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The Sad Case of Alaska**

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For many, sustainability has become the overriding concern when evaluating economic performance. While seldom defined with operational precision, the general principle behind economic sustainability seems to be avoiding any decision that benefits the current generation at the expense of future generations. According to the World Commission on Environment and Development, "The most commonly-cited definition of 'sustainable development' is: Development that meets the needs of the present without compromising the ability of future generations to meet their own needs."¹

Most people would agree with the sentiment that economic sustainability appears to embrace. And if the advocates of sustainability contented themselves with broad statements of their concern for the future, few would object. But those most vocally in favor of economic sustainability insist on being specific about what they see as the major threat to sustainability and the appropriate means for overcoming that threat. With few exceptions, they see the threat as the greed and short-sightedness of the market economy, with political action required to promote the far-sighted concern that is the hallmark of economic sustainability. For ex-

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ample, in criticizing the market's discounting of the future, Vice President Al Gore approvingly quotes Herman Daly's statement, "There is something fundamentally wrong in treating the earth as if it were a business in liquidation."² Or consider the statement by Lester Milbrat, Emeritus Professor of Political Science at the State University of New York at Buffalo:

Markets are very poor in providing foresight to deal with future problems. . . . Markets typically fail to recognize [the finiteness] of supply if the current supply is plentiful and cheap. Markets . . . have perpetually undervalued the earth. This failure imposes on future generations the costs we blindly refuse to pay. Only collective political decisions can provide focus and direction for the myopic vision of markets.³

There are many such statements attesting to the widespread belief that economic sustainability demands that political decisions be substituted for market decisions. The popularity and persistence of this belief is surprising given the undeniable record of market economies in achieving not just economic sustainability, but economic growth. In market economies, the well-being of successive generations has been persistently improved, with well-being broadly defined to include longevity, leisure time, and environmental quality.

The success of market economies when measured against the objectives of sustainability is not only easily observed, it is readily explained. Private property rights and voluntary exchange, the two hallmarks of any market economy, have been increasingly recognized by economists as essential for creating the information and motivation for people to appropriately take into consideration the future conse-

quences of their actions.⁴ And because political decisions are not guided by the incentives provided by private property and voluntary exchange, there is little basis for believing that political action outperforms market action in highlighting the importance of the future. Indeed, both the insights of economic analysis and the evidence, strongly suggest that the goal of economic sustainability is poorly served by substituting political decisions for market decisions.

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This study considers an example of a state government that could have realized fiscal sustainability with a far-sighted approach to its natural resource endowment. The fiscal windfall that the state of Alaska received from North Slope petroleum presented the state government with a unique opportunity to realize a sustainable benefit from a nonrenewable natural resource. This opportunity has been squandered despite the dire and easily foreseeable consequences. Some efforts were made in Alaska to preserve the temporary oil wealth, but these efforts were more than offset by myopic incentives that exist in all political settings. Alaska's response to its oil revenue windfall should serve as a warning to those who see government action as the appropriate way of achieving sustainability in the use of our natural resources.

A Brief History

The discovery of oil at Prudhoe Bay on Alaska's North Slope in 1968 dramatically altered the state government's revenue picture. The first large infusion of Prudhoe Bay revenues to the state came from \$900 million in North Slope oil lease sales in 1969. The \$900 million bonanza (equivalent to \$2.9 billion in 1993 dollars) was five times the total state budget the year before.⁵

State spending nearly doubled between 1969 and 1971 and increased by 46 percent again in 1972 as the legislature began gearing expenditures to expectations of huge oil revenues once the Trans-Alaska Oil Pipeline was completed. Construction delays pushed the pipeline's completion date back several years, but rapid growth in government spending continued. To bridge the gap between current government spending and expected oil revenues, the state raised severance taxes on oil again and enacted a "reserves tax" in 1976 on holders of North Slope oil and gas leases which due to a rebate provision was really a forced loan from the oil companies.⁶

The Trans-Alaska Oil Pipeline was finally completed in 1977 and oil began flowing to the Valdez tanker terminal in July of that year. State revenues from royalties and yet higher severance taxes began to rise slowly at first, but when the Iranian Revolution pushed oil prices to over \$30 per barrel in 1980 (\$58 per barrel in 1994 dollars), state revenues increased dramatically. General fund revenue skyrocketed from \$1.1 billion in 1979 to \$4.5 billion in 1982. State spending out of the general fund also spiraled upward, growing from \$1.4 billion in 1980 to \$3.6 billion the following year. From 1981 through 1988 Alaska's state spending increased nearly 20-fold, with total state spending over this period amounting to \$34

billion, or about \$70,000 for each Alaskan resident.⁷

As oil revenues soared, the taxes paid by Alaskan residents plummeted. The individual income tax and several other state taxes were repealed in 1979-80. As a result, real taxes paid to the state by individual Alaskans after 1980 were only 14 to 16 percent of the real taxes they paid during FY 1976.⁸

In 1990, Alaska per capita state spending was almost four times the national average.

Alaskans also eased their tax burdens at the local level as state dollars flowed to schools and municipalities. By 1982, tax rates in boroughs throughout the state were 30 to 40 percent lower than they had been before the opening of the pipeline. The only exception was the newly-formed North Slope Borough, where property tax rates were increased by more than 50 percent since nearly all property taxes were paid by oil companies operating at Prudhoe Bay.⁹ Alaska's tax burden is ranked fifty-first, behind all other states and the District of Columbia.¹⁰

Since Alaskans pay only a small percentage of the taxes needed to finance government spending, there is little public opposition to government spending. It is easier for Alaskan politicians to increase taxes on the oil industry than to resist constituent demands for more spending. Taxes on the oil industry have increased eleven times since 1955. Currently Alaska's tax rates on oil producers are the highest in the United States.¹¹

With Alaska able to export almost all of its tax burden, it is not surprising that the state dominates the competition in per-capita state spending. In 1990, Alaska per capita state spending was almost four times the national average and nearly two-and-a-half times higher than that of Wyoming, its closest competitor. The additional per-capita spending in Alaska is far in excess of the amount that can be explained by the higher cost of living in Alaska.

The Path Not Taken

The magnitude of the fiscal windfall to Alaska provided the state with a unique opportunity to realize sustainable benefits from its natural resource endowment. The state could have increased total spending in response to the population growth motivated by the development of its petroleum resources and also guaranteed that the revenue from those resources continued to provide indefinitely for future generations of Alaskans. If the state government of Alaska had behaved in the far-sighted way that the most vocal advocates of sustainable growth believe government will, it would have saved enough of the temporary oil revenues to generate the interest income necessary to sustain state spending at generous levels.

The state did try to preserve some of its oil wealth, which everyone recognized as a temporary windfall. In response to a voter-approved amendment to the Alaskan constitution, in 1976 the state began depositing a portion of all mineral lease rents and royalties into what is known as the Permanent Fund. Special legislative appropriations helped fatten the fund, and by the end of 1993 the value of the Fund's investments totaled \$15.6 billion — roughly \$26,000 for each Alaskan citizen. Each year some of the Fund's earnings go to "inflation

proof" the principal and by formula most of the remainder is paid out to Alaska citizens as a "dividend." In 1993, each man, woman, and child who qualified as an Alaska resident (anyone who has lived in the state for at least one year) received a dividend check in the amount of \$949.46.¹²

However, a state government motivated by the concern of sustainability would have done much more to assure a secure fiscal future for Alaska. In 1967, the year before oil was discovered at Prudhoe Bay, per capita state spending in Alaska was 2.47 times the U.S. average. Adjusting for Alaska's higher cost of living, real spending per capita was still 1.6 times the national average.¹³ Consider a policy where, starting from this already high base, the state had allowed real per-capita spending to grow at a rate equal to the U.S. average through 1993 (adjusting for the year-to-year differences in the cost of living increases between Alaska and the rest of the United States), with the excess revenue having been deposited in Alaska's Permanent Fund. Assuming that this augmented hypothetical fund generated a rate of return equal to that of the actual Permanent Fund, the Fund would have contained \$66.7 billion by the end of 1993.¹⁴

Assuming that the hypothetical fund continues to earn an average real rate of return of 5.15 percent (as it has since it started earning interest in 1978),¹⁵ the real value of the hypothetical Permanent Fund of \$66.7 billion could be maintained indefinitely, with no net additions, with \$3.4 billion being spent each year to finance state spending. This amount is \$500 million (or 17 percent) more than the total state spending in 1993. If the state had not distributed the \$4.47 billion in annual dividend checks to Alaskan residents (which began in 1982), and put it in the Permanent Fund and allowed it to accumulate interest, the hypothetical fund

would have contained \$75.03 billion at the end of 1993.¹⁶ At an interest rate of 5.15 percent, this fund would be producing an annual revenue stream of \$3.9 billion.

In other words, in our completely possible hypothetical world, Alaskans could now be benefiting on a sustainable basis from lavish state expenditures without paying a single cent of state taxes! And our hypothetical exercise understates on two counts the opportunity the Alaska state government had to benefit from a policy of fiscal sustainability. First, the population figures used to determine the hypothetical spending levels are based on the actual population which surely increased in response to the larger actual state spending. Second, if state spending were financed entirely out of interest payments from the hypothetical Permanent Fund, all future revenues from the oil industry could be used to further augment that fund.¹⁷

Surely the program of fiscal sustainability just discussed would have done more to promote the long-run well-being of Alaskans than the program of fiscal depletion that has been the hallmark of Alaskan spending policy since the availability of the North Slope oil revenues.

Wasting Resources and Disregarding the Future

There is little evidence from Alaska's recent fiscal history that politicians are motivated by the ideals of sustainability. The Alaskan state legislature has spent most of the huge, but temporary, influx of state oil revenue catering to the short-run interests of organized interest groups. This political process has allowed the current generation of Alaskans to capture benefits at the expense of future generations by plundering much of the wealth of a nonrenew-

able natural resource. The almost total disregard that political decision-makers show for sustainability can be seen in just a few of the spending programs that have been funded in Alaska with the windfall from the oil tax.

The Alaskan state legislature has spent most of the temporary influx of state oil revenue catering to the short-term interests of organized interest groups.

Barley Boondoggle

The state of Alaska has spent more than \$50 million in an attempt to promote Alaskan barley farming. This money has gone for loans which were never repaid, and the construction of access roads, rail lines, hopper cars, and grain elevators, all designed to facilitate the transportation and storage of large quantities of barley which were never grown. And many of the Alaskan farmers who were taking money from the state to grow barley were double-dipping — simultaneously taking money from the federal government *not* to grow barley.¹⁸

First-Class Trip

Many public-school students in Alaska are treated to field trips that make the typical visit to the zoo as exciting as extra homework. The Bering Strait School District, for example, received a \$300,000 grant from the Alaska Department of Education in 1980 as part of an "adventure based" education program. This grant was used to finance a tour of Europe for high-school students. The \$88,414 cost of travel was expensive, but the largest expense was the \$106,034 paid to "specialists" in ad-

venture-based education who arranged the trip and accompanied the students to Europe.¹⁹

Sour Milk

In a failed attempt to start a local dairy industry, the state gave away over 14,000 acres of land and made \$20 million in loans to would-be dairy farmers. Virtually none of the money has been repaid.²⁰ To provide an outlet for Alaska milk the state bought a creamery and promised to pay above-market prices to Alaska dairies. Since Alaskans could buy milk cheaper from Seattle, the price support scheme collapsed within a few years. The creamery, still owned by the state, continues to limp along by purchasing most of its milk from Washington State.²¹

A Dog's Life

The Alaska Renewable Resources Corporation (ARRC) was established in 1978 to provide venture capital for developing businesses based on Alaska's renewable resources. Some rather bizarre projects have received ARRC loans. Probably the strangest project funded, out of a field of strong contenders, was one for dog-powered washing machines.²² By 1987, three years after the legislature voted to terminate the program, ARRC had written off \$28 million in bad loans.²³ The success of Alaska's overall state loan program (of which ARRC is but a small part) has also been dismal. As of the end of 1987, over \$233 million in loans made by the Alaska state government were in default and another \$1 billion were delinquent.²⁴

Pay Per View

LearnAlaska, an instruction telecommunications system operated by the University of Alaska, was established by the state in 1981 to bring instructional programs to every Alaska village with a population of twenty-five or

more. Six years and \$23 million later, LearnAlaska was finally dropped as a bad idea. Barry Willis, Alaska's Director of Instructional Development during those years, called LearnAlaska "a technological solution in search of an educational problem which it never found." LearnAlaska did little more than duplicate RATNET, the state entertainment network that brings programs like Monday Night Football, General Hospital, The Simpsons, and Beverly Hills 90210 to rural areas at state expense.²⁵

Plenty of Pork

If one looked only at state spending it would be reasonable to conclude that Alaskans have prodigious appetites for the cultural, artistic, and athletic. Enormous sums have been spent building performing arts centers, convention centers, and sports arenas in towns and cities throughout the state. Even in the most populated cities these structures stand as monuments to government profligacy. The \$70 million Performing Arts Center constructed with state money in Anchorage loses over \$1 million annually even when all of the capital cost of the center is ignored.²⁶

This special-interest waste has insured that the long-run prospect for the Alaskan economy is one of painful adjustment and dislocations. The lack of accountability that has made the political decisions so responsive to the short-run demands for wasteful government spending has made them entirely unresponsive to long-run economic realities.²⁷

A bumper sticker commonly seen in Alaska after oil prices plummeted in the mid-1980s read "Please God, Just One More Boom. Next Time We Won't Piss It Away." Since then Alaska has had not one, but two "booms" and in each case Alaskans failed to keep the bumper sticker's promise. In August 1990 when Iraq

invaded Kuwait, oil prices soared temporarily on the fear that Mideast supplies would be interrupted. The result was a \$700 million windfall to state coffers. Instead of treating the revenue as transitory income and saving it, Alaska's politicians used it to maintain spending.

The long-run economic reality for Alaska is that the North Slope oilfields are being depleted.

An even bigger windfall followed in 1992 and 1993 when oil companies, including ARCO, Unocal, BP Exploration, and Chevron agreed to pay the state \$1.7 billion to settle long-running disputes over payments of back taxes and royalties. Again the promise of the bumper sticker was ignored and the governor and legislature appropriated over half the amount, ignoring a law passed by voters in 1990 which specified that such windfalls be placed in a Constitutional Budget Reserve Fund for future use. By spending rather than saving this latest windfall, the state was able to maintain overall spending and more than double capital spending from \$300 million to \$616 million.²⁸

Future Prospects

The long-run economic reality for Alaska is that the North Slope oilfields are being depleted. Since 1989, production at Prudhoe Bay (where virtually all of Alaska's oil is produced) has declined by over 15 percent. Most experts on petroleum recovery predict that even if new oilfields on the North Slope are brought on

line, petroleum production in Alaska will decline to half of what it is today by the year 2004. As oil production declines so will state tax revenues. If state spending from general fund revenues remains at the current (1993) level of \$2.9 billion per year, it will exceed projected revenues by as much as \$1 billion per year by the turn of the century. A recent study by the Institute for Social and Economic Research (ISER) at the University of Alaska in Anchorage concludes that the state is currently spending at an annual rate of \$1.2 billion more than can be sustained in the long run.²⁹ Indeed, Alaska already faces a fiscal crisis. Due to its lack of spending restraint and a drop in world oil prices, projected revenues for the current fiscal year (FY94) fall over \$1 billion short of appropriations. The projection for next year, even if oil prices rebound, is for a budget shortfall of \$600 million.

Even with the most optimistic projection of state oil revenues, there can be no doubt that Alaska faces wrenching economic adjustments. State spending, which accounts for over 33 percent of the jobs and three of every ten dollars of personal income in Alaska, will have to be decreased significantly and taxes on Alaskan citizens will have to be increased significantly. Regardless of the relative mix in spending cuts and tax increases, the effect will be the exodus of a large number of Alaskan residents with a further reduction in the tax base and significant declines in property values. Alaskan natives who have grown dependent on government programs will be harmed the most. According to the ISER, 41 percent of all economic activity in the rural interior is attributable to state spending.³⁰

A preview in miniature of what is likely in store for Alaska may be found in what happened during the 1986-88 recession when falling oil prices reduced tax revenues and forced

state budget cuts of \$1.4 billion over three years. During this period, Alaska lost 22,000 jobs (10 percent of the total) and \$1.07 billion in wage income (13 percent of the total); banks foreclosed on 10,429 residential properties (7 percent of the total). In Anchorage, Alaska's largest city, assessed property values fell by 46 percent and 29,000 people (9 percent of the total population) left the state.³¹

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The looming fiscal crisis in Alaska cannot be blamed on any difficulty in seeing it coming. It has long been recognized that the levels of state spending, and the oil revenues that supported them, could be sustained only temporarily. Neither can the coming crisis be blamed on the inability to respond adequately to it. As we have already seen, the magnitude of the temporary oil revenues is so large, relative to the population of Alaska, that they could have been converted into a generous and sustainable level of per-capita state spending. What explains the lack of fiscal foresight that, on balance, has characterized Alaska's political decisions during its oil boom? The best explanation is not found in some unique aspect of Alaska's situation, but in the myopic tendency intrinsic to all political decision making.

Political Privilege vs. Political Patience

As economists Rodney Fort and John Baden have pointed out, when government takes con-

trol of resources they become common property.³² This is most apparent when government assumes control of the revenue generated by resources. Unfortunately, government revenues are not systematically allocated to their highest valued public use by well-informed and public-spirited political decision makers. The allocation of tax revenues occurs primarily in response to political pressures brought to bear by organized groups, each with a dominant interest in a particular government program.

Predictably, the advantage to each interest group is in grabbing as much tax revenue for itself as possible, as soon as possible. Taking into account the long-run cost of expanding current government commitments would, for an interest group, be an exercise in folly and futility. The special-interest lobbyists who converge in the corridors of government power, including those in the Alaskan capital of Juneau, are surely aware that the long-run interest of all would be best served if each moderates his or her current demands on the public treasury. Yet each special interest also knows, as does every exploiter of a common property resource, that the wealth it fails to capture today will not be invested for its future benefit, but will be captured tomorrow by another special interest. Patience may be a virtue, but it doesn't pay in politics.

The benefits from a government program are typically concentrated on a small organized group (with the benefit to each member of the group being quite large). The tax burden necessary to finance such a program is spread over the entire group of unorganized taxpayers (with the cost to each being very low). So organized political activity is sure to be mobilized in support of any government spending proposal and little if any organized political activity will be

mobilized in opposition. When people organize politically it is almost always to obtain special-interest benefits for themselves, not to oppose the special-interest benefits of others. The result is a bias in the political process that favors transferring wealth into the public sector where it is dissipated as a common property resource with little regard for the long-run consequences.

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The political bias toward depletion rather than sustainability is amplified in Alaska because of the per-capita magnitude of the oil revenue windfall and because the taxpayers providing this windfall (the consumers of petroleum products) are more remote and dispersed relative to the recipients (those living in Alaska) than is typically the case. But organized special interests tend to dominate the unorganized general interest in all political jurisdictions, elevating immediate concerns over long-run concerns.³³ The most effective way of controlling the adverse effects of political myopia is by imposing strict limits on the ability of government to gain control over resources. Unfortunately, this lesson is being ignored by those who constantly call for more government control to promote their noble objective of protecting the interests of future generations.

Conclusion

Alaska's recent fiscal history is a cautionary tale for those who believe that economic sustainability is best achieved by political means. If ever a government had the opportunity to implement a policy of economic sustainability, it was the state government of Alaska. With the oil tax revenues that began flowing into the state treasury in 1969, Alaska could have maintained per-capita spending at its existing (and generous) rate relative to per-capita spending by the other states, while saving enough to maintain current per-capita spending indefinitely with the interest on the accumulated capital. Such a policy of sustainability has not been the case in Alaska. Most of the oil money that flowed into Alaska's treasury flowed right back out to fund a bewildering array of special-interest programs that have done much to foster dependency on continuing government spending and little to develop an economy that can sustain itself after the oil revenues dry up. Those oil revenues are drying up, and as they do Alaska is going to pay a high price for its political myopia. But even as the fiscal abyss draws near, the occasional oil revenue surges into Alaska's treasury (such as the one that occurred during the 1990-91 Gulf War) are spent rather than saved.

The irresponsible and short-sighted government spending that has been Alaska's response to its oil boom is sad, but not surprising. It is a completely predictable result of the disproportionate influence special-interest groups can exercise through the political process. While such groups would be collectively better off in the long run if all exercised restraint in their demands on government resources, each recognizes that its interest is best served by capturing as much as possible now with little concern for the future.

While disregard for the future may be more apparent in Alaska than in other political jurisdictions, the problem of political myopia is general. The Alaskan case illustrates vividly the perversity of relying on government to promote the ideals of economic sustainability.

Notes

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10. Beth Kobliner, "Cut These State and Local Taxes," *Money*, January 1994, pp. 82-87.
11. From material provided by the Alaska Department of Revenue, Oil and Gas Audit Division, May 1994.
12. *An Alaskan's Guide to the Permanent Fund*, Alaska Permanent Fund Corporation, Juneau, September 1993.
13. Goldsmith, Gorsuch, and Leask.
14. The authors arrived at the \$66.7 billion figure by starting with 1967 real per-capita spending in Alaska and increasing it each year by the average national real rate of growth in per-capita state spending. The Anchorage, Alaska Consumer Price Index (CPI) was used to compute the hypothetical nominal rate of Alaska per-capita spending that would have kept pace with the U.S. states' average. By using Anchorage, rather than U.S. prices, the authors compensate for the year-to-year difference in cost of living increases between Alaska and the rest of the U.S. These hypothetical per-capita amounts are multiplied by each year's population to compute the hypothetical total nominal state expenditure. This amount is subtracted from actual nominal spending (which does not include contributions to the Permanent Fund). The difference is assumed to be deposited in a savings account. Interest is then imputed to the account at a rate equal to the change in the CPI plus 3 percent prior to 1978 when interest first began accumulating on the Permanent Fund. From 1978 onward, interest is calculated at the actual nominal rate of return earned by the Permanent Fund. The total amount in the hypothetical savings account is added to the equity in the actual Permanent Fund to arrive at the \$66.7 billion dollar figure. A table outlining these calculations is available from the Center for the Study of American Business.
15. *Alaska Permanent Fund 1993 Annual Report*, Alaska Permanent Fund Corporation, Juneau, 1993, p. 25.

16. Author's calculations.
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24. Alaska Office of Management and Budget, Division of Budget Review. Also see Strohmeyer, p. 121.
25. Quote from Barry Willis is from an interview by Efie Caldarola, a student of Steve Jackstadt.
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