The Three Basic Policy Questions
Concerning the Permanent Fund

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A. Prologue

There are three policy questions concerning the Permanent Fund, each of which I would like to address in turn. They are as follows:

How much should we save?

What investments should our savings go into?

What shall we do with the income from our investments?

First, however, I want to touch on the more fundamental question concerning the wealth currently controlled by the state. Should the State of Alaska be a wealth holder at all, or should all revenues not currently necessary to fund government be distributed to current Alaskans? Several economists have appeared before this group suggesting that the best thing to do with our wealth would be to distribute it immediately and completely to the private sector. One cannot argue that this course of action is best for current Alaskans since it maximizes individual freedom of choice. This may not be the best course of action for Alaska though because complete privatization of the wealth would result in most of the wealth immediately leaving the state. Benefits would go to individuals, but not necessarily to Alaskan individuals.

If Alaska is more than the sum of individuals who are currently residents, then what is "best" for individuals may not be what is best for Alaska. The best solution may be for the state to save the majority of our wealth and use the earnings generated from that wealth to create a steady, stimulative force for economic growth and development for generations to come.
B. How Much Should We Save?

It is easier to deal with this question if we stand it on its head and ask how much we want to spend—not only this year but also in future years. From that, we can calculate how much we need to save to meet our spending target. Obviously, the initial spending decision would need to be changed if it did not leave enough savings for future years. Back-of-the-envelope calculations suggest that we should be putting a much larger proportion of our current income into savings than the 10 percent that now goes into the Permanent Fund.

A simple example should demonstrate this. The state gets virtually all of its revenues from Prudhoe Bay petroleum production activities. In a very real sense, there is a bank on the North Slope—The First National Bank of Prudhoe Bay—and the State of Alaska has a major account there. A rough estimate of the balance in the state's account made last spring was $80 billion. Today, its value might be only $70 billion in 1981 dollars due to the softening of the world oil market. Each year, the state makes a forced withdrawal from its bank account as it collects the various petroleum-related revenues and royalties. Some of this forced withdrawal is interest, but principal is taken as well.

If we adopted the conservative rule, "never spend principal," we would have a very simple spending rule as well as a rule for determining how much of our petroleum revenues should be set aside in the Permanent Fund each year. With a 2 percent real rate of return on the
$70 billion, $1.4 billion in 1981 dollars could be spent annually. We could spend that amount each year and still have $70 billion in the bank. Any petroleum revenues over and above $1.4 billion would be saved in the Permanent Fund. In time, of course, the oil would be all gone and the principal would be the Permanent Fund, which would amount to $70 billion in 1981 dollars. At our current savings rate of 10 percent, we are clearly eating into principal.

There is one important argument against the "never spend principal" rule, and it is directed specifically at the assumption underlying the rule that Alaska will not be richer in the future than it is today. As a nation, we have tended to reject such an assumption in favor of the idea of continuous material progress, with each generation being richer than the previous one because of technological improvements. Consequently, we feel that we don't need to save and deprive ourselves for the benefit of future generations, because we believe that our descendants will be better off than we are today. (This does not mean, however, that all individuals or regions of the country will share in this progress, as the declines in the fortunes of Appalachia and New England readily attest.)

Unfortunately, the evidence to indicate that Alaska has or is developing an independent source of wealth to maintain a continuously increasing flow of dollars after Prudhoe Bay is non-existent. Consider the corporate income tax, our largest source of revenue even partially independent of petroleum, which in the fiscal year just
ended produced $35 million in revenues. Assuming a continuation of
the historic growth rate in receipts (10.8 percent), it will be over
35 years before it will generate an annual income of $1.4 billion. Or
consider coal—this year's glamour resource. The current annual
production of about 1 million tons directly accounts for less than
four-thousandths of one percent of our revenues ($200,000, or .004 per-
cent). If the state could get 30 cents in royalties for every ton of
col mined, 4.7 billion tons—which is just about all of our current
reserves (4.8 billion tons)—would need to be extracted annually to
put $1.4 billion into the treasury. So even if it were physically or
technically possible to mine this much coal in one year, it only
provides one year of revenues.

As we debate the merits of coal or agriculture or petrochemicals,
time is inexorably running out on finding an alternative to petroleum.
Of the 9.4 billion barrels of recoverable oil originally estimated at
Prudhoe Bay, 7.1 remain. Almost one-fourth, 2.2 billion barrels
(24 percent), has already flowed through the pipeline and out of the
state.

What this suggests to me is that history will repeat itself, and
Alaska will be relatively much poorer in the future when the petroleum
boom has passed. The only way to prepare for that day is by following
the simple rule: "never spend principal."
C. What Investments Should Our Savings Go Into?

The choice is between those investments which will earn a market rate of return and maximize income (government securities, corporate stocks, and real estate, for example) and investments made below the market rate of return which result in subsidies to particular activities that are deemed to be socially desirable or that will allegedly produce other economic benefits.

It is clear what we get by following the first approach: a return on investment with no side effects. The results of the second approach are more complicated, but usually the state makes a tradeoff in which it gives up revenues in exchange for immediate job creation and short-run increases in personal incomes, or for infrastructure development that presumably will, in turn, stimulate economic development. Previous reports to the Trustees have pointed out the two difficulties with the latter approach—first, economic activity in the private sector is distorted away from the goal of profit maximization toward the dubious goal of subsidy maximization (in Columbia, this has resulted in a new "ism" in memory of the pyramids--Pharaohism!); and, second, the benefits of the programs go to a small portion of the population. (These attributes mean that subsidies are really just like taxes in the sense that they cause distortions of the private economy and impact the pocketbooks of certain groups, and, consequently, their use should be determined by an open political process.)
One version of the subsidization approach is to invest in Alaska mortgages at interest rates below the market. The benefits claimed to result from this type of investment include a positive rate of return on investment, job creation, improvement of the quality of the housing stock, and a form of wealth distribution that will remain in Alaska and be widely shared. In addition to the obvious revenue loss, there are two problems with this use of our wealth which have not been explored. First, in terms of job creation, these subsidies are like a narcotic. In response to the initial subsidy, there is a rush of construction activity and job creation as people scramble for the cheap mortgages before the increase in housing prices offsets the subsidy and monthly housing costs return to their pre-subsidy level. This rush is followed by a contraction of activity and a return to normal levels of construction and employment. To get a larger number of construction jobs again, another "fix" is necessary, but this time the price is higher. The subsidy must be increased each season to get the same stimulation in the industry. The construction industry rapidly becomes an addict with an ever-increasing fix necessary to satisfy its habit.

Second, the benefits of this method of wealth distribution may not remain in Alaska. In the short run, they do, as rising real estate prices, benefit all Alaskan property owners (and penalize renters). (Incidentally, the "bang per buck" for this program in terms of houses built is very small. If $100 million in subsidies was
allocated, and this resulted in 1,000 housing starts that would otherwise not have occurred, then each housing start cost the state $100,000! If there is a post-Prudhoe economic bust, however, three factors will combine to produce the unthinkable—a fall in housing prices. (Residents of the Lower 48 are discovering that unthinkable as it may be, this is clearly not impossible.) First, property taxes, which have declined in recent years as the state has picked up a larger share of funding of local government, will have to be increased to provide for such basic government services as education and highway maintenance. Second, the promise of future mortgage subsidies will evaporate. These two factors will combine to have exactly the opposite effect that they are having today. They will drive up the monthly cost of owning a home and drive down the price. Third, the demand for housing will fall as higher taxes and less government subsidization of the private sector combine to contract the economy and result in a decline in population. Under this grim scenario, the benefits of the housing subsidy program will clearly go to those who sell out while housing prices are high and head South. Those who remain behind in Alaska will see their housing assets depreciate in value and their share of Alaska's wealth disappear.

Thus, while a housing mortgage subsidy program has some appeal, as a job creating device that distributes Alaska wealth to a large group, it suffers from the same shortcomings that affect other subsidy programs.
A final point on subsidies: If the subsidization approach to investment is chosen, it must be based upon explicit criteria for evaluation just as regular investments can be evaluated on the basis of their rate of return. Specifically, subsidized investments must demonstrate the capability of generating tax revenues. If those revenues do not materialize, then this approach should be abandoned.

D. What Shall We Do with the Income from our Investments?

In the early years, all income should be plowed back into the Fund to build up its principal in anticipation of the day when it will be the primary source of revenue to the state. The "never spend principal" rule requires that the annual spending of $1.4 billion in 1981 dollars eventually come from Permanent Fund earnings. Current residents are benefiting from Alaska's wealth, and it seems fair that the next generation of Alaskan residents, our children, should get their share. We, today, are already benefiting from the abolition of the income tax, low property taxes, subsidized loan programs, and massive government expenditures to improve the quality of life in the state. Future generations should not be denied their benefits because of the premature distribution of Permanent Fund earnings only to current residents.

Looking toward the long run, permanent fund earnings should go into a special escrow account for Alaska residents against the day when the state may need to reintroduce the personal income tax. For every year that a person remains a resident, his account would be
credited with his per-capita share of fund earnings. All money would remain in this account until the tax was reintroduced, at which time individuals could pay their taxes each year out of their share of the balance in the account. If a person left the state, his share would revert to the Permanent Fund and increase its principal.

Such a plan has four attractive features. First, its benefits would be 100 percent targeted to Alaskans because only Alaskans pay Alaskan income taxes. Second, it would reward those who had been living in the state longer with larger benefits. Third, it would reward a broad population group. And, fourth, it would minimize any "false boom" resulting from a large cash distribution, which would stimulate in-migration of non-Alaskans seeking cash handouts. With such a plan, there would be no need to discriminate against our children, who are bonafide residents.

Some people will argue that the state personal income tax is gone forever, in which case this escrow fund would never be used and the benefits never realized. They could be right, although there is as yet no solid evidence that this is the case. To handle this possibility, a special stipulation of the fund would allow for distributions to begin after five years, but only on the condition that a target of 25 percent of government expenditures could be financed at that time by renewable revenues. This stipulation would create a clear target toward which state policy could aim as well as a clear incentive for Alaskans to work to ensure the future economic viability of our state.