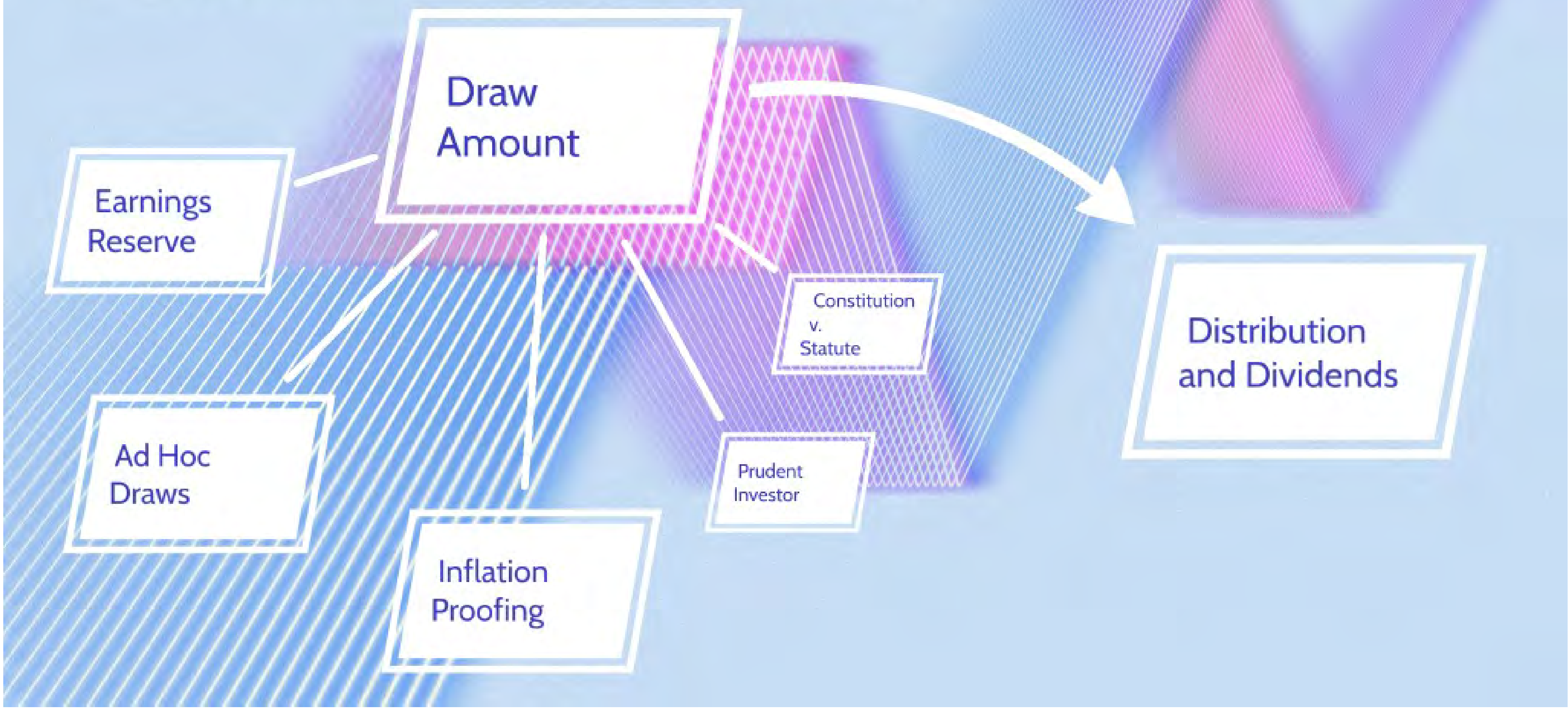
Overview of Permanent Fund Proposals

Reid Magdanz & Rob Ervine *House State Affairs 3.29.18*



Draw Amount

Objective: Maintain or grow value of the Permanent Fund

Smaller draw: Fund grows faster, but provides less money in the short term

Larger draw: Provides more money in the short term, but results in slower fund growth

The options →

POMV

OR

Earnings-Based

PLUS

Lookback?

PLUS

Net Income Cap?

Percent of Market Value Approach

Withdraw a set percent of the fund's total value each year

- Provides most stable draw amount
- Most commonly proposed approach

Proposed Draw Rates

- 4.0%
- 4.5% – e.g. SJR 9
- 4.75% – e.g. HB 286 (op budget)
- 5.0% – many resolutions
- 5.25% – e.g. SB 26 (first years)

More conservative

More aggressive

Earnings-Based Draw

Draw all or a portion of the fund's average earnings

- Draw amount more responsive to short-term market conditions
- More volatile funding stream than percent of market value approach

Proposed Draw Rates

21% of the last five years' realized income (i.e. 5-year average)

Proposed only in SJR 1 and HJR 34

Also used for existing statutory dividend formula

Lookback Options

A lookback period results in a more stable funding stream

Some legislative proposals include a lookback, others don't

5-year lookback

- SB 26
- HB 286 (op budget)
- Current law
- HJR 34
- HJR 36
- SJR 1
- SJR 9
- CS HJR 23 (FIN)

No lookback (draw based on prior year)

- HJR 23
- SJR 8
- SJR 10

Cap Draw at Prior Year Net Income

Results in less stable funding stream

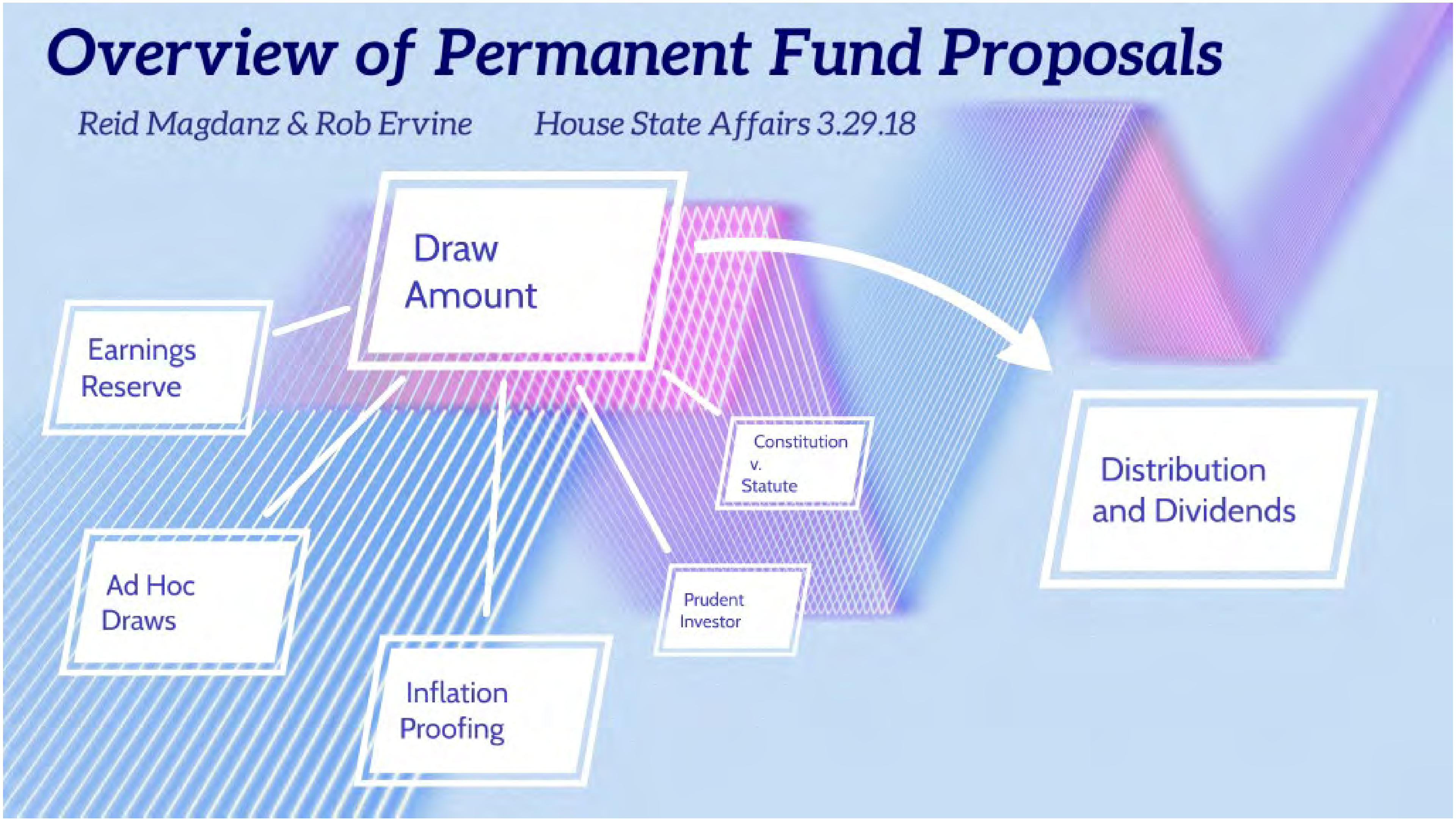
- Stronger protection for fund value
- But higher risk of too little money to pay for dividends or public services

No cap

- SB 26
- CS HJR 23 (FIN)
- HJR 36
- SJR 9

Cap

- HJR 23
- HJR 34
- SJR 1
- SJR 8
- SJR 10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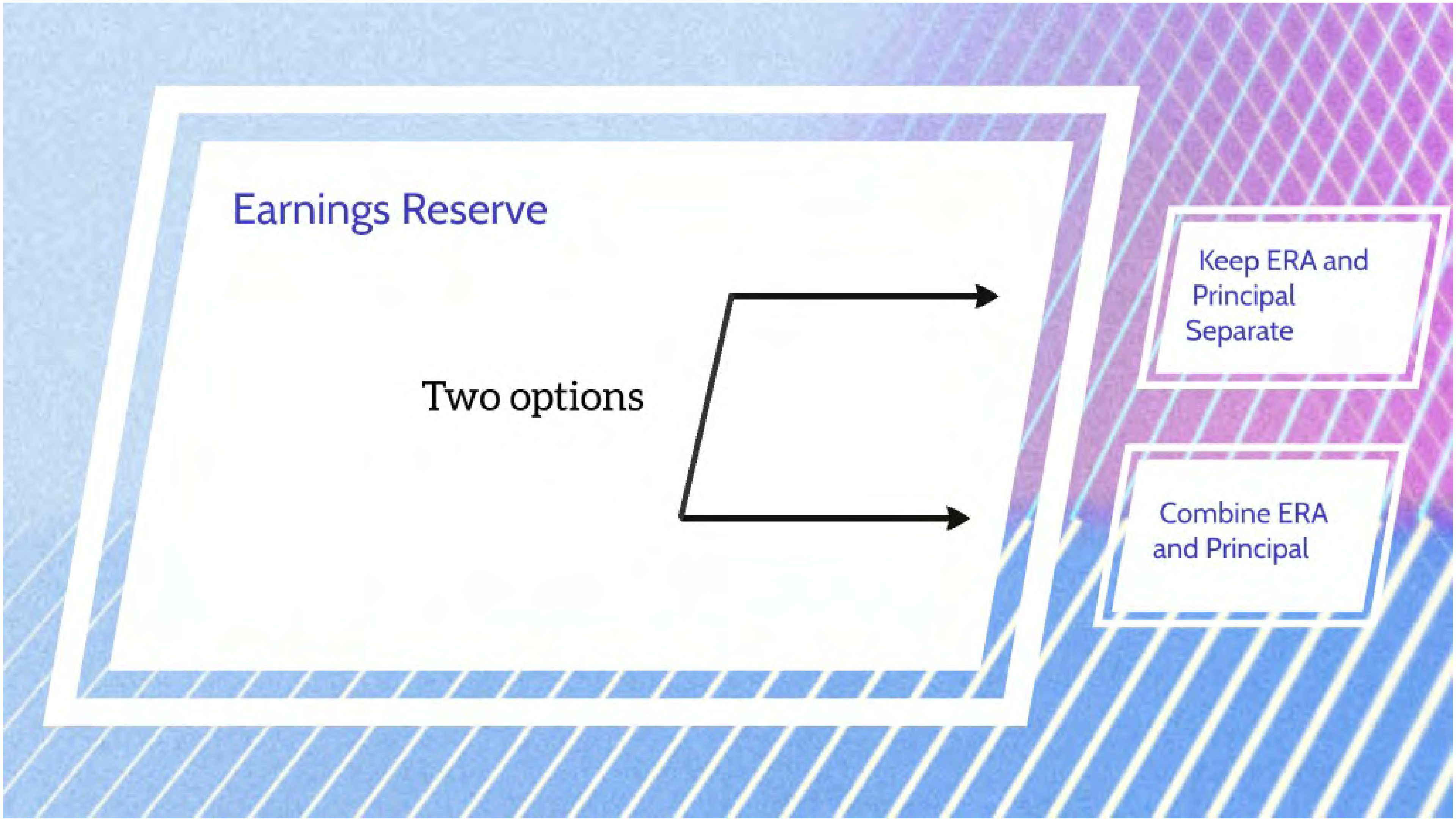

Earnings Reserve
Two options
Keep ERA and Principal Separate
Combine ERA and Principal

Maintain ERA and Principal as Separate Accounts

Has the effect of establishing a floor value for the Fund

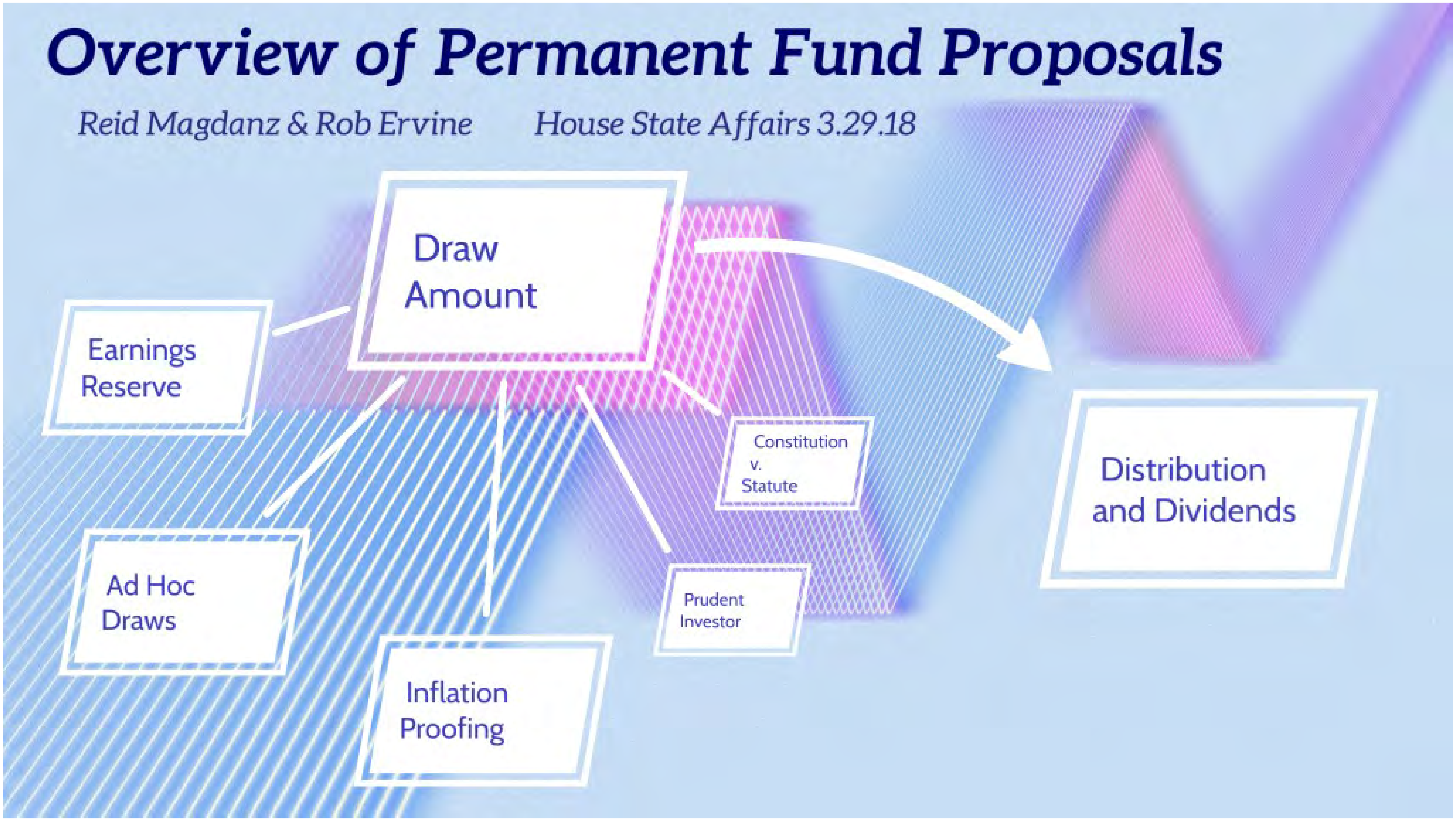
Floor could be set in different ways

- But if earnings reserve empty, no money from the Permanent Fund to pay for dividends, schools, or other public services

- Requires Alaska Permanent Fund Corporation to manage the fund differently than most endowments

Combine ERA and Principal into Single Endowment Fund

- The "pure endowment" approach
  - Ensures money is available every year for dividends, schools, or other public services
- A sustainable draw rate should maintain fund value over time. But in market downturns, fund value could fall lower than in case of a separate principal
- Nearly all large funds are managed as a single endowment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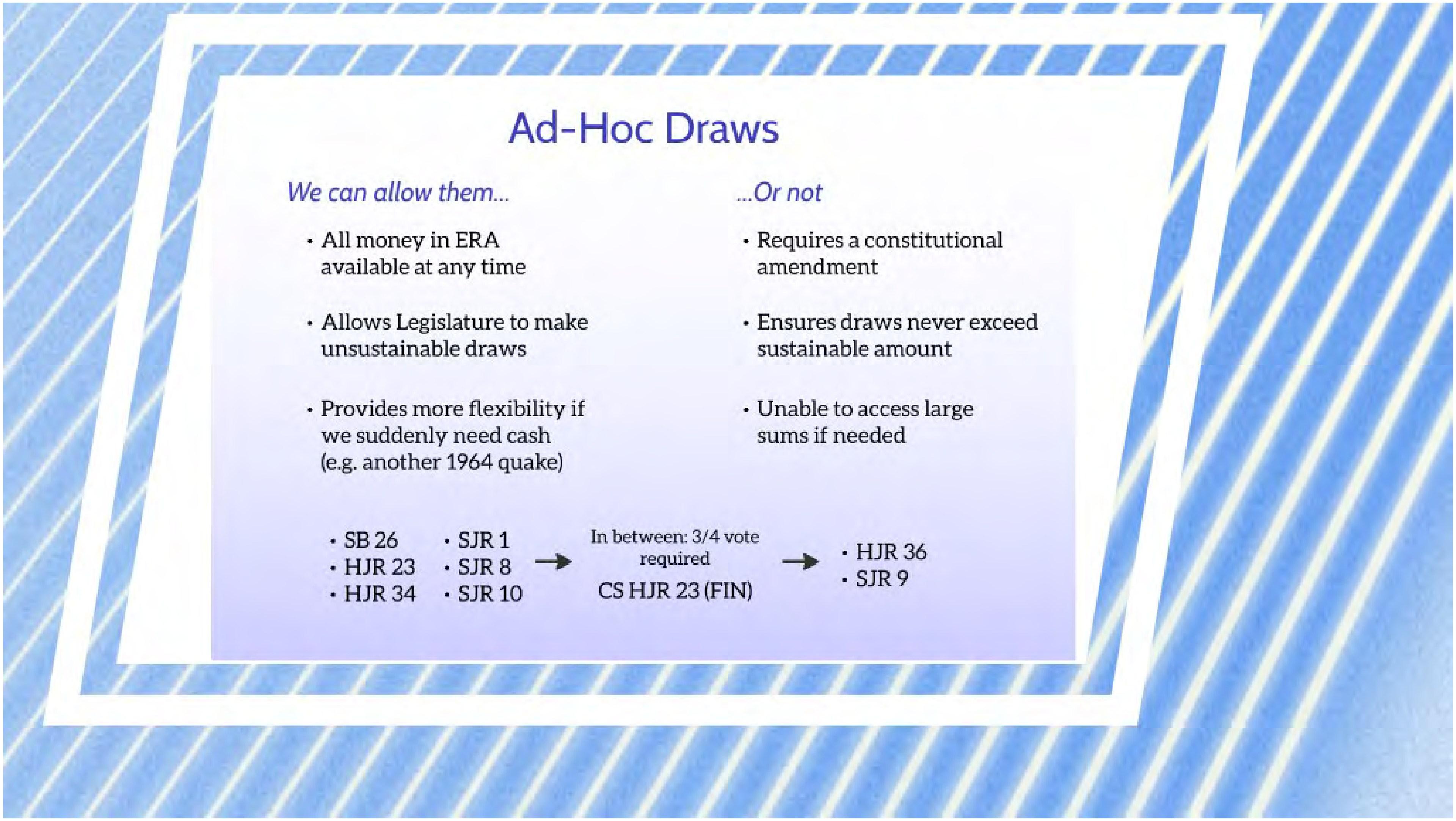
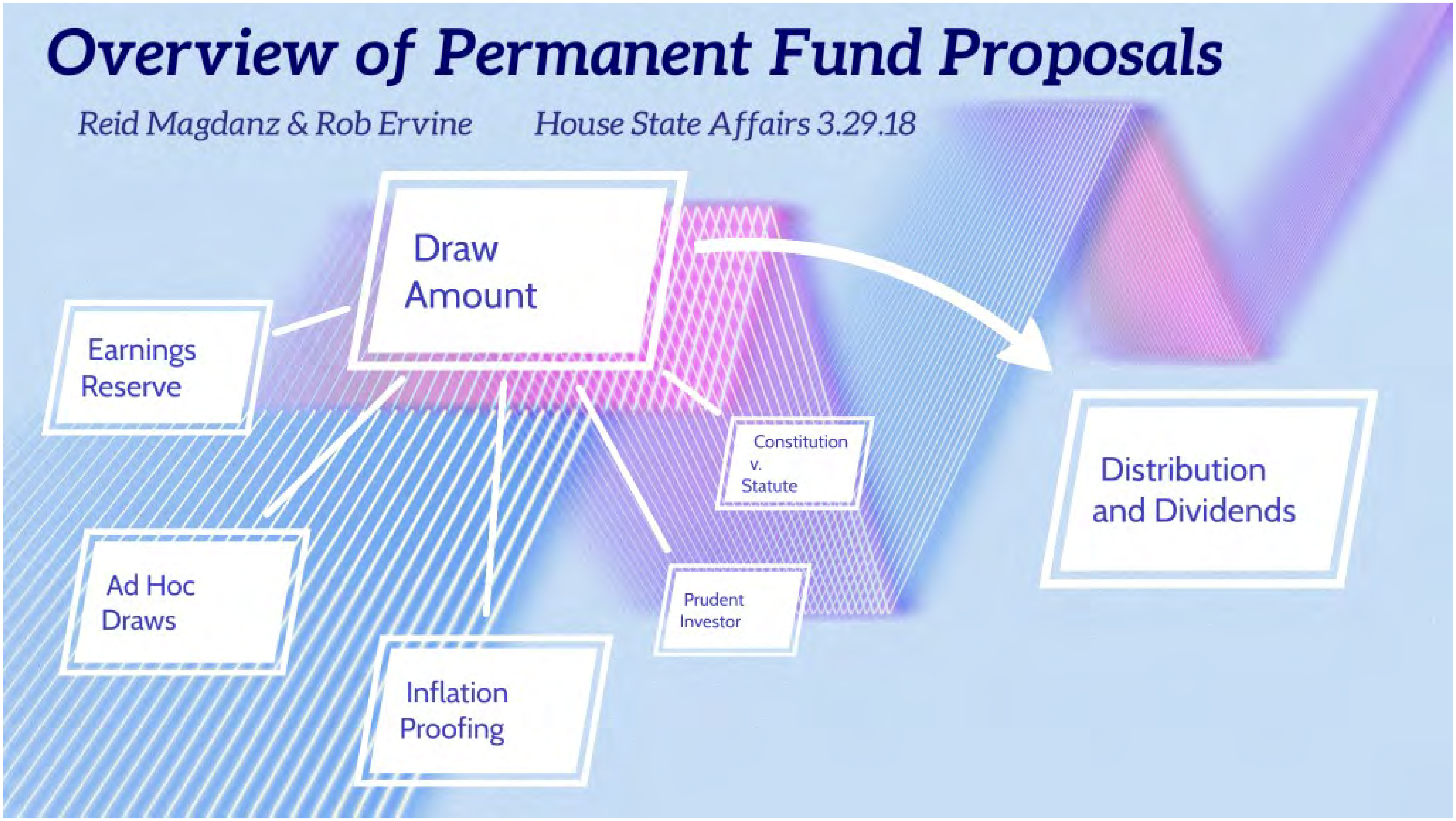

Ad-Hoc Draws
We can allow them...
All money in ERA available at any time
Allows Legislature to make unsustainable draws
Provides more flexibility if we suddenly need cash (e.g. another 1964 quake)
...Or not
Requires a constitutional amendment
Ensures draws never exceed sustainable amount
Unable to access large sums if needed
SB 26
HJR 23
HJR 34
SJR 1
SJR 8
SJR 10
In between: 3/4 vote required
CS HJR 23 (FIN)
HJR 36
SJR 9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Inflation Proofing Transfers: A tricky question

The importance of inflation proofing transfers depends on the other choices you make.

Important to remember: if using a POMV draw, there is a difference between inflation proofing the *fund as a whole* and inflation proofing the *prinicpal*.

If ad-hoc draws from the ERA are possible

If fund is managed as a pure endowment

If ERA remains, but ad-hoc draws are prohibited

Scenario: Ad-hoc draws allowed from the earnings reserve

This is the scenario for every statutory draw formula.

Other scenarios are possible only with a constitutional amendment.

Because the Legislature can access all funds in the ERA at any time, inflation proofing is essential for maintaining the real value of the principal.

Statutory Inflation Proofing	Waterfall approach	Alternative approaches
Mandatory in HJR 34/SJR 1	*SB 26 uses this method*	*E.g. set percent of total draw*
Optional in other proposals	*Not true inflation proofing*	

Scenario: ERA and Principal combined and managed as a single endowment

This can only be accomplished by constitutional amendment.

To inflation proof the fund, earnings must cover both the draw and the effect of inflation.

$$\boxed{\text{Earnings} \geq \text{Draw} + \text{Inflation}}$$

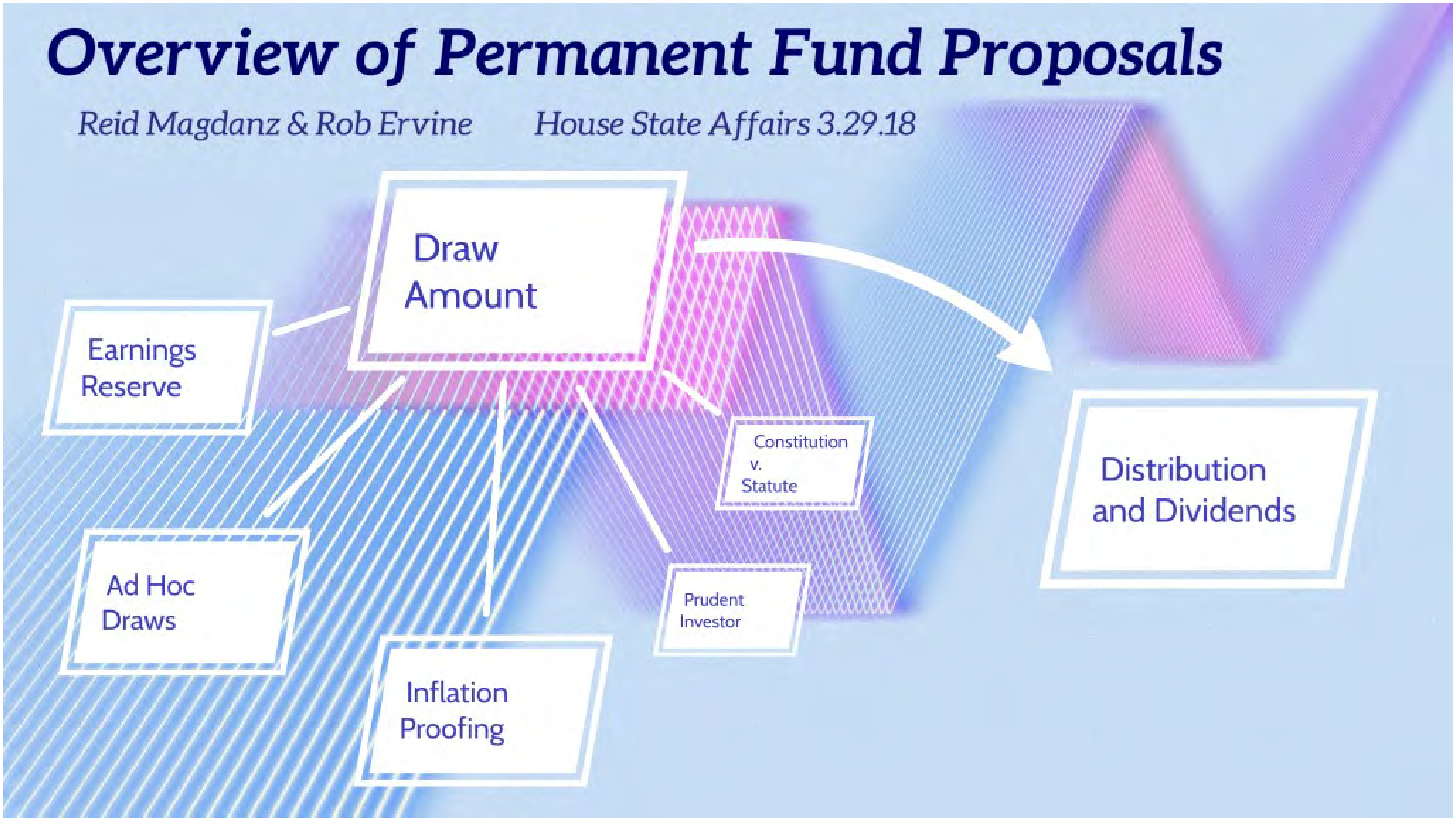
In this scenario, the only inflation proofing that matters is inflation proofing of the entire fund.

There is no need to inflation proof the "principal" because the whole fund is the "principal."

Scenario: ERA remains separate, but ad-hoc draws prohibited

This closely resembles inflation proofing in the pure endowment scenario.

- Similarly, this scenario is only achieveable with a constitutional amendment.
- The total draw amount serves to protect the entire fund from inflation.
- **Transfers from the ERA to the principal serve only to increase the floor (minimum) value of the fund.**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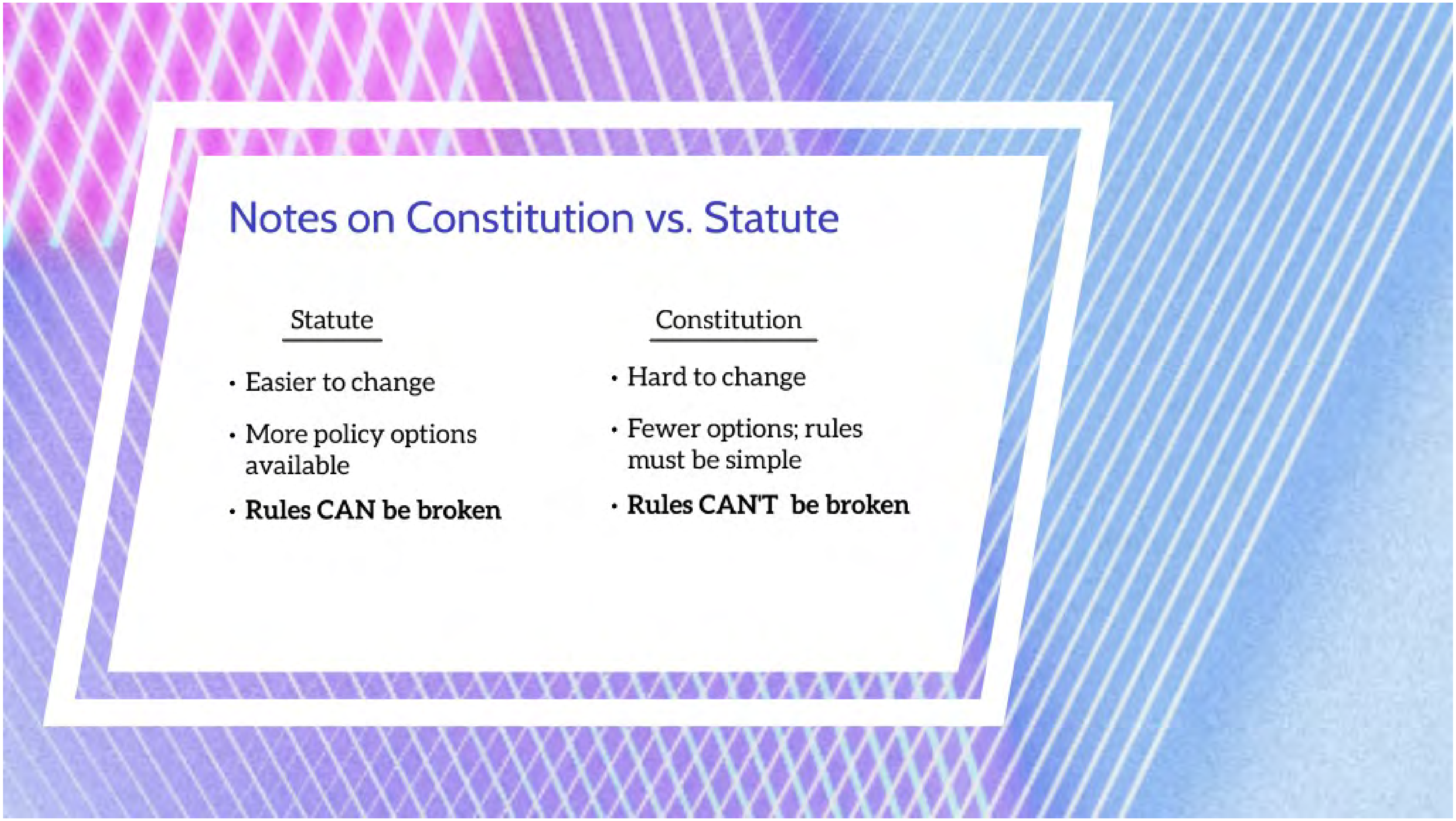
The Prudent Investor Rule

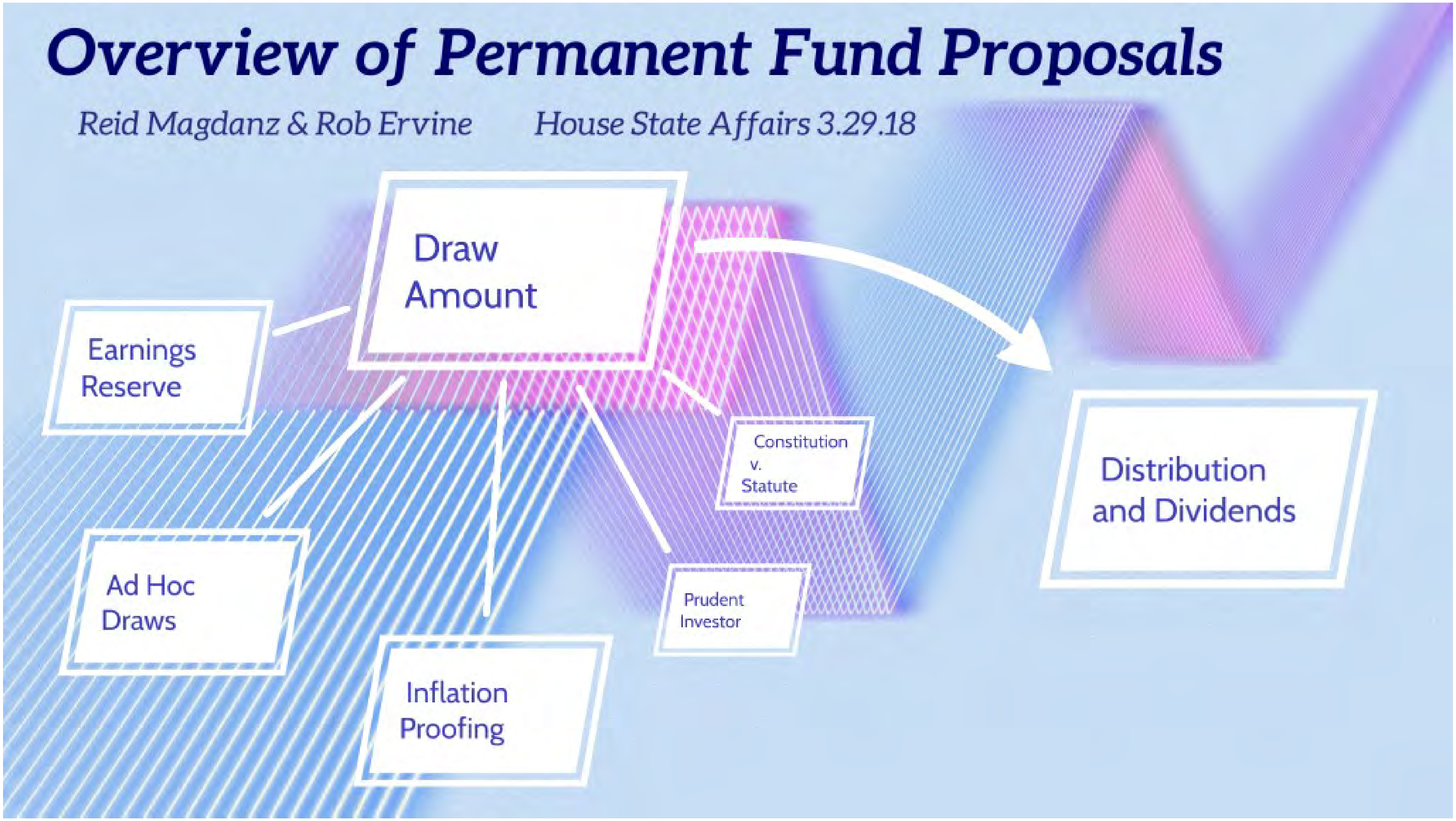
Currently used by the Permanent Fund Corporation

Not constitutionally required. Legislature could direct Corporation to make risky or low-return investments

A constitutional amendment could require use of the prudent investor rule

Include Rule	HJR 23 SJR 8 SJR 10	Maintain status quo	HJR 34 HJR 36 SJR 1 SJR 9 CS HJR 23 (FIN)


Notes on Constitution vs. Statute
Statute
Easier to change
More policy options available
Rules CAN be broken
Constitution
Hard to change
Fewer options; rules must be simple
Rules CAN'T be broken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Statutory Draw Formula

Use of the money must be defined, in annual budgets if nowhere else

Constitutional Draw Formula

Distribution could be defined in the constitution, or left to statute

Split options

- 50/50
- Other Splits
- Revenue Caps

The 50/50 Plan

50% of funds available to dividends

50% of funds available for public services

- HJR 34
- SJR 1
- SJR 8

Other Splits

Most common proposal: Roughly one third of draw goes to dividends

- Varies from 25% (SB 26 Senate version) to 44% (SJR 9)
- Can require a minimum dividend, with potential for more (e.g. SJR 9, HJR 36)

Remainder available for public services or other purposes

- Can make this draw optional (Legislature "may" appropriate)

When we have a deficit, the equation for all dividend decisions is simple.

More money to dividends
=
More money required from cuts, savings (CBR), revenue, or unstructured draws on the Permanent Fund.

Revenue Caps

You can force money back to the Permanent Fund, or into larger dividends, if other revenue is high

- SB 26: When oil revenue hits a certain level, Permanent Fund draw reduced

  Dollar for dollar (Senate version)

  80 cents on the dollar (House version)

- Possible, but harder, to implement by constitutional amendment

  For example, could cap amount for public services at budget deficit that fiscal year