their growth only allowed them to hold their share.

Looking forward, with implementation of the right policies, these traditional sectors will continue to grow. But their contribute, at best, will be modest. For example a doubling of the contribution of mining to the economy would increase total employment only 2.5%.

At this point I need to mention the two terms most often heard in conversations about economic development in Alaska -- value added processing and economic diversification. 50 years of effort in these areas has produced minimal results. I don't think its because we were stupid. Rather there are some hard economic facts that make these goals nearly impossible.

Turning to federal spending, everyone is aware of the “Ted Stevens” effect, but many people don't realize that the increase in those dollars has accounted for a large part of the job growth we have enjoyed over the last decade. That boom ran out of steam in 2006, and falling federal spending since then has been a brake, acting against growth.

That brings me to petroleum.

Everyone agrees that petroleum is an important driver, but like federal dollars, Alaskans tend to underestimate just how much petroleum means to the economy.

First, unlike tourism or commercial fishing, most of the action occurs remote from where most Alaskans live, so we just do not see it. If the Liberty oil rig, almost as tall as the Statue of Liberty, were off shore down at Ship Creek, we would have a much better sense of what drives our economy.

Second, 9 out of 10 of us were not here before petroleum. So we have little collective memory of the difference petroleum has made.

Also, our attention has been diverted by good fortune--the run-up in the price of oil and other commodities, a decade long boom in federal spending, and a booming US economy. These made us complacent about petroleum's role.

So how important is petroleum?

The easiest way to understand this is to think of what would happen if a terrorist set off an atom bomb under Prudhoe Bay while we sit here over lunch, rendering all the oil and gas radioactive and un-saleable.

Over 40 thousand jobs directly and indirectly related to exploration, production, and transportation would disappear. The large share of government jobs funded by petroleum revenues plus many private sector jobs dependent on public spending would disappear, leaving an additional 50

thousand Alaskans without employment. The boost from the PFD would soon disappear as well. Altogether 1/3 of all jobs would be gone.

But this is only part of the story of petroleum's importance. If we look at how the state has developed, we can see that the petroleum industry has generated spinoff benefits for our other economic drivers, helping them grow, and for the rest of the economy as well—transforming it from infancy to adolescence.

Here are 3 characteristics of petroleum and how each has contributed to this transformation.

First Stability.

The 100 thousand petroleum dependent jobs are non seasonal—in contrast to our two other big private drivers—fishing and tourism. The stability that comes with year round employment provides fertile ground for support businesses to spring up and thrive.

Second. Size. It matters.

The growth from petroleum has increased the size of the economic multiplier—that indicator that describes how many jobs are created by each new dollar coming into the economy.

Now, thanks to petroleum, every new dollar that a tourist brings to Alaska or that comes in from the sale of zinc circulates longer in the economy before

leaking out. Without petroleum many of those multiplier jobs would not exist.

### Third. Value Added

Through 2008 the state of Alaska had collected \$141 billion in revenues (measured in 2008 \$) from petroleum activities—a significant portion of the value added created from production.

We have saved \$35 billion, but most--\$106 billion--has been spent, about half on reduced taxes for households and businesses, and half for expanded public programs (compared to the US average).

Lower taxes have enhanced the profitability of our non petroleum drivers. Higher public spending—some targeted at development but most not—has also given these drivers a boost—reducing the cost of business and increasing opportunities.

In fact if we account for these spinoffs, about two-thirds of the growth of the economy since statehood can be traced to the petroleum industry.

And what would we look like today without the growth from petroleum?

Growth would have come from our other resource industries (the most jobs would come from tourism—highly seasonal) and the federal government—but the economy would be half its current size.

It would look today a lot like it did at statehood—small, thin, seasonal, poor, and dominated by the federal government. I have suggested it would look a lot like Maine—a state that perennially ranks near the bottom for economic vigor.

(To finish the petroleum 1/3 rule of thumb. Nearly the entire state general fund operating budget 3/3 has been financed by petroleum revenues for 30 years.)

Looking back, oil production skyrocketed from nothing to over 2 million barrels per day in 1989. 16 billion barrels of oil has come out of the North Slope, much more than originally predicted, and it has proven to be a sustained economic driver for 50 years.

Looking forward, petroleum has the potential to be a sustaining economic driver for another 50 years. 6 billion in reserves remain on state lands. Perhaps 50 billion is under federal lands and the waters offshore in the OCS. Natural gas and heavy oil are additional resources.

But we won't realize that potential if we depend on luck. The fact that petroleum employment was at an all time high at the start of this year was certainly good news, but it should give us pause. Production is now only 1/3 of its peak, having fallen for 20 straight years at about 5% each year.

Together these facts tell us that it is becoming more challenging over time to coax each additional barrel of oil out of the ground. More and closer attention will need to be devoted to crafting policies to sustain this effort.

Unfortunately not everyone understands what petroleum can contribute or what its contribution has been.

For example, support for OCS development is luke warm from some quarters because the state will not be able to collect royalties or severance taxes from that production. This way of thinking not only ignores the jobs potential, which is an order of magnitude greater than a gas pipeline by the way, but also the spinoff revenues from onshore activity stimulated by expansion of infrastructure on the slope. Consider this. If recoverable reserves are 10 billion barrels and the price of a barrel is \$50, the total value of OCS development would be \$500 billion. Surely Alaskans have the imagination to see this as an opportunity worth pursuing.

In closing

As we look ahead we need to keep in mind how the transformation and current strength of the economy depend on petroleum. Alaska businesses have benefited from an expanding market, low taxes, and public expenditures. Alaskan households have benefited from high wages, low taxes, and public expenditures.

Devoting additional attention to the development of our petroleum resources is the best single strategy for the continued economic prosperity of this state.

In the past we followed a lot of dead end economic development paths by taking dollars from a winner—petroleum—and spending them on losers. Unfortunately we don't have the extra cash any more to go in those directions.

It should give us pause to recall that it was Don Quixote, that addle brained knight who jousting with windmills who first said

...A wise man does not trust all his eggs to one basket.

I am not suggesting we abandon that philosophy, but I do think we should pay more attention to another quote, variously attributed to Warren Buffet, Andrew Carnegie, and Puddinhead Wilson via Mark Twain

Put all your eggs in one basket, and watch that basket.

Thank you for your kind attention.