

**PERMANENT
FUND
MODELS**

State Affairs Committee
Alaska House of Representatives
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Testimony Of

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Mr. Chairman, members of the Committee, thank you for the opportunity to testify today on the matter of Permanent Fund modeling. I will keep my remarks brief.

Today's review of Permanent Fund modeling is especially timely because it focuses attention on the fact that the way we look at the Permanent Fund is changing. In the past oil revenue was plentiful, and we had no need to clarify our understanding or our expectations of the Fund. Today, however, both of those needs are great.

Several factors make this so:

- o Given our fiscal and budgetary outlook, the role of the Permanent Fund in the State's fiscal affairs will increasingly be greater, not lesser.
- o Existing statutes already pose a potential conflict insofar as dividends and inflation-proofing increasingly compete for Permanent Fund earnings, rendering problematic any additional use of earnings in the future.
- o As outlined recently by Scott Goldsmith of ISER, the Permanent Fund already may have reached its maximum size in constant-dollar terms.

There is as yet little agreement on the fundamental purpose or purposes of the Permanent Fund.

It is in this context of changing needs and unresolved questions that issues about Permanent Fund modeling and projections should be raised.

First, it needs to be said that forecasts and projections of all kinds are essentially ham-handed attempts to grasp the future. We should not rely on, or base fundamental policy decisions on, the appearance of precision in them. What matters is the extent to which they facilitate understanding, the extent to which they improve contingency planning through prediction and the assessment of probabilities, and the extent to which they enable decisions based on the best knowledge and experience available.

Second, it needs to be said that the projections of the Permanent Fund Corporation do not adequately meet any of these standards. The reasons for saying this are as follows:

- o Most importantly, the Corporation's projections are not projections, but rather only a static (and arbitrary) description of what the Permanent Fund's future performance might be, if the Trustees' three percent real rate of return earnings goal were to be achieved. The projections indicate nothing about the likelihood of such an achievement, or about the nature of Fund performance that can actually be expected. Though the projection model is simplistic, and guilty of some methodological inconsistencies, this is its main shortcoming: beyond the current fiscal year, it does not provide a projection.
- o By appearing to provide a projection when in fact it does not, the Permanent Fund's model confounds understanding by promulgating misleading fiscal information, and by creating an unreliable basis for evaluating policy options. Any amount of scenario testing (higher or lower earnings, inflation or dedicated revenue assumptions) quickly reveals how differently such critical factors as reserve account balances, per capita dividend amounts, the growth of principal and conflicts between dividends and inflation-proofing (as well as the interactions among these factors) can appear - - i.e., how extremely sensitive these factors are to input assumptions, and how differently their importance appears under varying scenario assumptions. Lack of a true projection thus complicates any assessment involving the restructuring or augmenting of current Permanent Fund policies.
- o In spite of all the proven investment management knowledge, skills and expertise of the Permanent Fund Corporation, little if any of these resources seem to inform the Corporation's projections. Evidence of this is the fact that (except for those governing the current fiscal year) the model's assumptions, which presumably should reflect the Corporation's informed outlook, have remained exactly the same from month to month for years now, though investment market conditions have continuously changed. The Permanent Fund model thus by no means provides policy makers with the benefit of the Corporation's "best guess" about future Permanent Fund performance.

Overall, therefore, it is not surprising that different modeling techniques including ad hoc procedures have been adopted by various agencies in their efforts to estimate future Fund performance and evaluate a multitude of Permanent Fund proposals. Nor is it surprising that policy makers as well as the general public have been frustrated in their attempts to interpret, compare and reconcile the results of these varying estimates and evaluations.

The bottom line is that a crucial gap exists in our understanding of the Permanent Fund, its expected performance, and the possible long term effects on the Fund of any of a dozen or more major policy and budgetary proposals. The Permanent Fund Corporation is not entirely at fault in all this, because conditions have changed. What sufficed in the past, however, simply will not suffice any longer. We must progress from a state of limited useful information about the Permanent Fund to one that truly supports public decision making.

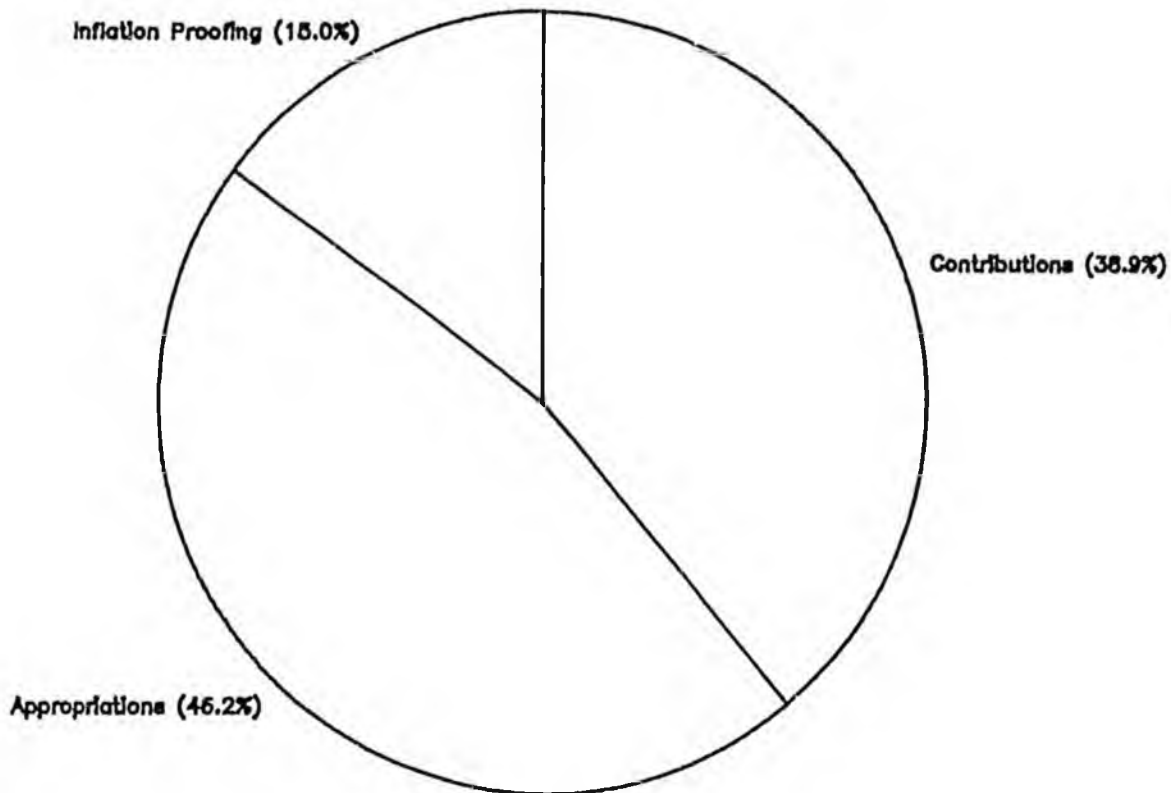
In view of these factors, the following suggestions are offered for consideration:

- o The Permanent Fund Corporation should make every effort to provide decision makers with a periodically updated projection that truly reflects their reasoned expectations about future events and actual Fund performance.
- o The projection should be more than just a spreadsheet print-out. Like our revised revenue forecast, it might include a narrative explaining the choice of assumptions used in compiling the projection, the sensitivity of key variables, and the market outlook on which the projection is based. In short, the projection should be recast as a tool useful to policy makers.
- o Policy makers should make their needs known, in this regard, to the Permanent Fund Corporation.
- o Technical and methodological inconsistencies in the model developed for the projections should be corrected.
- o The model should be used by other agencies as the basis for their own modeling of Permanent Fund performance and evaluations of Permanent Fund proposals.
- o More oversight of the Permanent Fund is needed.
- o A joint legislative-administration review of the Permanent Fund projection model should be undertaken.

Thank you, Mr. Chairman. I would be happy to answer any questions.

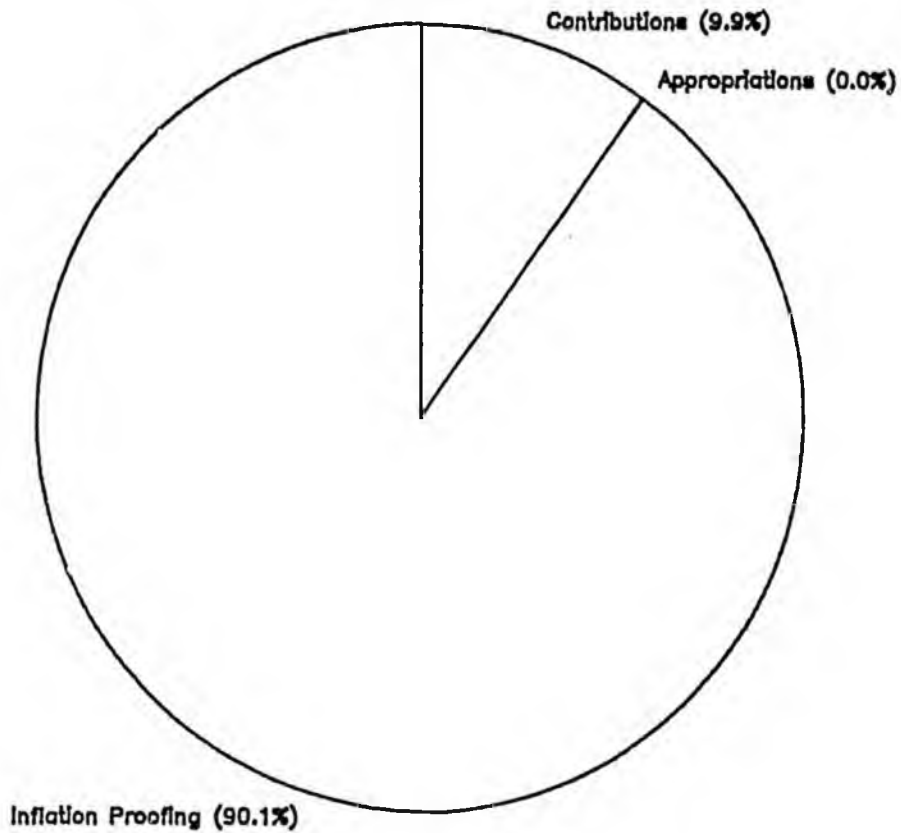
Permanent Fund: Sources of Income

FY 78 - FY 88



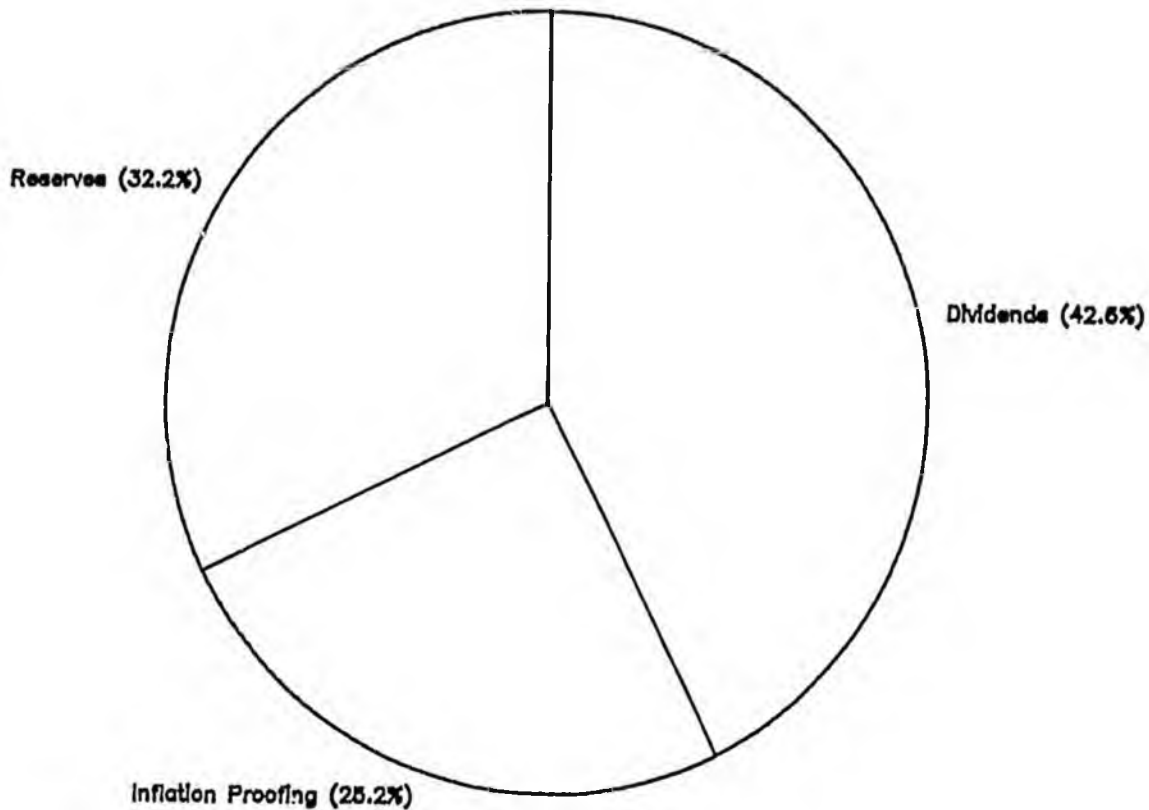
Permanent Fund: Sources of Income

FY 89 - FY 2008



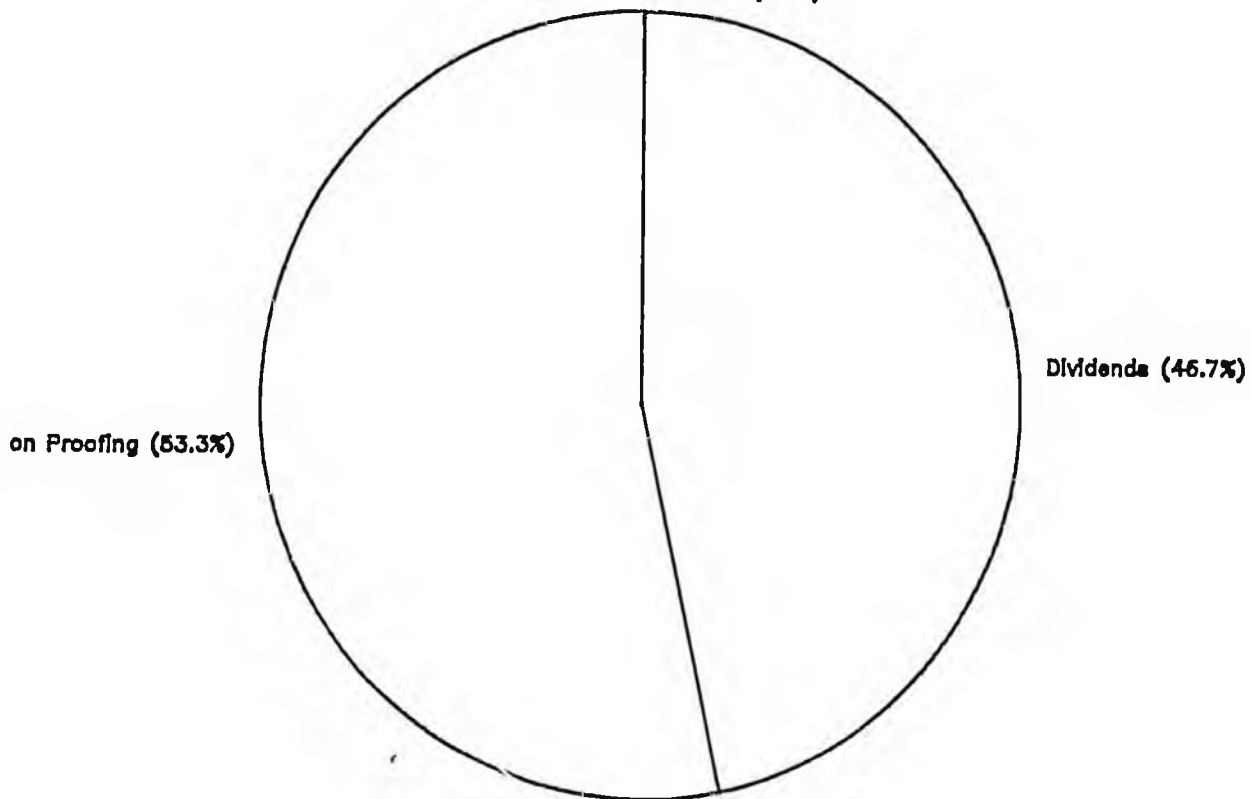
Permanent Fund: Distribution of Income

FY 78 - FY 88



Permanent Fund: Distribution of Income

FY 89 - FY 2005 PFD
Reserves (0.0%)

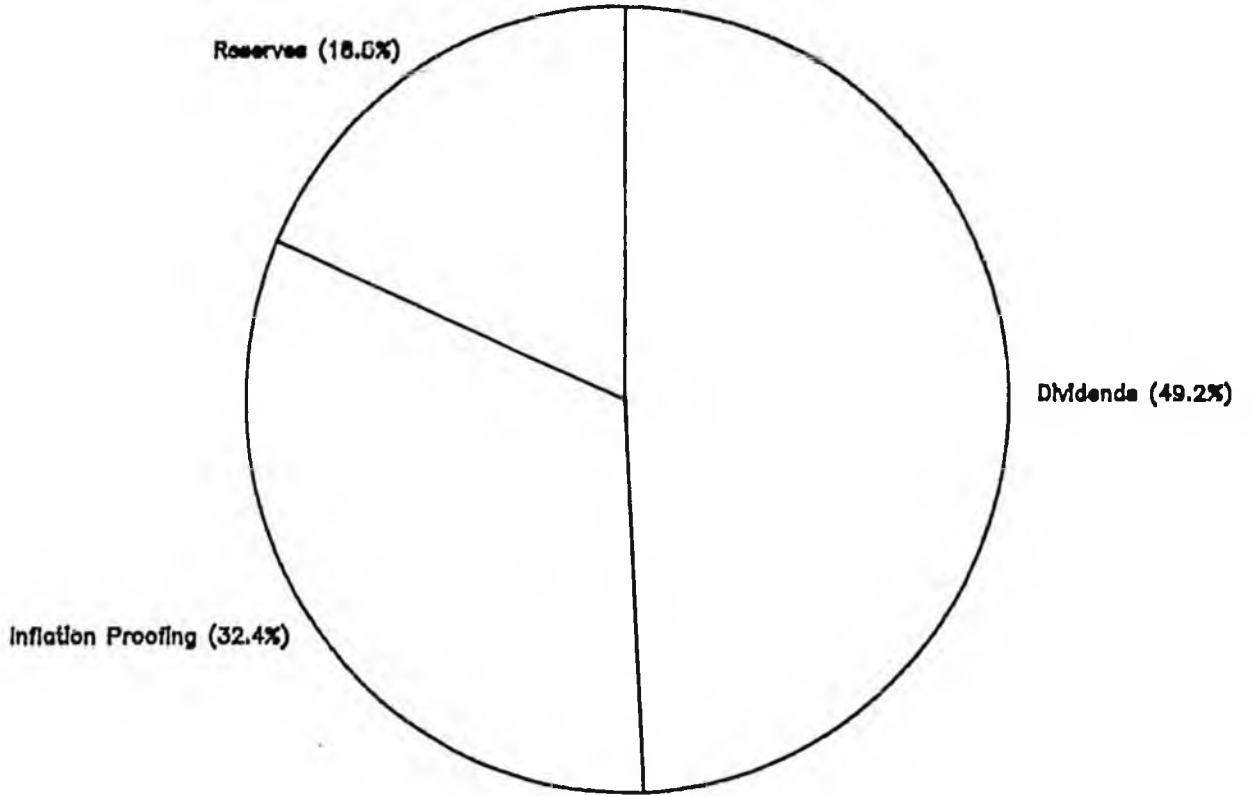


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	TOTAL RETURN	INFLATION	INFLATION AS A PERCENT OF TOTAL RETURN
DOR Low	8.15%	3.0%	37%
DOR Mid	9.6%	4.35%	45%
PFC	9.1%	6.0%	64%
GOVERNOR	10.5%	6.0%	57%

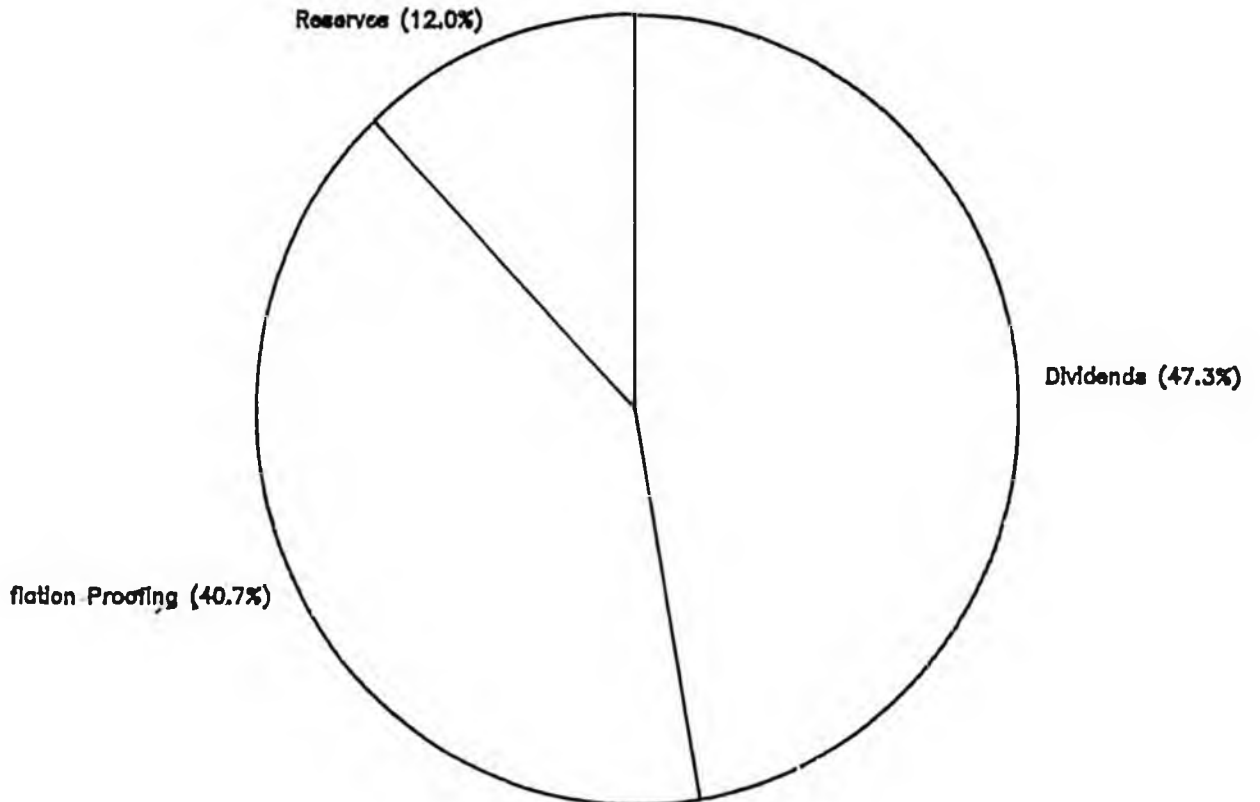
Permanent Fund: Distribution of Income

FY 89 - FY 2005 DOR low

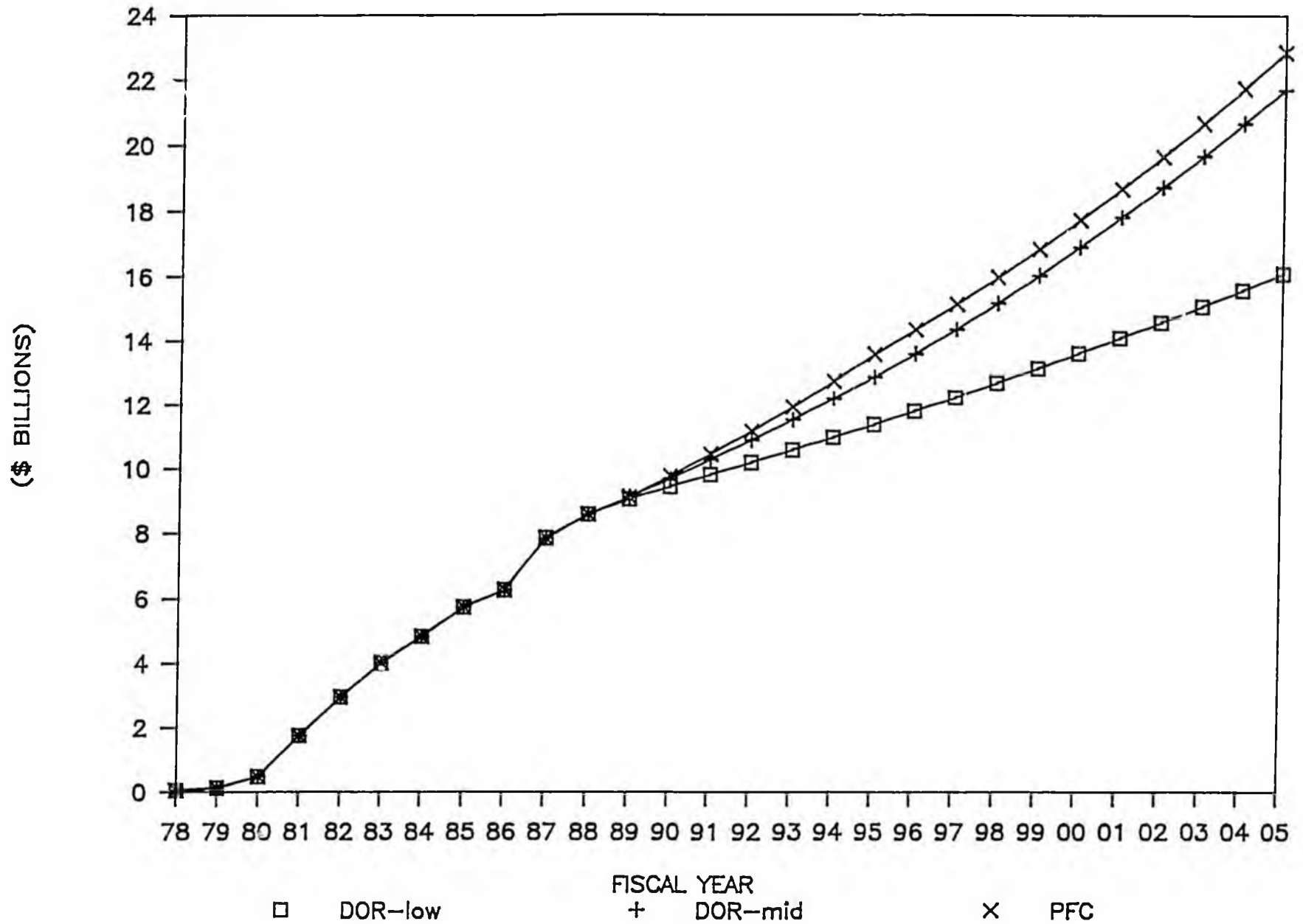


Permanent Fund: Distribution of Income

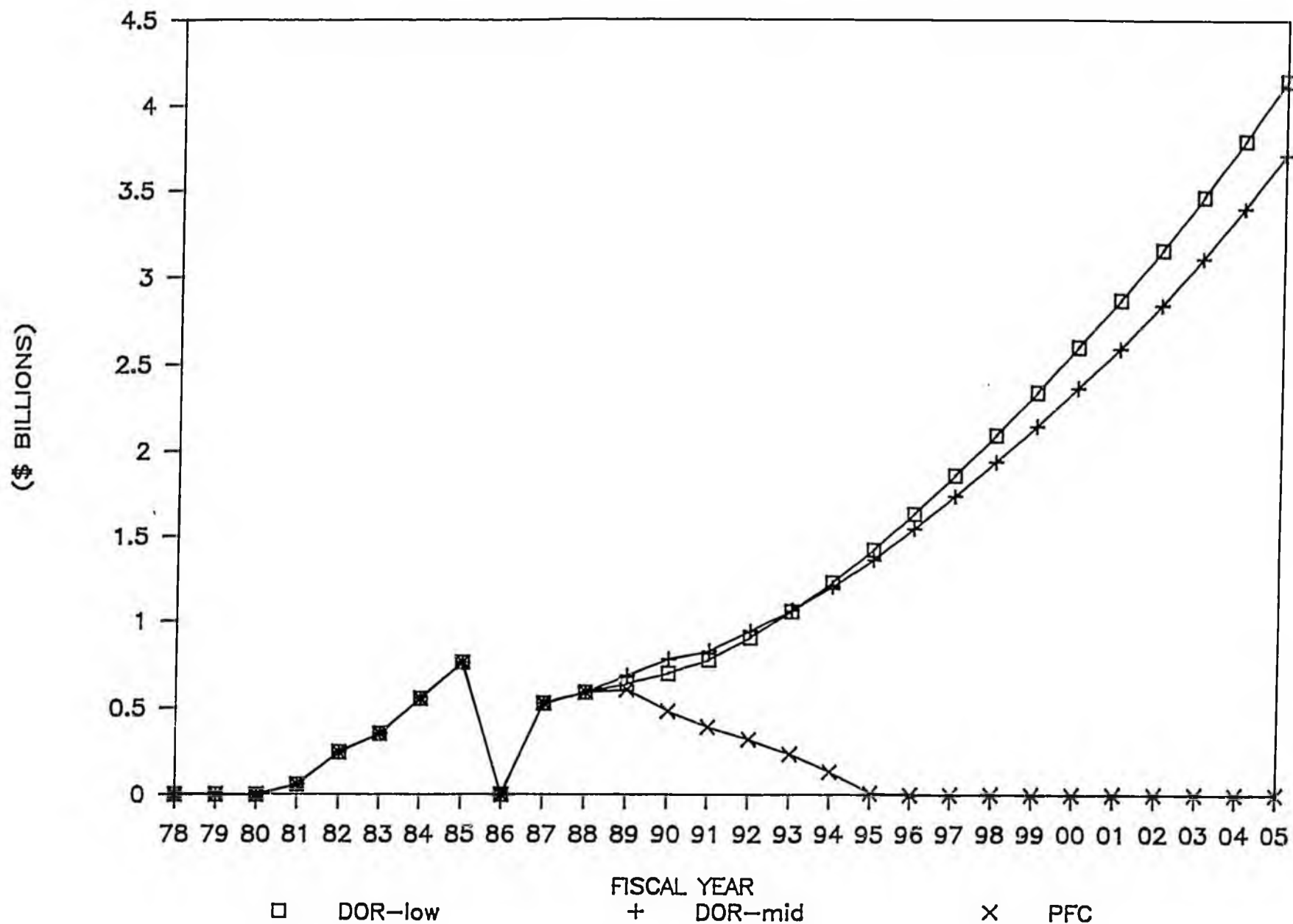
FY 89 - FY 2005 DOR mid



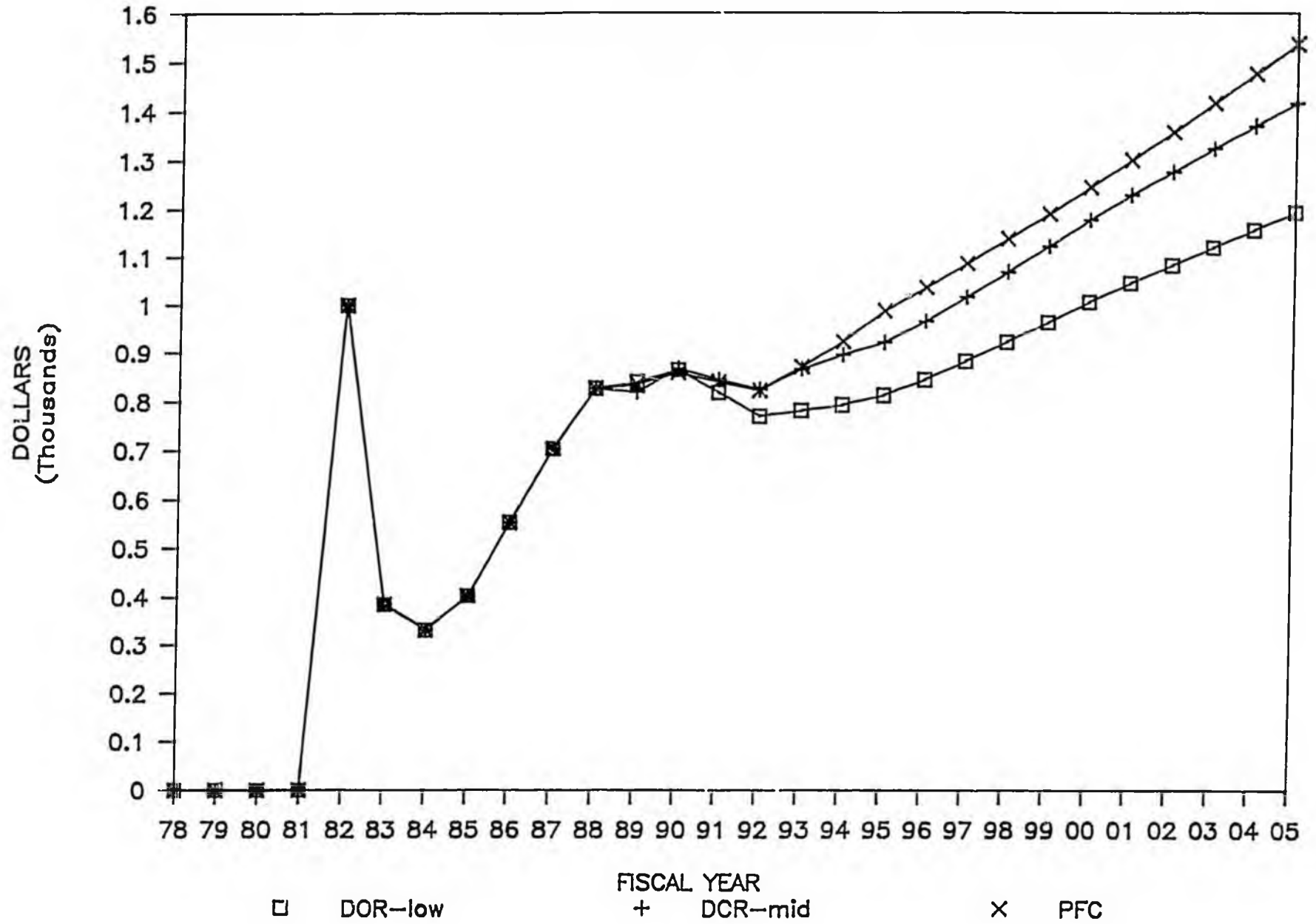
PERMANENT FUND BALANCE



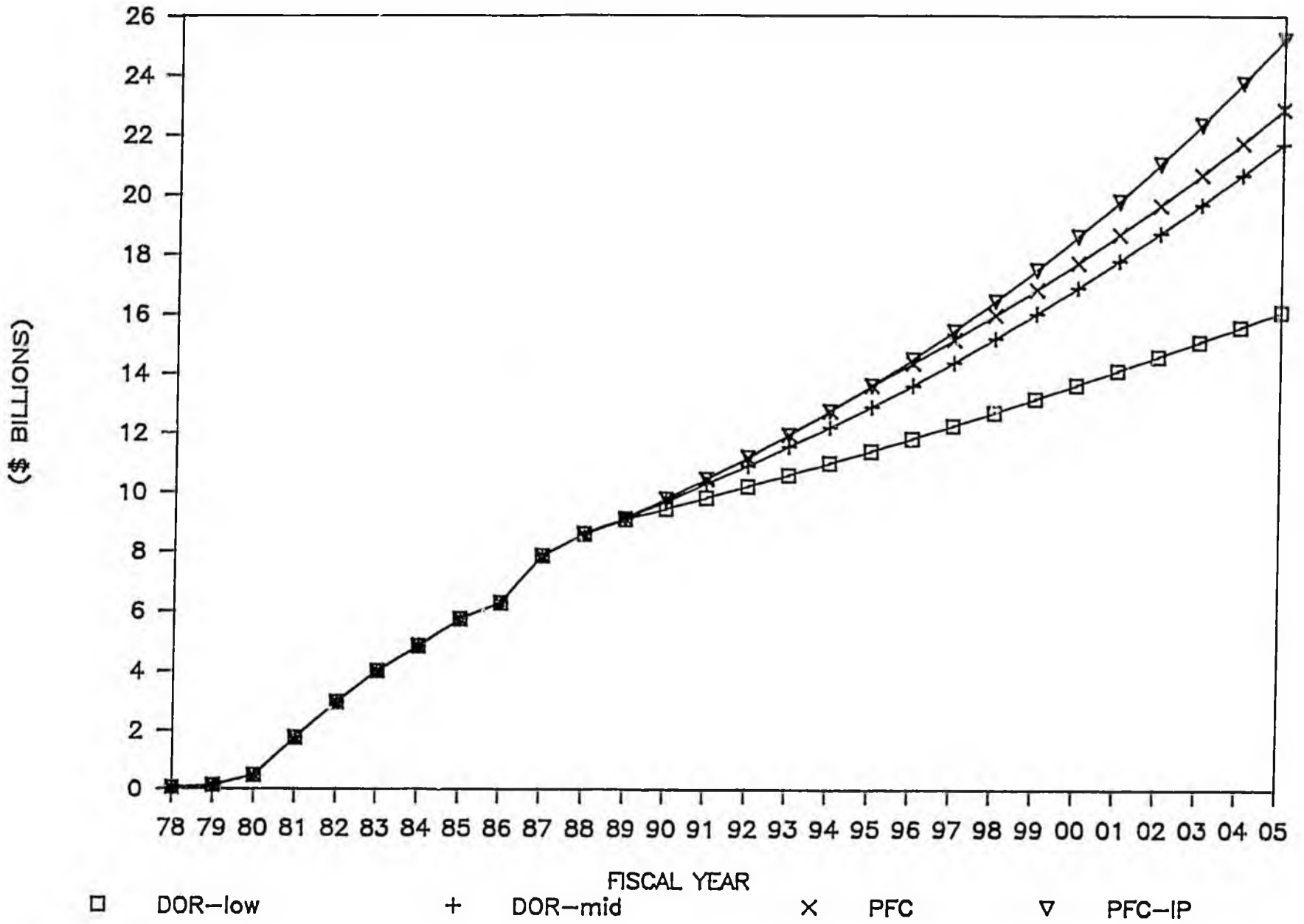
RESERVE BALANCE



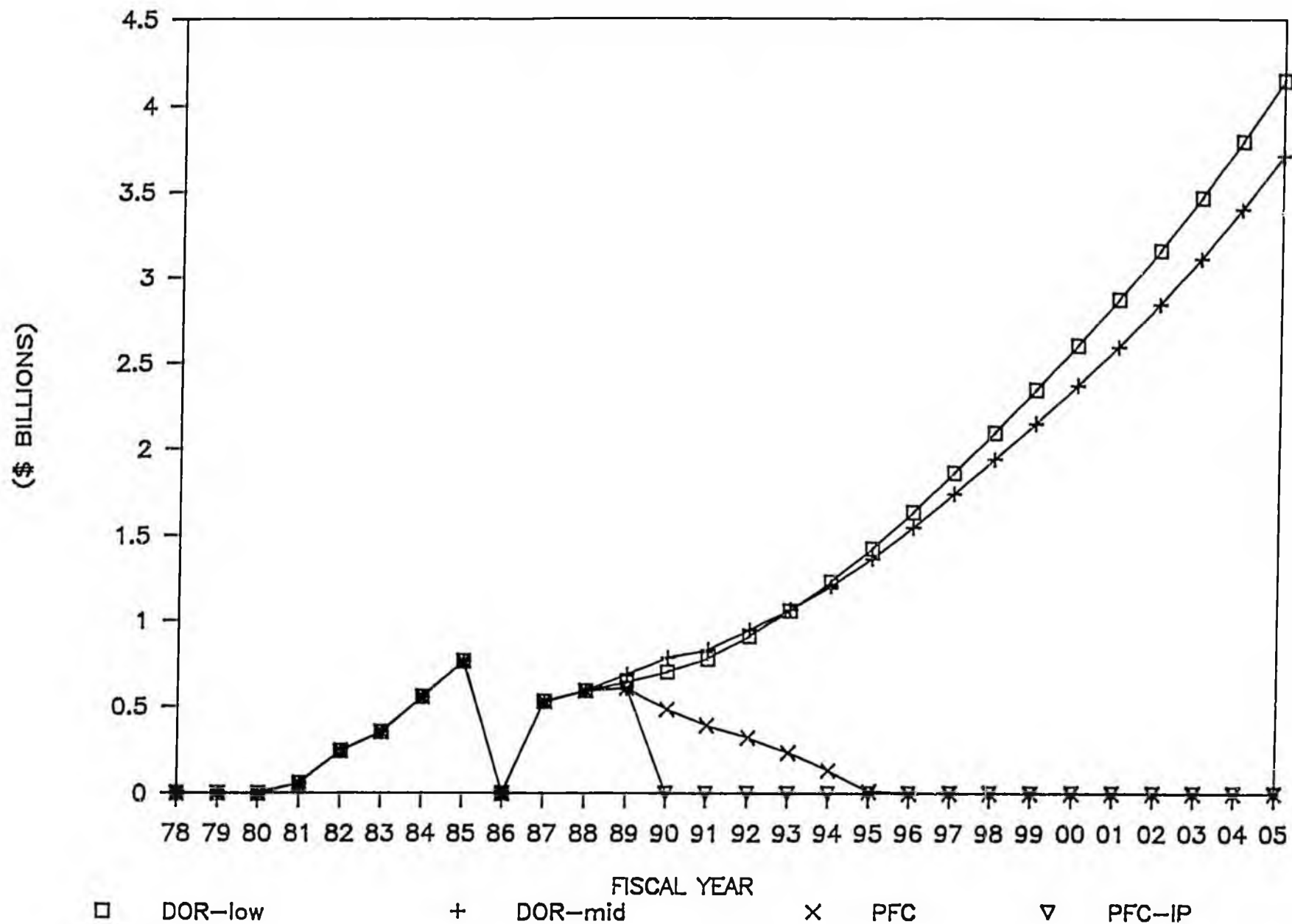
PERMANENT FUND DIVIDENDS



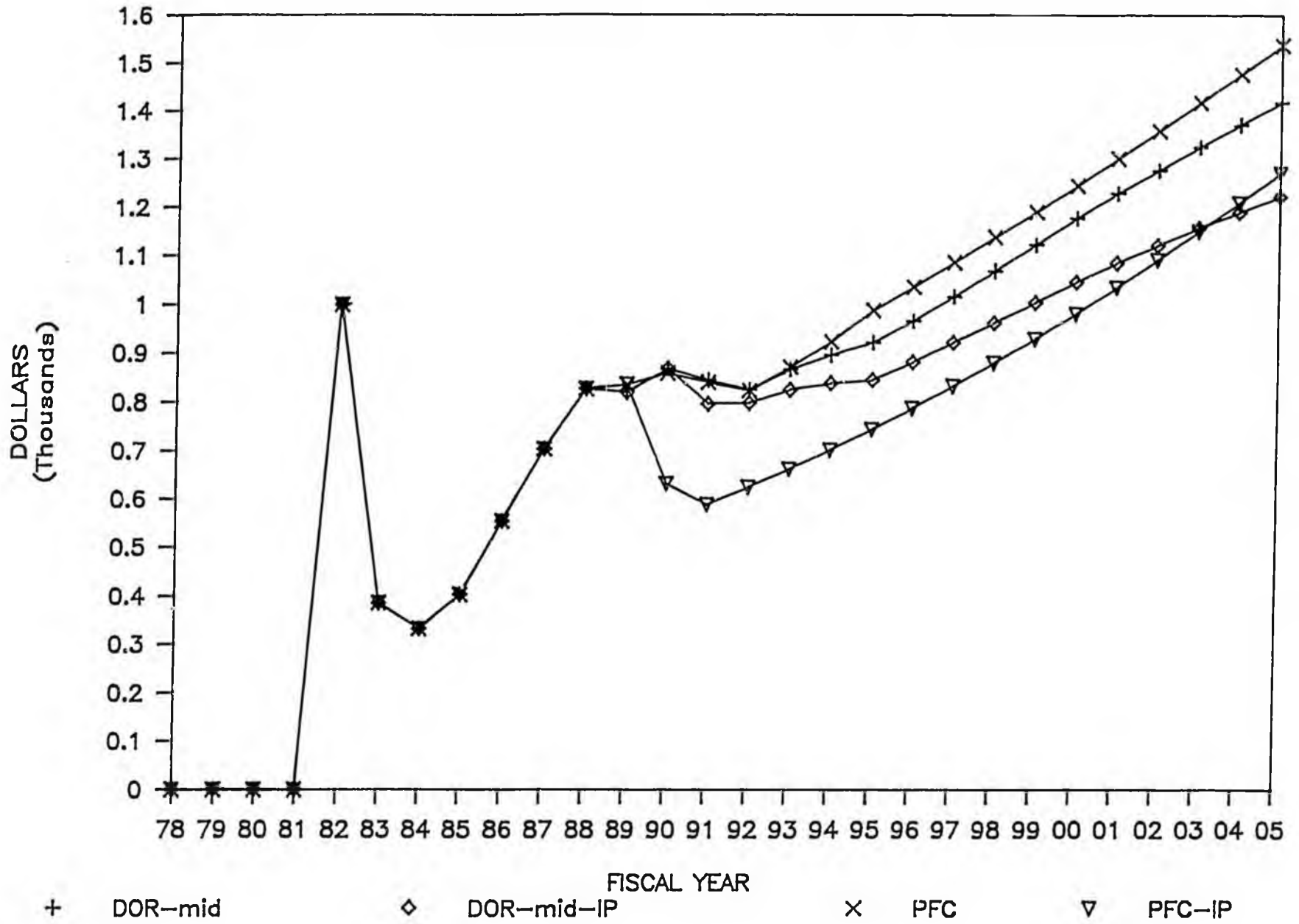
PERMANENT FUND BALANCE



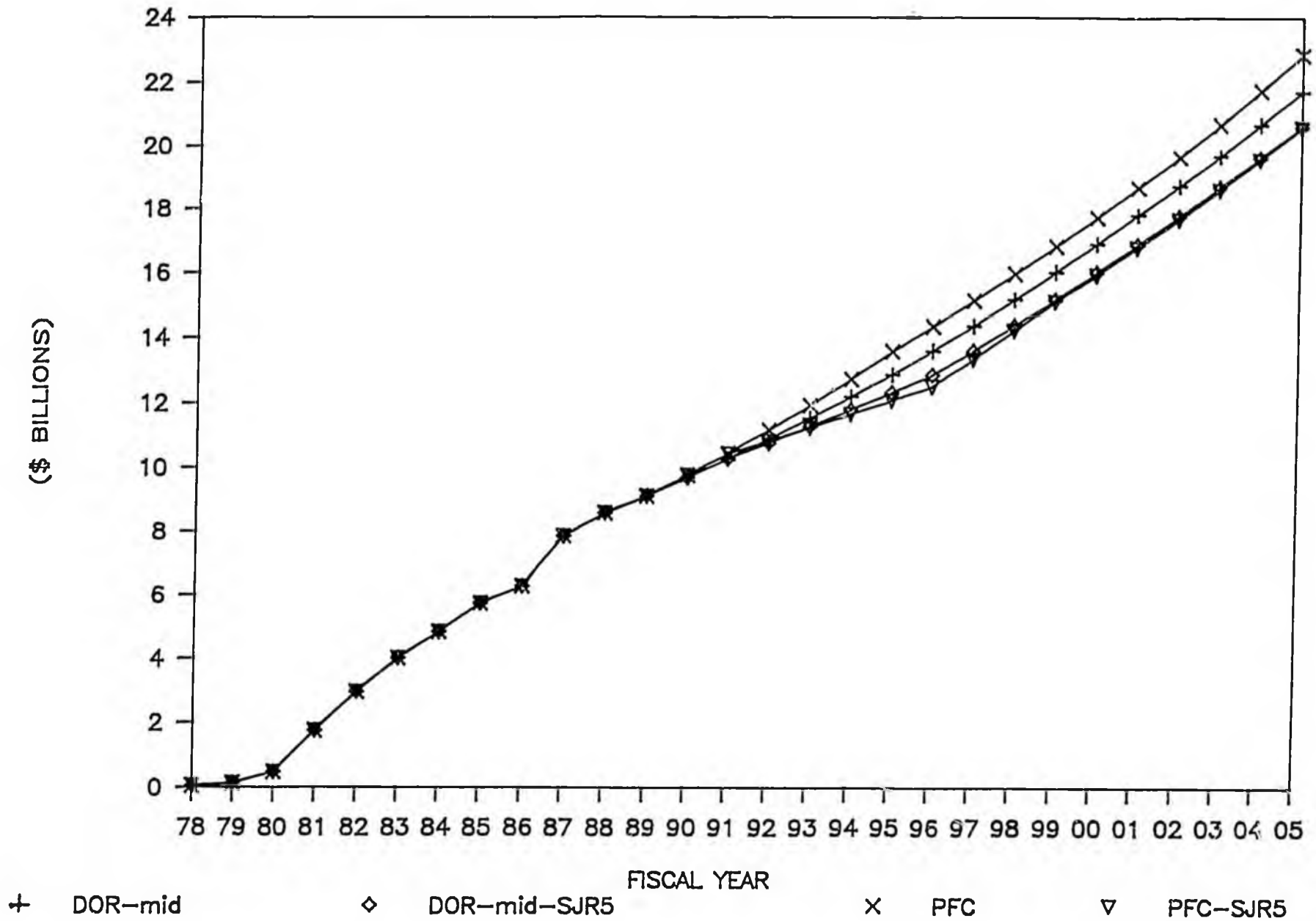
RESERVE BALANCE



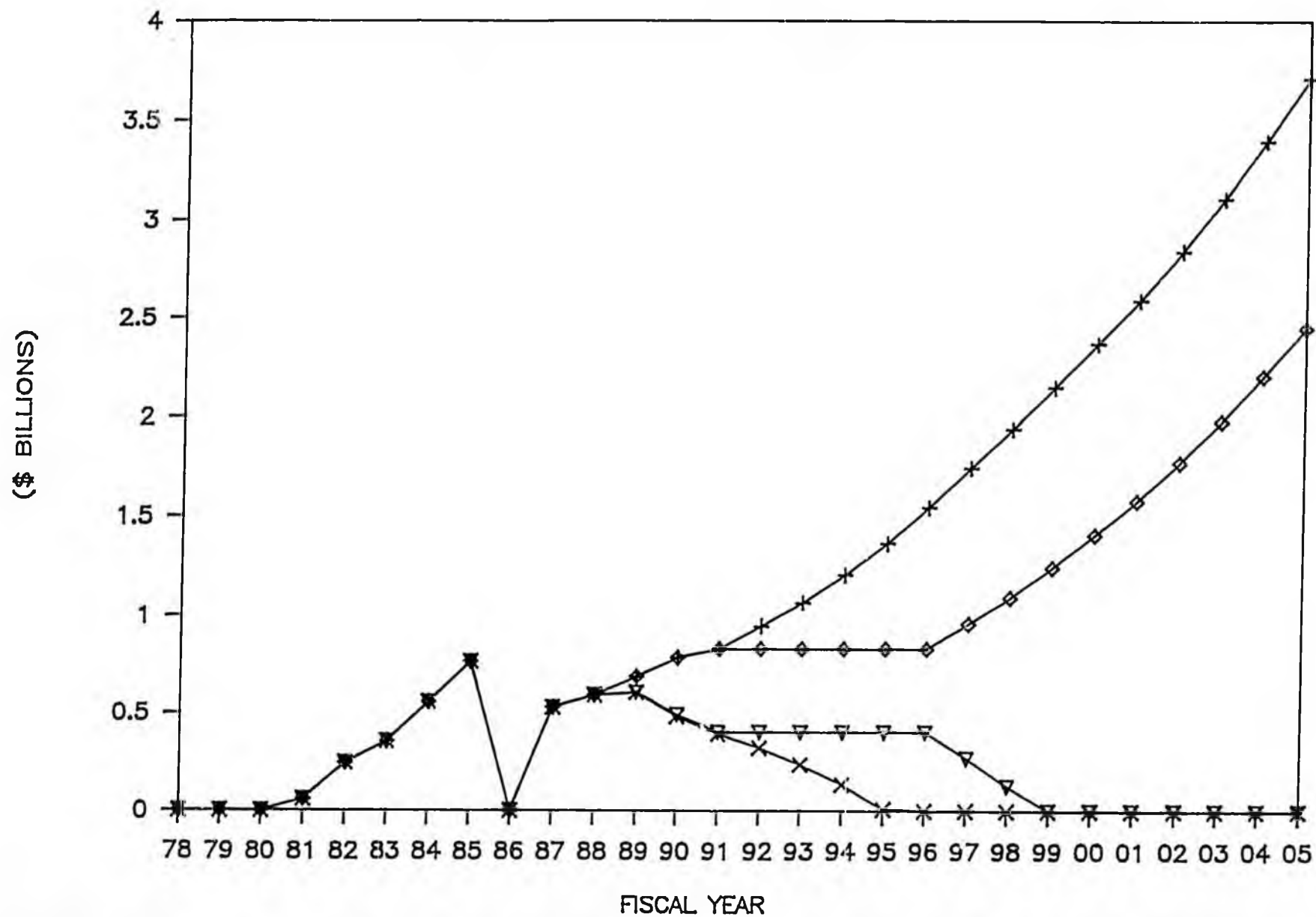
PERMANENT FUND DIVIDENDS



PERMANENT FUND BALANCE



RESERVE BALANCE



+ DOR-mid

◇ DOR-mid-SJR5

x PFC

▽ PFC-SJR5

PERMANENT FUND DIVIDENDS

