

HJR

26

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: 1
 Bill Version: CSHJR 26(W&M)
 (H) Publish Date: 5/2/03

Revision Date/Time (Note if correction): _____ Dept. Affected: Office of the Governor
 Title Constitutional Amendment limiting BRU Elections
appropriations from and inflation-proofing the APF.... Component Elections
 Sponsor House Rules Committee
 Requester House Ways and Means Component No. 21

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Personal Services						
Travel						
Contractual		1.5				
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	1.5	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF		1.5				
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	1.5	0.0	0.0	0.0	0.0

Estimate of any current year (FY2003) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

This figure includes the cost of providing information about this issue in the Official Election Pamphlet, as required by AS 15.58. If this measure requires the printing of an 8-1/2 by 18 inch ballot, the cost will increase by \$22.0.

Prepared by: Lauri Allred Phone 465-5347
 Division: Division of Elections Date/Time 4/18/03 11:46 AM
 Approved by: Laura A. Glaiser, Director Date 4/18/2003
 Agency: Office of the Lt. Governor, Division of Elections

FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: 2
 Bill Version: CSHJR 26(W&M)
 (H) Publish Date: 5/2/03

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
 Title: Constitutional Amendment: BRU Permanent Fund Corp
Permanent Fund Appropriations Component Permanent Fund Corp
 Sponsor: House Rules Committee
 Requester: House Ways and Means Component No. 109

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2003) cost: 0.0
 Check this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

HJR 26 would ask voters in the next general election whether to approve a constitutional amendment that would limit annual appropriations to no more than 5% of the average year-end market value of the fund for the preceding five years.

HJR 26 would not affect the budgeted costs to manage and invest the Permanent Fund, nor would it change the amount of income earned by Permanent Fund investments.

See the attached schedule for financial projections of the Fund comparing the "Status Quo" to a 5% percent-of-market-value (POMV) spending limit.

Prepared by: Robert D. Storer, Executive Director Phone (907)465-2047
 Division: Alaska Permanent Fund Corporation Date/Time May 2, 2003, 10 a.m.
 Approved by: Steve Porter, Deputy Commissioner Date 5/2/2003
 Agency: Department of Revenue



Alaska Permanent Fund Corporation
HJR 26 - Financial projection comparison of the Alaska Permanent Fund
under status quo versus POMV spending limit, beginning in FY05.

\$ millions

Status Quo	-----projected-----										
	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Total Return	-3.42%	7.38%	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%
Principal - end of year (after payouts)	22,348	23,268	24,149	25,057	25,988	26,937	27,910	28,899	29,899	30,918	31,956
Realized earnings reserve (after payouts)	633	398	648	1,102	1,581	2,028	2,446	2,886	3,358	3,865	4,487
Unrealized earnings reserve	(632)	118	610	960	1,232	1,468	1,708	1,929	2,135	2,332	2,434
Total earnings reserve - end of year (after payouts)	0	516	1,258	2,062	2,813	3,496	4,154	4,816	5,493	6,197	6,921
Total Market Value End of Year (after payouts)	<u>22,349</u>	<u>23,784</u>	<u>25,407</u>	<u>27,118</u>	<u>28,801</u>	<u>30,433</u>	<u>32,065</u>	<u>33,715</u>	<u>35,392</u>	<u>37,115</u>	<u>38,876</u>
Annual net income	(851)	1,620	1,775	1,897	2,026	2,152	2,275	2,397	2,521	2,647	2,776
Dividend (lump sum) - Status Quo	686 *	510	409	442	597	766	887	979	1,059	1,131	1,209
Transfer status quo Inflation-proofing (ER to principal)	102	590	612	635	659	683	707	732	758	783	810

* The APFC FY03 projected dividend, paid to Alaska citizens in October, 2003 is subject to available earnings reserve. The volatility in the stock market has taken earnings reserve to zero or below several times this fiscal year. If the earnings reserve balance is zero or negative on 6/30/03, no dividend distribution will be paid to the Department of Revenue.

POMV - 5% (beginning in FY05)	-----projected 5% POMV beginning in FY05-----										
	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Total Return			7.60%	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%	7.60%
Total Market Value End of Year (after payouts)		<u>23,784</u>	<u>24,581</u>	<u>25,429</u>	<u>26,307</u>	<u>27,186</u>	<u>28,078</u>	<u>28,978</u>	<u>29,881</u>	<u>30,795</u>	<u>31,717</u>
Annual net income			1,775	1,834	1,898	1,963	2,028	2,094	2,161	2,228	2,295
POMV Payout available for appropriation in lump sum			1,235	1,243	1,274	1,329	1,380	1,426	1,473	1,520	1,568
5 year average market value			24,706	24,854	25,480	26,576	27,608	28,526	29,463	30,409	31,363

Assumptions: Callan Associates 2003 Capital Market Assumptions, APFC 2003 asset allocation, Spring 2003 revenue forecast, financial statements through 3/31/03. All payouts are assumed to happen at fiscal year end, all dollar values in millions.

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: 3
Bill Version: CSHJR 26(FIN)
(H) Publish Date: 4/7/04

Revision Date/Time (Note if correction): _____ Dept. Affected: GOV
Title Constitutional amendment relating to and RDU Elections
limiting appropriations from and inflation-proofing APF Component Elections
Sponsor Rules
Requester House Finance Component No. 21

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Personal Services						
Travel						
Contractual	1.5					
Supplies						
Equipment						
Land & Structures						
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TOTAL OPERATING	1.5	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

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Mark this box (X) if funding for this bill is included in the Governor's FY 2005 budget proposal:

POSITIONS

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Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

This figure includes the cost of providing information about this issue in the Official Election Pamphlet, as required by AS 15.58. If this measure requires the printing of an 8-1/2 by 18 inch ballot, the cost will increase by \$22.0.

Prepared by: Leonard G. Jones Phone 465-3051
Division: Division of Elections Date/Time 1/16/04 9:06 AM
Approved by: Laura A. Glaiser, Director Date 1/16/2004
Agency: Office of the Lt. Governor, Division of Elections

ALASKA PERMANENT FUND CORPORATION

RESOLUTION OF THE BOARD OF TRUSTEES OF THE
ALASKA PERMANENT FUND CORPORATION RELATING TO A
CONSTITUTIONAL AMENDMENT LIMITING APPROPRIATIONS FROM
AND INFLATION-PROOFING THE ALASKA PERMANENT FUND
BY ESTABLISHING A PERCENT OF MARKET VALUE SPENDING LIMIT

RESOLUTION 03-05

Preserving the real value of the money deposited into the Alaska Permanent Fund ("Fund") over the long term has been a public policy priority of the Board of Trustees ("Board") since the original Board was appointed over 20 years ago. In response to the Board's concerns in 1982 about the effects of inflation on the value of the Fund, the legislature adopted statutory inflation-proofing that same year. That change has successfully protected (by statute) the principal of the Fund for the past 20 years. After several years of review, the Board believes it is now time for the People of Alaska to make another decision that would: 1) constitutionally protect the current purchasing power of the whole Fund (both principal and income) against inflation; and 2) improve the rules governing distributions from the Fund.

To accomplish these goals, the Board has examined the use by various large endowment and public funds of a formula approach to establish appropriate limits on the size of payouts from those funds. This formula approach, generally referred to as a "percent of market value" ("POMV") spending limit, is applied by those funds in a manner that assures that, on average, only *real* income of a fund (i.e. income *net of inflation*) can be spent, thereby assuring that the real value of the contributions paid into the fund will not be touched. Because a POMV spending limit would provide for distributions from the Fund that are

predictable and limited, the Board believes that its use is in the best interest of the Fund and of the people of the State of Alaska.

The Board further believes that the best way to implement a POMV spending limit methodology for determining a level of distributions from the Fund that is predictable and limited is to amend the constitutional provision that established the Fund (Article IX, section 15 of the Alaska Constitution). Providing for a POMV spending limit in this manner would assure all Alaskans that the real value of the contributions to the Fund will be preserved for all time.

At the Board's request, APFC staff has presented a draft constitutional amendment for further discussion by the Board which, if adopted by the people of the State of Alaska, would provide for the following:

1. an annual limit on appropriations from the Fund of up to five percent of the total market value of the Fund, averaged over a period of five years;
2. using a five year period that allows the legislature and the governor to know before a fiscal year begins the exact amount that will be available for distribution from the Fund;
3. Fund income is part of the Fund, rather than being subject to appropriation by the legislature, as currently provided;
4. assures that the current statutory earnings reserve account established by AS 37.13.145 becomes part of the Fund when the constitutional amendment takes effect; and
5. the current references to "principal" and "income" are removed, as POMV ensures protection of the principal over the long-term through a constitutional spending limit.

The Board believes that this approach effectively balances the goal of providing for an annual distribution from the Fund that is predictable and limited with the long-term goal of protecting the real value of contributions to the Fund.

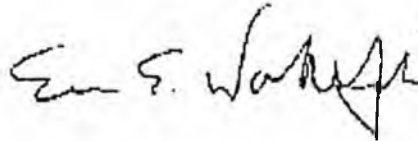
In addition, the Board believes strongly that implementing a POMV spending limit approach by constitutional amendment is such an important public policy goal that proposals for incorporating any other amendments to Article IX, section 15 which might in any way either lessen the chances of approval of such an amendment by the voters or undermine the legal status of the Fund should be rejected by the legislature.

Finally, the Board recognizes that implementation of a POMV spending limit methodology by constitutional amendment may necessitate changes to existing statutes that deal with the formula for determining and distributing the amount of the Fund that may be spent each year, including, but not necessarily limited to, payment of Permanent Fund Dividends and inflation-proofing the Fund. In anticipation of voter approval of a constitutional amendment providing for a POMV spending limit, the Board is hopeful that the legislature and the governor will work together to develop appropriate legislation to harmonize existing statutory provisions with the operation of the amendment and/or to adopt such new statutes as they may consider desirable. In this regard, the Board and APFC staff stand ready to provide any information or other assistance that may be helpful.

NOW, THEREFORE, BE IT RESOLVED by the Board of Trustees that the legislature of the State of Alaska, in consultation with the governor and the Board, are urged to consider and approve the proposal (dated 4/14/03) for a constitutional amendment that would implement a POMV spending limit mechanism that would provide an annual distribution from the Fund that is predictable and limited.

BE IT FURTHER RESOLVED by the Board of Trustees that the proposal for such an amendment be limited solely to implementation of the foregoing goal.

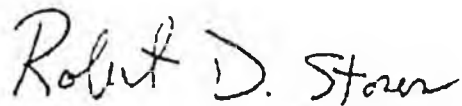
PASSED AND APPROVED by the Board of Trustees of the Alaska Permanent Fund Corporation this 14th day of April 2003.



Eric E. Wohlforth

Chair, Board of Trustees

ATTEST:



Robert D. Storer, Corporate Secretary

Methods to determine funds available for appropriation:

**Five key differences between the
Status quo and the proposed
Percent of Market Value (P.O.M.V.)**

A presentation by the Alaska Permanent Fund Corporation
to the House Ways and Means Committee
April 21, 2003



Five key differences between the status quo and POMV

1. POMV offers constitutional inflation-proofing protection of the entire Fund. The status quo statutorily inflation-proofs Fund principal.
2. POMV is a spending limit. It limits funds available for appropriations to real income over time. Under the status quo, the entire earnings reserve may be appropriated.
3. During volatile markets, POMV offers greatly improved stability in year-to-year amounts available for appropriation as compared to the status quo.



Differences between the status quo and POMV

4. POMV is compatible with the Fund's diversified, long-term investment strategy of achieving a 5% real rate of return over time. The status quo was designed a quarter century ago for a Fund invested 100% in bonds.
5. Predictable annual appropriations are provided under POMV. Under the status quo, it is not known whether funds will be available for appropriation in any given year.





Alaska Permanent Fund Corporation
HJR 26 - Financial projection comparison of the Alaska Permanent Fund
under status quo versus POMV spending limit, beginning in FY05.
\$ millions

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Assumptions: Callan Associates 2003 Capital Market Assumptions, APFC 2003 asset allocation, Spring 2003 revenue forecast, financial statements through 3/31/03. All payouts are assumed to happen at fiscal year end, all dollar values in millions.



Alaska Permanent Fund Corporation
 Calculation of annual effective rates of 5% POMV spending limit
 \$ millions

	<u>FY05</u>	<u>FY06</u>	<u>FY07</u>	<u>FY08</u>	<u>FY09</u>	<u>FY10</u>	<u>FY11</u>	<u>FY12</u>	<u>FY13</u>
Payout based on 5 year moving average	1,235	1,243	1,274	1,329	1,380	1,426	1,473	1,520	1,568
Ending market value (after payout)	24,581	25,429	26,307	27,186	28,078	28,978	29,831	30,795	31,717
Ending market value (pre payout)	25,816	26,672	27,581	28,515	29,458	30,404	31,354	32,315	33,285
Effective payout rate *	4.78%	4.66%	4.62%	4.66%	4.69%	4.69%	4.70%	4.71%	4.71%
	<u>FY05</u>	<u>FY06</u>	<u>FY07</u>	<u>FY08</u>	<u>FY09</u>	<u>FY10</u>	<u>FY11</u>	<u>FY12</u>	<u>FY13</u>
Payout based on 5 year moving average	1,235	1,243	1,274	1,329	1,380	1,426	1,473	1,520	1,568
less APFC costs to manage the Fund	38	39	41	42	43	44	46	47	49
5% available for spending after deducting APFC costs	1,197	1,203	1,233	1,287	1,337	1,382	1,427	1,473	1,520
Effective rate after deducting APFC costs *	4.64%	4.51%	4.47%	4.51%	4.54%	4.55%	4.55%	4.56%	4.57%
APFC costs to manage the Fund in %	0.16%	0.16%	0.16%	0.16%	0.16%	0.16%	0.16%	0.16%	0.16%

* Note: The effective rate is defined as the payout over the ending market value of the Fund (pre-payout) expressed as a percentage.

**Testimony before the
House Special Committee on Ways & Means
Clark S. Gruening
April 22, 2003**

Mr. Chairman and members of the House Special Committee on Ways & Means, thank you for the opportunity to discuss with you HJR 26, a proposed constitutional amendment for inflation-proofing the Alaska Permanent Fund.

Before speaking to how this proposal changes the way the Permanent Fund is inflation-proofed, I'd like to make some brief comments about how the Board came to recommend this change.

For 23 of the Fund's 27 years of existence, the APFC has been governed by a six-member Board of Trustees. Protecting the Fund against inflation has been the highest public policy goal of the Trustees since the original Board was appointed in 1980. The first Board testified to the legislature that the greatest threat to the permanence of the Fund is inflation. In response, the legislature adopted statutory inflation-proofing in 1982.

In more recent years, the Board has examined the use by various large endowments and public funds of a formula approach to determine the method and size of payouts from these funds. This approach is generally referred to as "percentage of market value" payouts or "POMV" for short.

The purpose of placing this formula in the state constitution is to protect the long-term real value of the Fund and to provide consistent and predictable distributions for the long-term. After considerable review and discussion, the Board recommended in February of 2001, a constitutional change in the form of

HJR 15 and SJR 13 which received committee hearings but did not come to the floor for a vote.

As in the prior proposal, the language in HJR 26 provides a spending limit on what can be currently spent or, in legislative parlance, appropriated. The existing constitutional language establishing the Alaska Permanent Fund only prohibits the appropriation of principal. In other words, anything but "principal" is income and can be spent.

Since the first Board of Trustees, 23 years ago, the Permanent Fund corporation has calculated principal as a notational number that simply equals the sum of the constitutionally mandated 25 percent of mineral deposits and the non-mandated (or voluntary) deposits the legislature has chosen to make. Principal does not vary or move up or down with the market.

Unlike the present statutory provision for inflation-proofing, HJR 26 provides for inflation-proofing of the entire Fund. But clearly, one of the most important reasons to support the proposal is that it would maximize distributions over the long term by establishing a percent of market value spending limit. By eliminating the distinction between principal and income, this proposal would also avoid the situation where market volatility on the down side prevents any distribution from the fund for any purpose, whether for dividends or anything else.

This is significant because since 1982, Alaska's fiscal picture has changed dramatically. The Alaska Permanent Fund can be reasonably expected to produce more future state revenue than any single Alaska resource – more than oil or natural gas, more than fishing or any other natural resource.

Whatever future decisions are made by the legislature or the voters regarding the use of Fund earnings, the five percent payout of market value limit will assure complete and protected inflation-proofing while providing predictable and sustainable distributions over the long term.

In managing Alaska's fishery stocks, the only sensible choice is to avoid taking too much of any fish stock so that, over the long term, the harvest is maximized. Of course, over-harvesting can reap short-term rewards of more fish, but the inevitable result is, at best, fewer fish, and at worst, permanent impairment or destruction of a fisheries stock. The same is true for managing distributions from a large investment fund like the Alaska Permanent Fund.

I want to close by emphasizing two key points regarding the Board's proposed constitutional amendment. The first point is that if Alaska is going to have a Fund that is truly permanent, we must take those steps necessary to ensure permanence. This means investing for future generations as well as current generations. This will require commitment to basic principles of long-term investing.

But the critical flip side of a sound long-term investment strategy is a sound, sustainable, and predictable distribution plan – a plan that will sustain and provide benefits to each generation of Alaskans.

The second and last point I want to leave you with is that if the Permanent Fund is going to continue to serve each generation of Alaskans it has to be able to make distributions so that current generations receive some benefit while not

"over harvesting" the fund so that there is little or nothing left for future generations.

We all want to avoid, at all costs, defaulting to the position where the Constitutional Budget Reserve (or "CBR") is today. Within the next three to four years, the CBR is destined for extinction. As the investment horizon of the CBR steadily shortens, it will be necessary to keep the assets of the CBR in very short-term and less-profitable investments.

I believe that as the day of the CBR's demise grows near, the Trustees and staff of the Fund may have to seriously consider a shorter investment horizon for a significant portion of the Fund.

So, whether we liken the Alaska Permanent Fund to a resource industry like Alaska's fisheries, one thing is clear: the Alaska Permanent Fund can continue to import significant new money into our state year after year.

Properly invested and protected, the Alaska Permanent Fund will successfully convert the non-renewable petroleum wealth of our State into a permanent and substantial stream of revenue for generations after the last barrel of oil has been pumped.

Legislative passage and voter approval of the Board's proposed amendment would protect the ability of the Fund to be managed for the long-term and to continue to pour money into the Alaska economy over the long-term.

The proposed constitutional change before you in the form of HJR 26 is more compatible with the Fund's diversified, long-term investment strategy of achieving a five percent real rate of return over time. The present constitutional

language was designed over a quarter century ago for a Fund that was invested 100 percent in bonds.

I believe that succeeding generations will rightly view this proposed amendment with the same degree of appreciation and admiration as the original one Alaskans overwhelmingly approved 27 years ago. The Trustees believe that this proposal for complete and protected inflation-proofing makes ultimate good sense for Alaska's Permanent Fund and for Alaska's future.



**Alaska Permanent Fund Corporation
Analysis of House Joint Resolution (HJR) 26
March, 2004**

OVERVIEW

The Resolution proposes changes to the Alaska Constitution Article IX, Section 15, which governs the Alaska Permanent Fund. The latest version of the Resolution is CSHJR 26 (JUD).

SUMMARY OF CHANGES

- 1) Page 1, line 10. Adds a reference to the new subparagraph (b) being added to the constitution.
- 2) Page 1, line 11. Removes the words "the principal of which" from the constitution. This change removes the distinction between the principal and the earnings reserve. The Fund becomes one pool of money versus two.
- 3) Page 1, lines 13 & 14. Deletes the guidance for where income of the Fund should be deposited. The intent is for all income to remain in the Fund until appropriated by the Legislature.
- 4) Page 2, lines 2 - 4. Adds a new subparagraph (b) that establishes an annual payout limit of 5% of the total market value of the Fund. The market value will be based on a five-year average. This is to protect the Fund from inflation and preserve the real value over the long term. Additionally, this provision allows the legislature and the administration to know one year in advance the amount available for appropriation.
- 5) Page 2, line 7 - 10. Adds a transitional provision that makes clear the balance in the Fund's earnings reserve remains in the Permanent Fund. Some have argued that the earnings reserve belongs in the General Fund.
- 6) Page 2, lines 11 - 13. States that the amendments will be placed before the voters at the next general election.



Alaska Permanent Fund

House Finance Committee

A Fund overview and discussion of POMV

ACCOUNTABILITY

TO LEADERS FOR ALASKANS



"To benefit all generations..."

AS 37.13.020 (1)

...the Fund should provide
a means of conserving a portion
of the state's revenue from mineral resources
to benefit all generations of Alaskans.

ACCOUNTABILITY

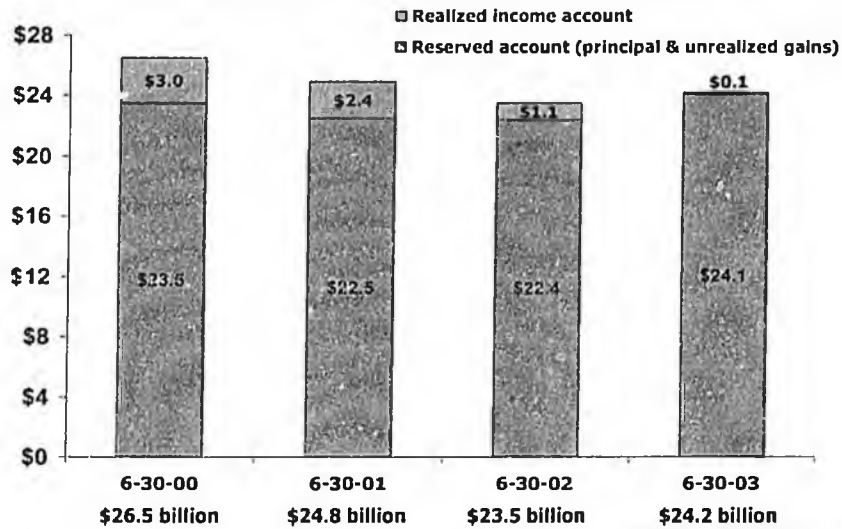
2

TO LEADERS FOR ALASKANS



Permanent Fund market value

Four-year change in realized and reserved accounts

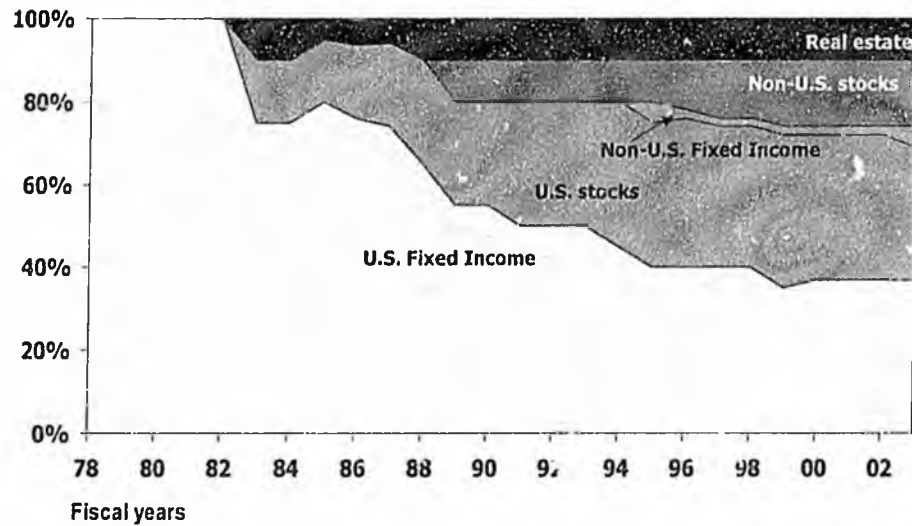


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Fund's historical asset allocation



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Trustees' proposal

The APFC Board of Trustees propose
a constitutional amendment
to limit annual fund spending
to five percent
of the Fund's total market value.

POMV

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What is POMV?

POMV, or "Percent of Market Value," is a formula that
limits spending to a set percent of a fund's total market value.

The set percent is based on the expected difference between
total annual return on investments and the rate of inflation.

8% projected average annual return

-3% projected average annual inflation

5% maximum annual sustainable payout

retained in the Fund for inflation proofing

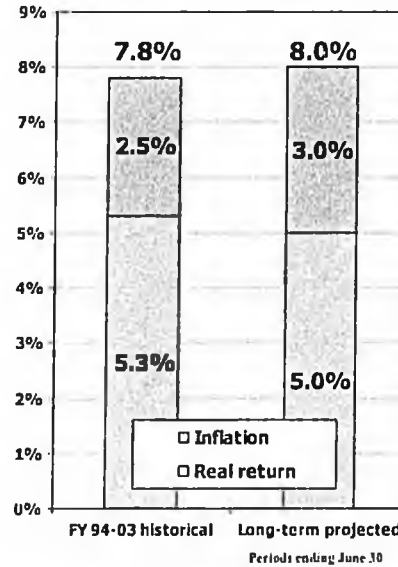
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Fund performance

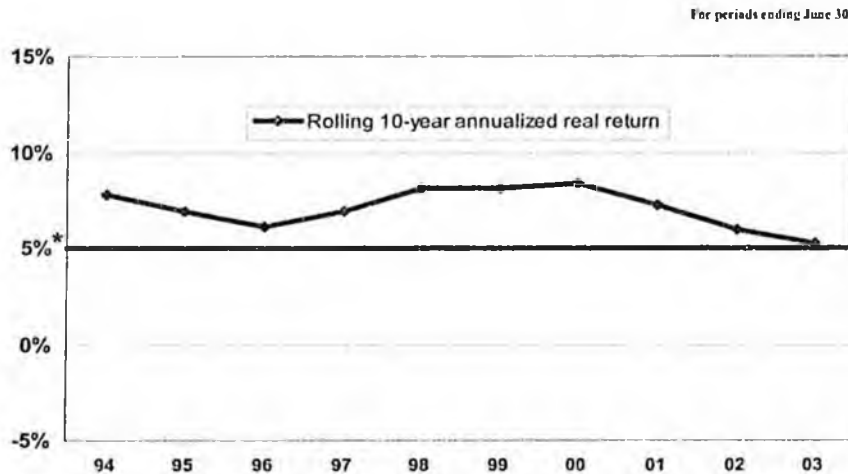
- Historically, Fund returns would have hit their long-term real rate of return target.
- Fund returns going forward, after adjusting for inflation, are expected to meet the target payout rate over time.



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Rolling 10-year real return



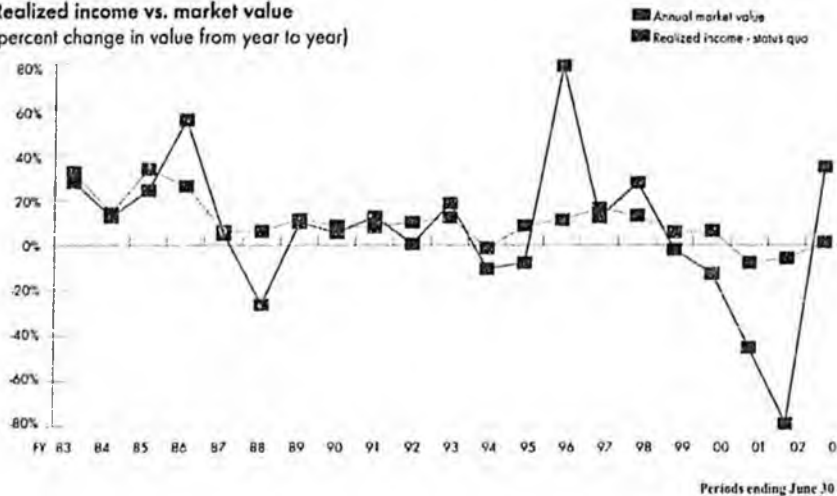
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Realized income v. market value

Volatility

Realized income vs. market value
(percent change in value from year to year)



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Why do we need POMV?

For the present

- Ensure the option of an annual payout
- Make payout amounts more stable from year to year
- Make payout method compatible with investment strategy

For the future

- Prevent overspending in the good years
- Maintain purchasing power for the entire Fund

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What are Alaskans asking?

- **Will this change leave the principal unprotected?**
- **How will POMV affect my dividend?**
- **Is POMV a raid on the Permanent Fund?**
- **Why fix the Permanent Fund if it isn't broken?**

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ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE



Division of Legislative Finance

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MEMORANDUM

DATE: February 17, 2004
TO: Senator Lyman Hoffman
FROM: David Teal, Director
SUBJECT: Potential Impact of POMV on Dividends and Government Operations

Some time ago, we discussed the impact the Percent of Market Value (POMV) approach to managing the Permanent Fund might have on Permanent Fund Dividends (PFDs) and the state's fiscal gap. As you know, the POMV plan proposes an annual payout of up to five percent of the market value of the Permanent Fund but does not specify how that payout would be divided between dividends and government operations. I suggested that the split between uses did not have to be set in concrete; in fact, POMV did not require any change in calculation of the dividend. You asked me to describe the impact POMV might have on dividends and government operations.

The issue is less technical than philosophical. A guarantee that the legislature will follow the plan appears to be the key goal of POMV proponents. The POMV approach could be implemented by statute rather than by Constitutional amendment, but only a Constitutional amendment can guarantee the results desired by proponents of the plan. The desired result appears to be growth (not merely protection of the existing balance) of the Permanent Fund. Legislative Finance cannot answer the philosophical questions associated with a change to POMV, but we can discuss the technical impact. From a budgetary perspective, analysis of proposals affecting the Permanent Fund boils down to three questions

1. What happens to the Earnings Reserve account?
2. What happens to PFDs?
3. What happens to the fiscal gap?

Although the POMV proposal appears simple, each of the above questions raises some complex points to consider.

1. What happens to the Earnings Reserve Account (ERA) under POMV?

Future Earnings—under existing statutes, earnings accumulate in the ERA and are used for dividends and inflation proofing. Surplus earnings (that is, the remaining balance of the ERA) are available for appropriation for any purpose. Under POMV, Permanent Fund earnings would remain in the Permanent Fund and would not be available for appropriation except as discussed below.

The Balance—under POMV, the ERA will no longer be available as budget reserves because the account will be merged with Permanent Fund principal and the only money that can flow from the Permanent Fund is the 5% annual payout. The ERA balance would not be available to reload the Constitutional Budget Reserve Fund or otherwise fill the fiscal gap.

Limiting access to future earnings and the ERA balance has huge implications. The Permanent Fund would cease being a Trust with untouchable principal and would become an endowment. Fund principal would be less protected under POMV than under the Trust approach.¹ Endowment principal might be subject to erosion under POMV, but proponents of POMV appear willing to trade that protection for a probable increase in Fund growth.

The Permanent Fund Trustees refer to POMV as a management tool. POMV appears to have less value as an asset management tool than as a tool to enlarge the Fund. As the fiscal gap grows and the CBR shrinks, the Fund Trustees undoubtedly perceive the ERA as endangered because it offers one of the few viable means of filling the fiscal gap. The key to Fund growth under POMV is that earnings in excess of 5% of market value would not be available for appropriation, but would remain in the Fund.

Inflation Proofing—under existing statute, inflation proofing is appropriated from the ERA to principal. Under POMV, earnings in excess of the payout can be considered inflation proofing. Inflation proofing under POMV could be substantially higher than under the current system because the market value of the entire Fund (not just principal) will be inflation proofed and any “extra” earnings beyond the payout remain in the Permanent Fund as inflation proofing, regardless of the actual rate of inflation.

From the Fund’s perspective, inflation proofing may be a more important issue than the disposition of the ERA; inflation-proofing transfers under existing statutes are far larger than the expected share

¹ Footnote added March 16, 2004. Any Trust that invests in equities is subject to loss of principal (because equities can lose value). This discussion applies to *appropriation* of principal. No money can now be appropriated from the Permanent Fund itself. Under POMV, principal could be appropriated from the Fund. The implications are more theoretical than practical; no principal will be lost under Trust or Endowment if investment returns are within historical norms.

of POMV payout that would be available for government operations. If the fiscal gap can no longer be filled with draws from the Constitutional Budget Reserve Fund (CBR), there will be increased pressure to use the ERA to fill the gap. At some point, it will be argued that simultaneously adding to the Fund (via inflation proofing) and removing money from the Fund (for government operations) makes little sense.

Discontinuing (or reducing) inflation-proofing appropriations is the most painless means available to obtain money to fill fiscal gaps. Reducing inflation proofing would make money available for government operations while removing no money from the economy (as increased taxes or reductions of PFDs would do).

Arguably, the legislature has vastly over-inflation-proofed the Fund by making large transfers from the ERA to principal when ERA balances were high. About one third of the market value of the Fund is attributable to these special deposits.

No inflation-proofing appropriation is necessary under POMV. By making inflation proofing automatic (and self-adjusting to "grab" all earnings in excess of the 5% payout), POMV protects the Fund (more accurately, protects *growth* of the Fund) by eliminating an attractive tool for filling future fiscal gaps.

2. What happens to PFDs under POMV?

The key point regarding PFDs is that any reduction in the Permanent Fund balance (including the ERA) reduces future dividends. This applies to use of earnings for any purpose other than inflation proofing (which simply moves money from the ERA to principal). As Fund balances are used, market value and future earnings potential decline, reducing the amount available for funding future PFDs.

If we replace the current dividend formula with a fixed split of the 5% payout, dividends would not necessarily be lower than under the current method of calculation. The amount of dividends would, of course, depend on the split between dividends and government operations. Returning to the key point: any portion of the payout used for government operations would reduce future dividends (relative to a scenario in which Fund earnings are used only for dividends and inflation proofing).

Stopping this decay of dividend payments would require that a growing share of the total payout go to dividends. Unfortunately, a growing fiscal gap and a shrinking share of the payout available for government operations would make POMV an uncertain means of filling the fiscal gap.

The more likely scenario is that filling the fiscal gap would become the driving force in decisions regarding use of the payout; there would be pressure to use an increasing share of the payout for government operations as the size of the gap increases. The most obvious way to reduce this pressure is to specify provisions for the dividend in the Constitution.

In any case, the issue is not so much a technical problem as a political and a marketing issue. The marketing aspect is important because public acceptance of POMV may depend on how the public perceives the proposal's impact on dividends.

The marketing aspect of dividend calculation prompted the suggestion that the current formula for computing dividends could be retained under POMV. The statutory formula simply specifies that about half of average realized net income may be used for dividends. POMV would not affect the ability to calculate this amount. Note, however, that POMV might limit the ability to pay the calculated dividend, just as existing law limits the dividend to the balance of the ERA.

The advantage to retaining the current formula is that doing so would end arguments about how (and how fairly) the payout would be split between dividends and government operations. The dividend would be calculated exactly as it is now, and the portion of the 5% payout not used for dividends would be available for government operations. Higher Permanent Fund earnings would generate higher dividends (taking a larger share of the 5% payout) while poor earnings would reduce dividends and leave more of the payout for government operations. If earnings were very high, the dividend calculation could produce an amount that exceeds the 5% payout. In that case, dividends would consume the entire payout.

A variable split of the POMV payout would provide a less stable cash flow for government operations than would a fixed split. Variability is not a particularly severe problem; the variations would be fairly predictable and pose no fiscal problem if the Constitutional Budget Reserve Fund held balances sufficient to absorb the variability.

When considering the option of retaining the existing dividend formula, it is important to differentiate between the *formula* and *money-in-pocket*. Retaining the formula is no guarantee that dividends won't change. Returning again to the key point: using the current formula *will* reduce dividends if money is diverted from the Fund balance (because a lower balance will generate lower earnings). Although POMV by itself does not divert money, the proposal is being marketed as a partial solution to the fiscal gap, implying that some money would be used for government operations.

3. What happens to the fiscal gap under POMV?

There can be no certain answer to this question until all elements of the plan are clearly specified. The fiscal gap was discussed above, but there are a few more points to ponder.

The impact on the fiscal gap depends on how much of the POMV payout goes to the general fund and how much to dividends. It appears unlikely that the payout will be sufficient to fill future fiscal gaps completely if current dividend levels are retained.

If inflation is higher than the real rate of return on Fund investments, the "payout of up to five percent of market value" clause becomes interesting. There may be some pressure to appropriate less than 5% of the market value if a full payout meant less-than-full inflation proofing. This would leave less money to fill the fiscal gap.

- POMV would affect access to the Constitutional Budget Reserve Fund (CBR). The primary reason simple majority access to the CBR has not been a viable option in most years is that a large ERA balance makes the simple majority trigger conditions impossible to meet. By eliminating the ERA and providing a relatively stable flow of revenue available for appropriation, POMV greatly increases the probability of filling the fiscal gap with a simple majority vote to access the CBR.
- POMV's primary impact is enhanced protection of growth of the Permanent Fund. All of POMV's impact on dividends, inflation proofing, and the fiscal gap can be accomplished without a Constitutional amendment.

Summary

The bottom line is that POMV is a promising option for those who want to ensure continued growth of the Permanent Fund, particularly for those who are convinced that the ERA and/or inflation proofing are endangered by the continuation/growth of the fiscal gap. POMV is less attractive to those who prefer maximum flexibility to use Permanent Fund earnings to fill the fiscal gap. Retaining the current dividend formula under POMV may be a useful marketing tool, but may be somewhat disingenuous if the purpose is to make people believe that retaining the formula is equivalent to retaining the same level of dividends. Any use of Fund earnings for government operations will reduce future dividends.