

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672

2430 SCOM 101 LONG RANGE FINANCIAL PLANNING COMMISSION, 1995

Summary of Recommendations

Currently, the Alaska Permanent Fund is a well diversified portfolio that has enjoyed tremendous success in recent years. This success is mainly due to the Board's knowledge of the importance of asset allocation and its commitment to diversification. This has resulted in the Fund earning high rates of return at relatively conservative levels of risk. The Fund is well positioned to reap the benefits of diversification, having made investments in many different asset classes, both domestic and international. Also, the Fund appears to be efficiently managed, employing reputable and capable managers for both its equity and fixed income assets. The Fund has been able to manage its substantial fixed income portfolio entirely in-house, keeping administrative costs and outside management fees to a minimum. Several important issues must be addressed, however, in order to ensure the Fund's continued success.

Our analysis suggests the Permanent Fund should alter its asset allocation policy in order for the Fund to enjoy returns similar to those it has earned in recent years. Specifically, the Board should consider the following actions:

- ▶ Revise its current three-year target asset mix to include a larger allocation to domestic mid and small capitalization equities, European, Pacific Rim and emerging market equities, and mortgage-backed securities.
- ▶ Adopt a more aggressive investment style by allocating a larger percentage of Fund assets to equity assets and real estate.
- ▶ Revise its equity management plan by setting specific allocations for international and domestic mid and small capitalization equity managers.
- ▶ Set specific target allocations across fixed income sectors.

By implementing these changes, the Board can help ensure that the Permanent Fund will achieve the highest expected return for its chosen risk level. This will help the Board achieve its statutory goals of maximizing total Fund return and providing the maximum amount of disposable income to Alaska's citizens.

This report presents recommendations concerning the Alaska Permanent Fund. The first section provides background information on the procedures we used to perform the asset allocation study. The second section suggests improvements for those portfolios, and outlines a third portfolio suited to a more aggressive investment philosophy. The final section provides guidance on several important implementation issues.

I. Analyzing an Investment Portfolio

A first step in analyzing an investment portfolio is determining whether the portfolio adequately compensates the investor for taking risk. Ideally, the portfolio is *efficient* in providing return to the investor; i.e., the portfolio provides the most return possible for the amount of risk taken. In reality, however, few portfolios accomplish this objective.

Defining Asset Classes

In order to analyze the Fund's portfolio, we had to decide which assets to include in the Fund's investment universe. Currently, the Fund invests in 12 different asset classes that comprise six main categories. The benchmarks used to represent each asset class in our analysis are listed in Appendix A at the end of this report. The asset classes used in our study are as follows:

U.S. Equity Assets

Large Capitalization
Mid/Small Capitalization

Non-U.S. Equity Assets

Canada
Europe
Pacific
Emerging Markets

Other Assets

Real Estate

Non-U.S. Fixed Income Assets

Intermediate-Term Government/Corporate Bonds
Long-Term Government/Corporate Bonds
Mortgage-Backed Securities

Non-U.S. Fixed Income Assets

Non-U.S. Government Bonds

Cash

U.S. Treasury Bills



Forecasting Return

We also had to forecast three estimates for each asset class: expected return, expected risk (as measured by standard deviation), and expected return correlation between assets. Summary tables of our forecasts are provided in Appendix B. It is important to note that our return, risk, and correlation forecasts are *long-term* – they apply to an investment horizon of 10 years or more. Our forecasts are passive in nature and, therefore, would not change dramatically if we were to recalculate them a year from now. Consequently, the portfolio allocations we recommend will remain stable over a very long time period, and will require few changes over a long-term investment horizon.

The basis for our equity return forecasts is the risk-free rate of return and the historical premium, called an equity risk premium, that is demanded by investors for holding risky assets. We use the historical premium because the amount by which common stocks have outperformed risk-free government bonds has been consistent over time. The long-term equity risk premium for large capitalization domestic equities over the period January 1926 to September 1993 was 7.25 percent. Also, many researchers have found that, as the risk of an investment increases, so does its expected return. For this reason, we forecast the expected return of other equity asset classes, such as domestic small capitalization equities and international equities, to have greater expected returns.

The basis of our fixed income return forecasts is the current risk-free rate of return, as proxied by the current yield on a risk-free government bond with a maturity matching the investment time horizon. Currently, this rate is 6.31 percent, the current yield on 20-year U.S. Treasury bond. To this rate, we add the appropriate maturity premium (additional return required by investors for relinquishing the use of their money for long time periods) and default premium (additional return that compensates investors for buying bonds that have default risk, such as corporate bonds) for each class of bonds for which we are forecasting returns.

For international fixed income assets, we forecast returns as if the assets were denominated in U.S. dollars. Since currency fluctuations are expected to average to zero over time, any short-term currency gains or losses will not affect the long-term return on international assets. Currency fluctuations do increase risk, however, and are accounted for in our risk forecasts of non-U.S. fixed income assets.

Forecasting Risk

When forecasting the risk of an asset, we typically assume that the future will equal the past. Therefore, we forecast risk by calculating the historical standard deviation using a long time period over which we have reliable data, and data that is representative of possible future scenarios. Although investment risk can be quantified in a number of



ways for asset allocation purposes, we believe that risk is best modeled as the annual volatility of returns, and standard deviation provides an estimate of how much actual returns may deviate from the average, expected return over time. We use shorter time periods only when we can identify a permanent and dramatic process shift in the behavior of an asset class, such as the late 1960s when bond market volatility increased noticeably from its observed volatility during the previous 40 years.

Forecasting Return Correlation

Return and risk are not the only factors that determine how a portfolio performs. The correlation between the returns of two assets also plays an important role in portfolio performance. Correlation measures how much the returns of two assets tend to move together or move separately. If the returns move together, the assets are positively correlated. If they move in opposite directions, the assets are negatively correlated. If no pattern can be detected in the way the assets' returns move, the assets have a return correlation of zero.

Portfolios comprised only of assets that have high, positive correlations with each other are not well diversified. This tends to exaggerate both upside and downside volatility, and the risk of the portfolio. On the other hand, portfolios with assets that have low or negative return correlations will provide more stable returns because, even though some assets may perform poorly, other portfolio assets will perform better, serving to reduce portfolio volatility. The benefits of diversification, therefore, are a direct result of relatively low return correlations among portfolio assets.

When forecasting return correlation, we again typically assume that the future will equal the past. The basis for our forecast of return correlation is, therefore, the historical correlation between assets, observed over the longest time period for which reliable data is available.

Determining the Fund's Current Allocation

The amount of the Fund currently allocated to each asset class was determined by using information in the Fund's 1993 Annual Report, with supplemental information provided by William L. Means, the Fund's Chief Investment Officer. Market values of all investments came from the Annual Report, while Mr. Means provided clarification regarding the amount currently invested in equities of domestic companies with capitalizations larger than \$1 billion (large capitalization equities), the amount currently invested in equities of companies with capitalizations of \$1 billion or less (mid and small capitalization equities), and the amount currently invested in domestic government and corporate bonds with maturities ranging from one to seven years (intermediate-term),



and more than seven years (long-term). The Fund's current allocation, and its expected return and standard deviation is given on page 5.

Determining the Fund's Three-Year Target Allocation

The Permanent Fund's investment manual provided information regarding the three-year target allocation, although some guidelines were too broad for our purposes. For example, the manual lists a 10 percent target allocation for international equities, but gives no country-specific allocations. In this case, we assumed the Fund would increase its international equity exposure to 10 percent, while maintaining the current proportion invested among sectors. Also, the target allocation constrains the amount invested in non-domestic fixed income assets to 10 percent or less, but provides no specific number. We assumed the amount invested in international debt would decrease in proportion to the total decrease in the amount allocated to all fixed income assets. The Fund's three-year target allocation, and its expected return and risk, is listed on the following page.

Current and Three-Year Target Portfolios

Asset Class	Current Allocation (%)	3-Year Target Allocation (%)
U.S. Large Capitalization Stocks	21.17	24.00
U.S. Mid/Small Capitalization Stocks	0.65	6.00
Canadian Stocks	0.03	0.04
European Stocks	2.54	4.28
Pacific Region Stocks	2.94	4.97
Emerging Market Stocks	0.42	0.72
Real Estate	6.69	10.00
Cash	4.64	0.00
Intermediate Govt/Corp Bonds	30.86	25.32
Long-Term Govt/Corp Bonds	25.27	20.74
Mortgage-Backed Securities	3.94	3.24
Non-U.S. Government Bonds	0.85	0.69
Expected Return (%)	8.53	9.93
Standard Deviation (%)	7.57	9.91

II. Asset Allocation Recommendations

The next step in our analysis was to improve the Fund's current and target portfolios by increasing their expected return while keeping expected risk at a constant level.

Allocation with Risk of the Current Portfolio

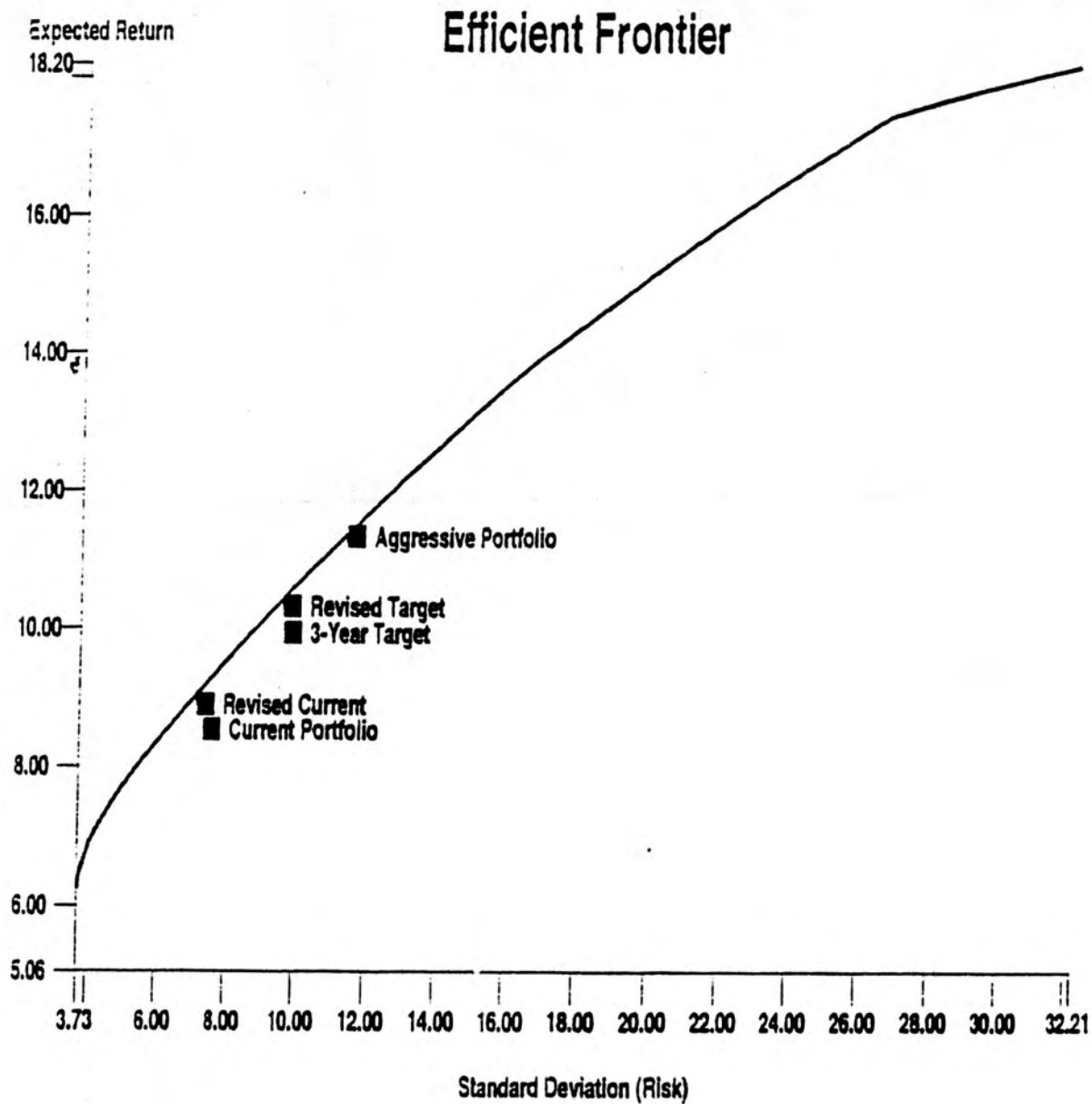
As shown in the graph on page 7, the Fund's current portfolio does not provide the maximum amount of expected return for the amount of risk taken. For example, the portfolio labeled "revised current" provides a higher expected return and slightly less risk than the current portfolio. (The graph is titled "Efficient Frontier" because the line in the graph represents those portfolios which are the most efficient in providing return to the investor; i.e., those portfolios provide the maximum return for a given level of risk.) The allocations for both the current and revised portfolios, as well as their expected returns and standard deviations, are shown on page 8.

The current portfolio need not be drastically changed in order to achieve a higher expected return. In fact, the percent of the portfolio invested in equities (approximately 35 percent, including real estate) and in fixed income assets (approximately 65 percent), is the same in both the current and revised portfolios. Rather, the composition of the equity and fixed income portions need only change. By shifting part of the equity portion from large capitalization stocks to mid and small capitalization and international stocks, and part of the fixed income portion from cash and long-term bonds to intermediate-term bonds and mortgage-backed securities, the Fund can achieve a higher expected return while taking less risk.

Although these changes represent shifts from safer assets to more risky ones, the overall risk of the portfolio actually decreases. This is because domestic mid and small stocks, mortgage-backed securities, and international stocks have low correlations with many of the other portfolio assets.

Allocation with Risk of the Target Portfolio

The graph on page 7 shows that the Fund's target portfolio also does not provide the highest possible expected return for the amount of risk taken. Although both the allocations of the target and revised target portfolios are equally divided between equity and fixed income assets, the revised target portfolio has a significantly higher expected return and less risk. The composition of both portfolios, along with their expected returns and standard deviations, is given on page 8.



Current and Recommended Portfolio Allocations

Asset Classes	Allocations				
	Current Portfolio (%)	Revised Current (%)	3-Year Target (%)	Revised Target (%)	Aggressive Portfolio (%)
U.S. Large Cap Stocks	21.17	11.00	24.00	16.00	18.00
U.S. Mid/Small Cap Stocks	0.65	4.00	6.00	8.00	10.00
Canadian Stocks	0.03	0.00	0.04	0.00	0.00
European Stocks	2.54	3.50	4.28	6.00	7.50
Pacific Region Stocks	2.94	4.00	4.97	7.00	10.50
Emerging Market Stocks	0.42	2.50	0.72	3.00	4.00
Real Estate	6.69	10.00	10.00	10.00	10.00
Cash	4.64	1.00	0.00	1.00	1.00
Intermediate-Term Govt/Corp Bonds	30.86	40.00	25.32	30.00	18.00
Long-Term Govt/Corp Bonds	25.27	12.00	20.74	5.00	6.00
Mortgage-Backed Securities	3.94	12.00	3.24	14.00	15.00
Non-U.S. Govt Bonds	0.85	0.00	0.69	0.00	0.00
Expected Return	8.53	8.89	9.93	10.31	11.33
Standard Deviation	7.57	7.40	9.91	9.89	11.69

The superior tradeoff between risk and return of the revised target portfolio can be accomplished by shifting a larger portion of Fund assets into domestic mid and small capitalization stocks, international stocks, mortgage securities, and real estate. Again, these riskier assets have low correlations with many other portfolio assets, and therefore provide enhanced diversification benefits.

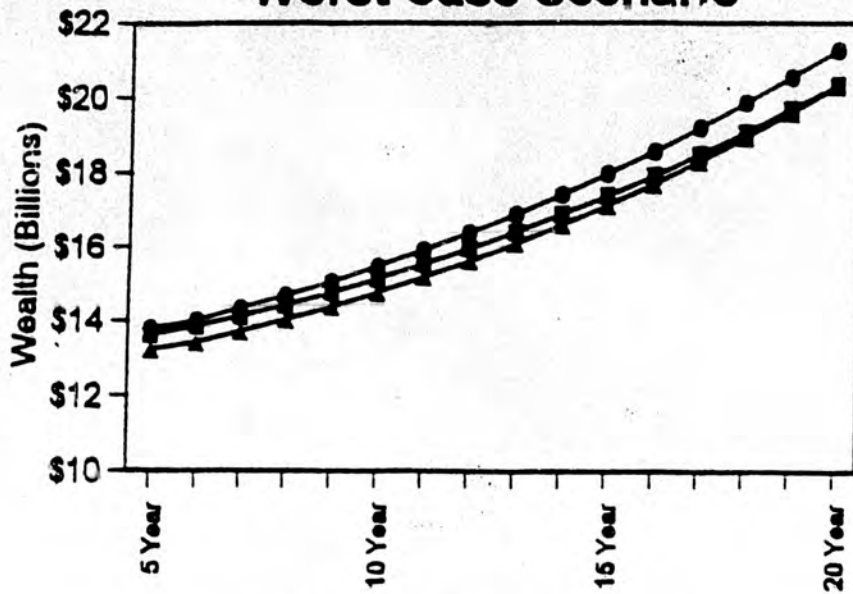
Allocation of a More Aggressive Portfolio

Although we have analyzed and suggested improvements to both the current and target portfolios, we have not yet commented on whether either portfolio is appropriate for the Fund. Ideally, a portfolio provides enough return to meet the goals of the investor while maintaining a level of risk that is comfortable for the investor. By setting a three-year target portfolio that has an increased allocation to equity assets, the Board has indicated that it is comfortable with a more aggressive investment philosophy. In our opinion, such an aggressive investing strategy is appropriate and necessary for achieving the Fund's statutory goals of maximizing total return and providing the maximum amount of disposable income to the citizens of Alaska. Consequently, we believe the Fund should consider the benefits of investing in the "aggressive portfolio," also shown in the graph on page 7.

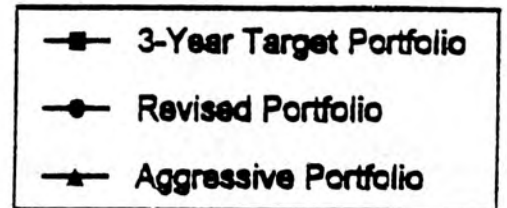
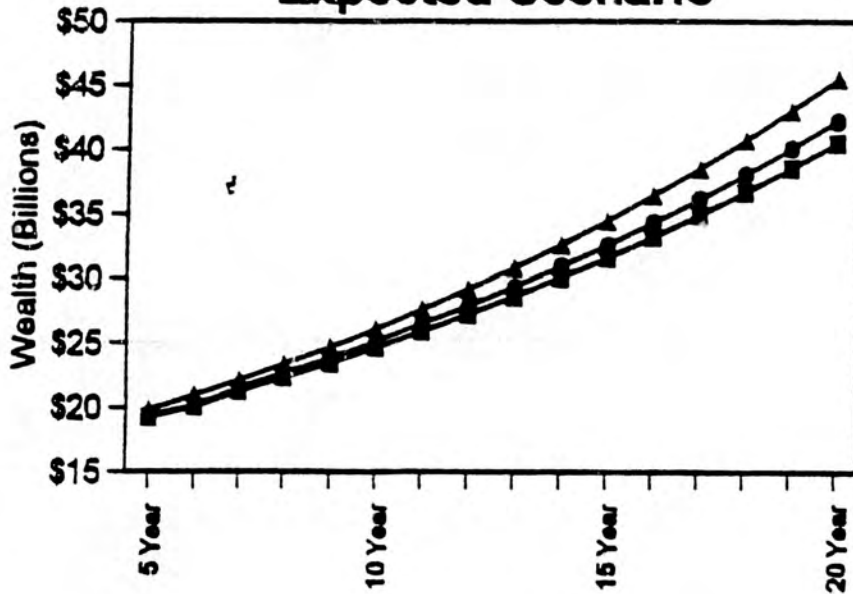
In recent years, the Fund has enjoyed relatively high returns, particularly on its fixed income investments. These high returns were due, in part, to rather unique market conditions, such as a dramatic decline in U.S. interest rates. These market conditions, however, are not expected to continue in the future, as evidenced by the returns expected on the current and target Fund portfolios. The potentially lower returns earned by both these portfolios are important factors to consider, because such low returns will inevitably lead to lower dividend payments to Alaskans. Our recommended aggressive portfolio, however, with its significant allocations to international equities and mortgage-backed securities, has an expected return in the range of the Fund's recent returns. The allocation of this aggressive portfolio, along with its expected return and standard deviation, is provided on page 8.

The graphs on the following page can help to compare the expected performance of each portfolio. The graphs show expected wealth values under the target, revised target, and aggressive portfolios for five-, ten-, and twenty-year investment horizons. Although the Board may consider the aggressive portfolio too risky, the graph shows that the majority of this portfolio's volatility is due to its broad range of possible high, positive returns, not negative ones. For all investment time horizons, the aggressive portfolio has a higher expected wealth value under the best- and expected-case scenarios. Only under the worst-case scenario does the aggressive portfolio underperform the target portfolio, while the revised target portfolio performs better than the target portfolio in all cases.

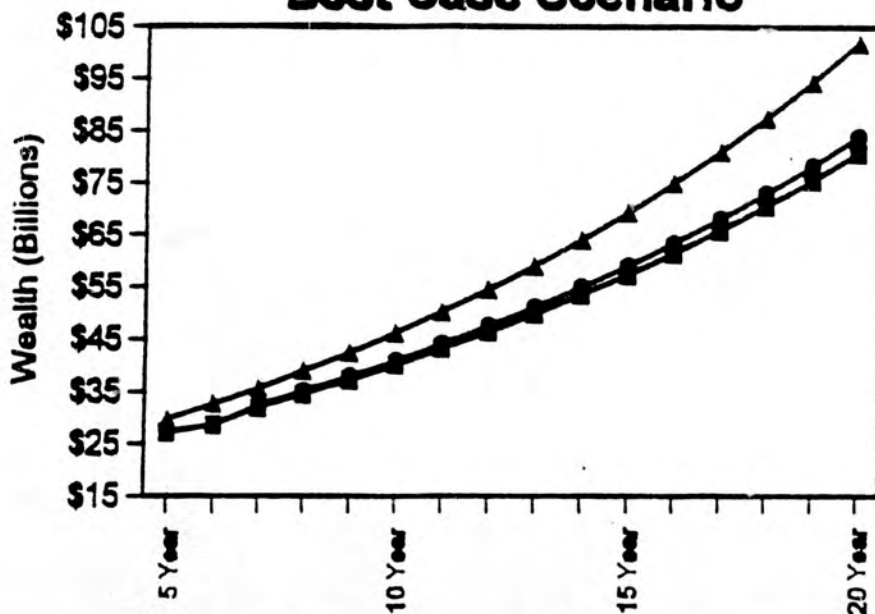
Worst Case Scenario



Expected Scenario



Best Case Scenario



III. Implementation Issues

Whichever portfolio the Board chooses, several issues must be addressed by the Board to ensure maximum Fund performance. The single most important issue is the degree of adherence to the chosen allocation. Research has suggested that the asset allocation decision accounts for over 90 percent of the variability of returns on a portfolio, and is the single largest determinant of portfolio performance.¹ Consequently, individual security selection and active security management, the two factors commonly assumed to contribute the most to the return of a portfolio, actually account for only a small amount of portfolio return variability. Therefore, adherence to the chosen allocation is *crucial* to the future performance of any investment portfolio, including the Permanent Fund. Accordingly, the Board must decide whether the current investment strategy of the Fund accommodates a strict adherence to the chosen allocation. We address this issue separately for equity and fixed income assets in the following two sections.

Equity Assets

As of April 1993, the Board decided to use active managers only for domestic mid/small capitalization stocks and all international equities. Since our recommended portfolios are based on passive benchmarks, we believe that the long-term performance we forecast can be achieved through the use of passive managers, although it is certainly possible for active managers to meet or exceed that performance. For this reason, we believe the Board's decision to retain active managers is appropriate, *as long as each manager is given only that portion of Fund assets that is recommended in the chosen allocation, and is required to invest those assets in the specific, recommended asset class.*

This stipulation is in direct contrast to the Board's new global investment strategy as outlined in the Fund's 1993 Annual Report. The new strategy allows active international equity managers to decide when and where to invest Fund assets, essentially shifting the asset allocation decision from the Board to the manager. As mentioned earlier, asset allocation, not security selection or active market timing, is the largest determinant of portfolio performance. Under the planned strategy, the Fund's equity allocation will shift continuously, violating the most crucial aspect of strategic asset allocation: maintaining a stable asset mix which was chosen based on long-term forecasts and needs of the fund. For this reason, we suggest a slightly modified strategy where the Board hires managers that have a specific style of investing. For example, under this modified strategy, the European equity allocation would be managed by a manager who specializes in European equities. This type of management strategy would allow the Board to retain control over the equity allocation of the Fund.

¹ Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, "Determinants of portfolio performance II: An update," *Financial Analysts Journal*, May-June 1991.

The Fund's domestic equity managers also have similar control over the asset allocation decision. Currently, the performance of each domestic equity manager is evaluated by using a benchmark portfolio that consists of 80 percent large capitalization equities and 20 percent mid and small capitalization equities. The equity managers, however, are not specifically required to invest 80 percent of their Fund allocation in large capitalization stocks and 20 percent in mid and small capitalization stocks. A manager could alternate between large cap and mid and small cap stocks, and still *average* an 80 percent large cap and 20 percent mid and small cap investment. This manager could potentially be 100 percent invested in large cap stocks when the return in the mid and small cap market is high, and vice-versa. Again, this causes the overall equity allocation of the Fund to change continuously, and shifts control of the asset allocation decision to individual managers. Because the asset allocation decision is so important to the overall performance of the Fund, we feel the Board should set specific domestic equity allocations, and select managers who specialize in each asset class. This will ensure the maximum expected return for the Fund's equity investments.

Fixed Income Assets

Currently, the Fund's fixed income assets are passively managed in-house by the Fund's Chief Investment Officer, and are generally treated as a single asset class. Our analysis, however, treats the fixed income category as five distinct asset classes, because each contributes unique benefits to the overall portfolio. Treasury bills, for example, provide more liquidity than the other assets, and are, consequently, the least risky. Also, mortgage-backed securities perform differently from government or corporate bonds. For this reason, each fixed income asset class must be considered separately in the asset allocation decision.

Currently, the Board treats all fixed income assets as a single asset class and provides only a broad allocation directive. This essentially shifts the asset allocation decision to the fixed income manager. While the current allocation across fixed income assets may be appropriate when viewed in isolation, that same allocation may be inappropriate when viewed in the context of the overall portfolio. The Board has a comprehensive perspective on the Fund and, as such, should determine the Fund allocation to each asset class. For this reason, we suggest that the Board set specific target allocations for fixed income asset classes. In this way, the Board maintains control over the Fund's asset allocation and ensures maximum overall Fund performance.

Prior to beginning our study, several Board members and senators voiced concern over the Fund having only one manager for the entire fixed income portfolio. We feel that a single, capable manager, such as the current manager, can manage a large, passive fixed income portfolio with few problems, as long as that portfolio has only a small allocation to mortgage-backed securities. However, if a larger proportion of funds was invested in



mortgage-backed securities (as is our recommendation), it may be required to hire additional staff. This is because mortgage-backed securities are more complex to analyze, and the holders of mortgage securities continually receive principal and interest payments which must be accurately recorded. All our recommended portfolios contain substantial allocations to mortgage-backed securities. Consequently, we suggest that the Board hire an outside manager to manage the mortgage portfolio, or, at the very least, hire additional support staff.

Conclusion

Although the Permanent Fund has an excellent performance history, the Fund faces new and uncertain investment challenges in the coming years. The Board, realizing the importance of asset allocation to overall Fund performance, has created a target allocation to meet those challenges. However, as our analysis reveals, the Board can implement a better allocation for the Fund, one that has higher expected return and less risk than the Fund's target portfolio. Also, the Board can implement a new investing policy, one emphasizing an adherence to the chosen allocation. By doing so, the Board will help ensure the maximum expected performance of the Fund over the long-term investment horizon, thereby providing the highest possible income to the State's citizens and fulfilling its obligation to those citizens.

Appendix A: Benchmarks Used in Asset Allocation Study

<u>Asset Class</u>	<u>Benchmark Description</u>
U.S. Large Capitalization Equity	S&P 500: A market capitalization-weighted index of 500 of the largest stocks of companies domiciled in the United States.
U.S. Mid/Small Capitalization Equity	Russell 2000 Index: A market capitalization-weighted index of the stocks of the bottom two thirds of the largest 3,000 publicly traded companies domiciled in the United States.
Canada Equity	Morgan Stanley Capital International Canada Total Return Index: A market capitalization-weighted index of 81 large Canadian stocks.
Europe Equity	Morgan Stanley Capital International Europe Total Return Index: A market capitalization-weighted index of large stocks from Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom.
Pacific Equity	Morgan Stanley Capital International Pacific Total Return Index: A market capitalization-weighted index of large stocks from Australia, Hong Kong, Japan, Malaysia, New Zealand, and Singapore.
Emerging Markets Equity	IFC Emerging Market Composite Index: A broad-based, market capitalization-weighted index of stocks listed in countries with a per capita GDP below an annually-disclosed figure. Currently, 20 countries are represented in the Composite index.
Cash	U.S. 90-Day Treasury Bills: Published by Salomon Brothers in <i>International Bond and Money Market Performance</i> .

IT Govt/Corp Bonds

Lehman Brothers Intermediate-Term Government/Corporate Bond Total Return Index: A portfolio of U.S. government issues (>\$100 million par value) and investment grade corporate debt (>\$50 million par value) with an average maturity of 4.42 years as of November 29, 1993.

LT Govt/Corp Bonds

Lehman Brothers Government/Corporate Bond Total Return Index: A portfolio of U.S. government issues (>\$100 million par value) and investment grade corporate debt (>\$50 million par value) with an average maturity of 10.81 years as of November 29, 1993.

Mortgage-Backed Securities

Lehman Brothers Mortgage-Backed Securities Total Return Index: An index of all fixed-rate securities backed by mortgage pools of the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and the Federal National Mortgage Association (FNMA). The index has an average maturity of 5.39 years.

Non-U.S. Bonds

Salomon Brothers Non-U.S. 1+ Bond Index: A market capitalization-weighted index of bonds from Australia, Canada, Germany, Japan, Netherlands, Switzerland, and the United Kingdom with one year or more to maturity. The average maturity of bonds in the index is 6.95 years.

Real Estate

Wilshire Real Estate Securities Total Return Index: A market capitalization-weighted index of approximately 85 real estate investment trust and real estate operating companies.



Testing Our Recommended Portfolios

To ensure the validity of our recommended portfolios, we tested those portfolios and the Fund's current and target portfolios for *stability*. A stable portfolio is one that performs well under a variety of possible future market conditions; i.e., the portfolio provides adequate return for the amount of risk taken under conditions that differ from our forecasts. We tested the portfolios using "worst-case" scenarios where the return of one or more assets is lower than expected and the risk is higher than expected. The following scenarios were used, both individually and in combination, to test our recommended portfolios:

- U.S. equity risk premium decreases to 5 percent
- Mid and small capitalization equity return decreases to 15 percent
- Europe equity return decreases to 10 percent
- Europe equity standard deviation increases to 26 percent
- Pacific equity return decreases to 10 percent
- Pacific equity standard deviation increases to 34 percent
- Emerging market equity return decreases to 10 percent
- Return between long-term and intermediate-term bonds increases to 1 percent
- Intermediate-term bond standard deviation increases to 6 percent
- Mortgage-backed securities return decreases to 6 percent
- Mortgage-backed securities standard deviation increases to 11 percent
- Real estate standard deviation increases to 25 percent
- Correlation between U.S. stocks and U.S. bonds increases 30 percent
- Correlation between U.S. stocks and non-U.S. stocks increases 30 percent

Under these scenarios, our recommended portfolios provided higher returns with less risk than either the Fund's current or target portfolios. For example, the improved target portfolio had 10 basis points more return and less risk than the current target portfolio when tested under the assumption that all international markets had the lower returns and higher risks outlined above. This indicates that the revised portfolios will perform better over the long run, despite possible extreme underperformance of some markets.

Appendix B: Forecasts Used in Asset Allocation Study

Forecasts of Expected Return and Standard Deviation

Asset Class	Expected Return	Standard Deviation
U.S. Large Cap Stocks	13.56	20.61
U.S. Mid/Small Cap Stocks	18.03	32.95
Canada Stocks	13.73	24.64
Europe Stocks	13.98	22.69
Pacific Stocks	15.11	28.24
Emerging Market Stocks	21.38	47.00
Real Estate	9.90	13.63
Cash	4.61	2.73
IT Govt/Corp Bonds	5.89	4.10
LT Govt/Corp Bonds	6.37	7.22
Mortgage-Backed Securities	7.45	9.28
Non-U.S. Govt Bonds	6.01	14.75

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Please see Page C-3
WAL-MART

... mortgage application to 30 days from more than 15 days at present.

Boosting speed is basic to corporate re-engineering, the trendy technique of using technology to reorganize operations. A survey by International Data Corp., of Framingham, Mass., found that of 200 big companies that were re-engineering, 23 percent said shortening cycle times of various processes was their primary goal; 13 percent viewed reducing costs as No. 1.

"You can only cut costs so far," says Paul Johnston, who ran the survey. "Cycle time helps differentiate you."

International Business Machines Corp. now takes an order for a personal computer over the phone and builds and ships the PC within 24 hours. Gillette Co. is accelerating the pace at which new products are unveiled globally to a two-year cycle from three years; it also says it is introducing 20 new products this year, up from 17 last year and fewer than eight a year in the 1980s.

Please see Page C-7. FASTER, FASTER



TIM BRADNER

Real dollars now means real dividends later

One of the most sensible public policy proposals I've heard recently is state Sen. Steve Rieger's idea for requiring the Alaska Permanent Fund to report its annual profits in real, or inflation-adjusted, dollars, rather than the nominal, or inflation-eroded dollars, as is now the practice.

The idea has merit not only because it is sound from a financial point of view — most big endowment funds look at their earnings this way — but it solves some problems in the way the fund must manage its income.

In effect, Rieger's plan would change the procedure the legislature set up more than a decade ago when it passed the law setting out how fund profits are to be used in paying the annual permanent fund dividend to Alaskans and making payments into the corpus of the fund to offset inflation.

The direction legislators gave was for the fund to pay dividends first and inflation-proofing second. Over time, this could cause a shortfall in the amount of profits available for inflation-proofing.

Please see Page C-2. BRADNER

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GOVERNOR TONY KNOWLES
LIEUTENANT GOVERNOR FRAN ULMER

Executive Summary

**KNOWLES/ULMER
POLICY
TRANSITION
TEAMS'
REPORT**

JANUARY 1995

Fiscal Policy

The Knowles/Ulmer Administration asked the Fiscal Policy team to build on the ideas from other public forums to develop guidelines for a responsible fiscal plan to guide the state into the 21st century, and to make recommendations on how to achieve the broad public support necessary for their implementation.

RECOMMENDATIONS

- Continue to articulate a "vision" of the state's financial future—the administration's views on the appropriate role of government and the values and criteria that should guide our public policy decisions—and recognize the threat the fiscal gap poses to ourselves and our children.
 - Make a commitment to develop a plan to bring annually recurring revenues into balance with state spending
 - Integrate the cabinet into the plan and process, i.e., the commissioners should all be speaking in concert and actively involved in the plan's development.
 - Convey the message that sound fiscal management equals good government and good government means good politics.
 - The team emphatically endorses the Knowles/Ulmer campaign pledge to cap total state spending (except for education funding) at the FY 95 level.
 - Continue with an unwavering policy of budget sustainability and develop an annual report card to inform the public about the success of the administration's actions to protect Alaska's fiscal future.
- Give average citizens a direct voice in shaping the future and invite the public to help develop a shared vision for Alaska and the role of government in their lives.
 - Develop a strategy for inviting public input into fiscal decisions and collect baseline information on public attitudes regarding the fiscal gap.
 - Implement a strategy for educating the public on Alaska's fiscal situation and our choices for the future. Effective forums might include: newspaper inserts, town meetings, market research, industry groups, social service groups and local government bodies.
 - Ask the legislature to participate in every step of the outreach process.
 - Make government more open to the public through better use of communication systems, including electronic media (video conference, internet, Alaska Online, etc.).
 - As part of a long-term strategy, the administration should budget for public participation in reexamining the respective roles of state and local governments, setting goals and benchmarks for Alaska, and deciding the role of the Permanent Fund in the state's fiscal future.
- Create an annually updated five-year fiscal plan.
 - Work with and inform the legislature in a timely manner of any changes the administration wishes to make in the FY 96 budget, and announce that a fiscal plan will be in place by the time the FY 97 budget is proposed.
 - Develop a five-year plan and a comprehensive reporting framework that encompasses all aspects of state spending and revenues, including "off-budget items" such as Permanent Fund earnings, Permanent Fund dividends, cash reserves, public corporations, etc. Include deferred maintenance and the operating and maintenance costs of capital projects in the plan.

- Resolve legal questions surrounding the use of the Constitutional Budget Reserve funds, the setting of specific revenue and expenditure targets (including Permanent Fund dividends), development of a debt policy (including school debt reimbursement), an overall reserves policy employing triggers for instituting an income tax, and a cash-flow management plan.
 - Implement the five-year plan and keep the public informed of Alaska's fiscal situation and progress toward reaching fiscal stability. Although no consensus was reached, one approach recommended was to set up a budget commission or blue ribbon task force to act as a conduit between the executive branch, legislature and the public to develop a long-term fiscal strategy for Alaska.
 - Capitalize cash reserves to the greatest extent possible.
 - Pass legislation to automatically inflation-proof the Permanent Fund by distributing only real earnings for dividends.
 - Explore means of controlling personnel costs.
 - Examine various public services for potential privatization.
 - Evaluate all entitlement programs on an ability-to-pay basis.
- Form partnerships for economic development and intergovernmental alliances.
 - Emphasize partnerships between the executive and legislative branches, state and local governments, and the public and private sectors.
 - Create a spirit of cooperation between the state of Alaska and the federal government.
 - Eliminate unfunded mandates on local governments.
 - Reexamine the state's petroleum tax and royalty regime with the intention of maintaining Alaska's competitiveness.
 - Improve federal relations and understanding of Alaska issues, particularly with respect to oil and gas development, and adopt a "Visit Alaska" program to allow members of Congress to see the state in order to make more informed decisions.
 - Maintain the economic viability of resource development by ensuring that efforts aimed at increasing revenues from resource industries are made via an income tax on jobs rather than through increased business taxes. (The team noted that non-petroleum resource development actually ends up costing the state money in comparison to revenues generated.)
 - Make serious efforts at regulatory reform to reduce government red tape.
 - Organize programs to streamline the delivery of state government services.
 - Make state government as cost-efficient as possible by adopting a customer-oriented approach to public service delivery.
 - Develop and begin to implement meaningful, real-world performance measures of the effectiveness of government programs.
 - In order to provide incentives to agencies, commissioners should be allowed to use part or all of their cost savings for investments that will increase future productivity.
 - An employee recognition and cash reward system should be developed and funded for employee ideas that save money.
 - Join in a partnership with local governments to thoroughly evaluate the delivery of services to the public. Ensure that public services are delivered at the most appropriate level of government to meet the needs of the citizenry in the most cost-effective manner possible, even if government roles need redefinition.

SCOMM

101:100

Significant Features of Fiscal Federalism

Volume 1

Budget Processes
and Tax Systems

TABLE OF CONTENTS
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1994



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Contents

Section I—Budget Processes and Tax and Expenditure Limits	1
<i>Table 1</i> The Federal Budget Process	3
<i>Table 2</i> State Budget Processes and Calendars	4
<i>Table 3</i> State Balanced Budgets and Deficit Limitations: Constitutional and Statutory Provisions	6
<i>Table 4</i> State Budget Stabilization Funds	8
<i>Table 5</i> Gubernatorial Veto Authority	12
<i>Table 6</i> Description of State Tax and Expenditure Limits	14
Section II—Federal Taxes	21
<i>Table 7</i> Federal Individual Income Tax (Average and Marginal Tax Rates), Selected Income Groups and Years, 1954-1993	22
<i>Table 8</i> Federal Individual Income Tax Rates and Exemptions, 1913-1994	24
<i>Table 9</i> Federal Corporation Income Tax Rates and Exemptions, Income Years 1909-1993	26
<i>Table 10</i> Federal Excise Tax Rates on Selected Items Selected Years 1944-1993	28
<i>Table 11</i> Old Age Survivors', Disability, and Hospitalization Insurance (Social Security) Rates and Maximum Contributions, Calendar Years 1937-2000	30
<i>Table 12</i> Federal Death Taxes and the State "Pick-Up" Credit	32
Section III—State and Local Taxes: Overview	33
<i>Table 13</i> Dates of Adoption of Major State Taxes	34
<i>Table 14</i> State Taxes by Major Source, 1993	36
<i>Table 15</i> 1993 Major Tax Changes, by Tax	38
Section IV—State and Local Tax Rates and Bases by Type of Tax	53
Individual Income Taxes	
<i>Table 16</i> State Individual Income Taxes: Summary of Personal Exemptions, Standard Deductions, and Deductibility of Federal Income Taxes, 1993	54
<i>Table 17</i> State Individual Income Taxes: Exclusions and Adjustments to Income, 1993	58
<i>Table 18</i> State Income Tax Treatment of Social Security and Pension Income Exemptions, 1993	63
<i>Table 19</i> State Individual Income Taxes: Itemized Deductions, 1993	68
<i>Table 20</i> State Individual Income Taxes: Rates, 1993	72
<i>Table 21</i> Local Income Taxes: Number and Type of Jurisdiction, Selected Years 1976-1992	77
<i>Table 22</i> Local Income Taxes: Rates, Selected Cities and Counties, November 1993	78
Corporation Income Taxes	
<i>Table 23</i> State Corporation Income Taxes: Rates, October 1993	80
<i>Table 24</i> State Corporation Income Taxes: Bases, Credits, and Formulas	84
<i>Table 25</i> State Corporation Income Taxes: Characteristics of Apportionment Formulas, 1992	92
<i>Table 26</i> State Corporation Taxes: Primary Bases, 1993	94
General Sales Taxes	
<i>Table 27</i> State Sales Taxes: Rates and Exemptions, November 1993	96
<i>Table 28</i> State General Sales Taxes: Rates, Selected Years, 1978-1993	100
<i>Table 29</i> State Sales Taxes: Number of Services Taxed, by Category and State, 1992	101

<i>Table 30</i>	State Use Tax Laws on Mail Order Sales	102
<i>Table 31</i>	Local Sales Taxes: Number and Type of Jurisdiction, Selected Years, 1976-1993	106
<i>Table 32</i>	State-Local General Sales Taxes: Combined Rates, Selected Cities, November 1993	108

Excise Taxes and Fees

<i>Table 33</i>	State Gasoline Taxes: Rates per Gallon, Selected Years, 1978-1993	114
<i>Table 34</i>	State Cigarette Taxes: Rates per Pack, Selected Years, 1978-1993	116
<i>Table 35</i>	State Alcoholic Beverage Excise Taxes: Rates, License States, February 1994	118
<i>Table 36</i>	State Alcoholic Beverage Excise Taxes: Rates and/or Markup, and Method of Control, Control States, February 1994	122
<i>Table 37</i>	Automobile Taxes and Fees, February 1994	126
<i>Table 38</i>	State Severance Taxes: Rates and Bases, November 1993	132

Property Taxes

<i>Table 39</i>	State Property Tax Relief: Circuit Breaker Programs	138
<i>Table 40</i>	State Property Tax: Homestead Exemptions and Credits	145

Transfer Taxes

<i>Table 41</i>	State Transfer and Real Estate Taxes, November 1993	150
<i>Table 42</i>	State Death and Transfer Taxes: Number and Type, November 1993	153
<i>Table 43</i>	State Estate Taxes: Rates and Exemptions, November 1993	154
<i>Table 44</i>	State Inheritance Taxes: Rates and Exemptions, November 1993	156
<i>Table 45</i>	State Gift Tax Rates and Exemptions, November 1993	160

Definitions	161
Sources	167
Index	169

*Significant Features
of Fiscal Federalism*

Volume 2

Revenues and Expenditures

1994

Advisory Commission
on Intergovernmental Relations
December 1994 M-190-II

Contents

Introduction	1
Technical Notes	3
Highlights	5
<i>Table A</i> Selected National Indicators, Selected Years 1929-1993	6
<i>Table B</i> Major Revenues and Expenditures of Governments and Percentage Change, 1991-1992	8
<i>Table C</i> Federal Grants-in-Aid in Relation to State and Local Outlays, Total Federal Outlays and Gross Domestic Product, 1955-1994	9
<i>Table D</i> State Intergovernmental Expenditures to Local Governments, by Function, Selected Years 1954-1992	10
<i>Table E</i> Public Employment in the United States, Percentage Change and Distribution, Selected Years 1929-1992	11
<i>Table F</i> Federal, State, and Local Debt, Selected Years 1929-1992	12
Economy and Population	13
<i>Table 1</i> Selected National Indicators, Selected Years 1929-1993	14
<i>Table 2</i> State Population, Percentage Change, Selected Years 1950-1993	16
<i>Table 3</i> State Personal Income with Percentage Change, Selected Years 1970-1993	18
<i>Table 4</i> State Personal Income Per Capita with Percentage Change, Selected Years 1970-1993	19
Federal, State, and Local Government: National Income and Budget Basis	21
<i>Table 5</i> Federal Budget Receipts, Outlays, Surplus or Deficit, Total Debt and Interest on Debt, 1789-1994	22
<i>Table 6</i> Federal Receipts and Expenditures, Selected Years 1965-1993	24
<i>Table 7</i> Federal Receipts and Expenditures as a Percentage of GDP and Per Capita, Selected Years 1965-1993	25
<i>Table 8</i> State and Local Receipts and Expenditures, Selected Years 1965-1993	26
<i>Table 9</i> State and Local Receipts and Expenditures as a Percentage of GDP and Per Capita, Selected Years 1965-1993	27
Intergovernmental Fiscal Flows	29
<i>Table 10</i> Federal Grants-in-Aid in Relation to State and Local Outlays, Total Federal Outlays and Gross Domestic Product, 1955-1994	30
<i>Table 11</i> Federal Grants-in-Aid to State and Local Governments by Function, Selected Fiscal Years 1965-1994	31
<i>Table 12</i> Federal Expenditures by State, FY 1993	32
<i>Table 13</i> Federal Grants to State and Local Governments, with Percentage Change, Fiscal Years 1988-1993	34
<i>Table 14</i> State Intergovernmental Expenditures to Local Governments, by Function, Selected Years 1954-1992	35
<i>Table 15</i> State Intergovernmental Expenditures to Local Governments, FY 1992	36
<i>Table 16</i> State Intergovernmental Expenditures, by Function, FY 1992	38
<i>Table 17</i> State Intergovernmental Expenditures, by Function, Percentage Distribution, FY 1992	40
Federal, State, and Local Government Revenues and Expenditures: Census Basis	43
<i>Table 18</i> Total Government Revenues, Selected Years 1927-1992	44
<i>Table 19</i> Total Government Revenues, Per Capita, Selected Years 1927-1992	45
<i>Table 20</i> Total Government Revenues as a Percentage of Personal Income, Selected Years 1927-1992	46

<i>Table 21</i>	Total Government Expenditures, Selected Years 1927-1992	47
<i>Table 22</i>	Total Government Expenditures, Per Capita, Selected Years 1927-1992	48
<i>Table 23</i>	Total Government Expenditures, as Percentage of Personal Income, Selected Years 1927-1992 ...	49
<i>Table 24</i>	Federal, State, and Local Revenues and Expenditures, by Character, Object, and Function, Selected Years 1965-1992	50
<i>Table 25</i>	Federal Revenues and Expenditures, by Character, Object, and Function, Selected Years 1965-1992 ..	52
<i>Table 26</i>	Federal Revenues and Expenditures, by Character, Object, and Function, Per Capita, Selected Years 1965-1992	54
<i>Table 27</i>	Federal Revenues and Expenditures, by Character, Object, and Function, as a Percentage of Personal Income, Selected Years 1965-1992	56
<i>Table 28</i>	State and Local Revenues and Expenditures, by Character, Object, and Function, Selected Years 1965-1992	58
<i>Table 29</i>	State and Local Revenues and Expenditures, by Character, Object, and Function, Per Capita, Selected Years 1965-1992	60
<i>Table 30</i>	State and Local Revenues and Expenditures, by Character, Object, and Function, as a Percentage of Personal Income, Selected Years 1965-1992	62
<i>Table 31</i>	State General Revenues, by Source, 1948-1992	64
<i>Table 32</i>	State General Revenues, by Source, Percentage Distribution, 1948-1992	65
<i>Table 33</i>	Local General Revenues, by Source, 1948-1992	66
<i>Table 34</i>	Local General Revenues, by Source, Percentage Distribution, 1948-1992	67
<i>Table 35</i>	Major Federal, State, and Local Tax Revenues, by Source, 1948-1992	68
<i>Table 36</i>	Federal, State, and Local Tax Revenues, by Government, Selected Years 1967-1992	70
<i>Table 37</i>	Federal, State, and Local Tax Revenues, Average Annual Percentage Increase or Decrease, Selected Periods 1965-1992	72
<i>Table 38</i>	Federal, State, and Local Tax Revenues as a Percentage of Gross Domestic Product, Selected Years 1965-1992	73
<i>Table 39</i>	State and Local General Expenditures, by Function, 1948-1992	74
<i>Table 40</i>	State and Local General Expenditures, by Function, Percentage Distribution, 1948-1992	75
<i>Table 41</i>	State General Expenditures, by Function, 1948-1992	76
<i>Table 42</i>	State General Expenditures, by Function, Percentage Distribution, 1948-1992	77
<i>Table 43</i>	Local General Expenditures, by Function, 1948-1992	78
<i>Table 44</i>	Local General Expenditures, by Function, Percentage Distribution, 1948-1992	79
<i>Table 45</i>	Federal, State, and Local Direct General Expenditure, by Government, Selected Years 1955-1992 ...	80
<i>Table 46</i>	Federal, State, and Local Direct General Expenditure, by Government, Percentage Distribution, Selected Years 1955-1992	81
State-by-State Revenues		83
<i>Table 47</i>	State and Local General Revenues, FY 1992	84
<i>Table 48</i>	State and Local General Revenues, Percentage Distribution, FY 1992	86
<i>Table 49</i>	State and Local General Revenues, Per Capita, FY 1992	88
<i>Table 50</i>	State and Local General Revenues as a Percentage of Personal Income, FY 1992	90
<i>Table 51</i>	State and Local Tax Revenue as a Percentage of Personal Income, Selected Years 1965-1992	92
<i>Table 52</i>	State and Local Tax Revenues, Per Capita, Selected Years, 1965-1992	94
<i>Table 53</i>	State and Local Property Taxes as a Percentage of Total Taxes, Selected Years 1965-1992	97
<i>Table 54</i>	State General Revenues, FY 1992	98
<i>Table 55</i>	State General Revenues, Percentage Distribution, FY 1992	100
<i>Table 56</i>	State General Revenues, Per Capita, FY 1992	102
<i>Table 57</i>	State General Revenues as a Percentage of Personal Income, FY 1992	104
<i>Table 58</i>	State Lotteries, Gross Revenues, Fiscal Years 1980-1992	106
<i>Table 59</i>	State Lotteries, Net Proceeds, Fiscal Years 1980-1992	108
<i>Table 60</i>	Local General Revenues, FY 1992	110
<i>Table 61</i>	Local General Revenues, Percentage Distribution, FY 1992	112
<i>Table 62</i>	Local General Revenues, Per Capita, FY 1992	114
<i>Table 63</i>	Local General Revenues as a Percentage of Personal Income, FY 1992	116
<i>Table 64</i>	Local Property Taxes as a Percentage of Total Local Tax Revenues, Selected Years 1965-1992	118
State-by-State Expenditures		119
<i>Table 65</i>	State and Local General Expenditures, FY 1992	120
<i>Table 66</i>	State and Local General Expenditures, Percentage Distribution, FY 1992	122
<i>Table 67</i>	State and Local General Expenditures, Per Capita, FY 1992	124
<i>Table 68</i>	State and Local General Expenditures as a Percentage of Personal Income, FY 1992	126

<i>Table 69</i>	State and Local Direct General Expenditures, Per Capita, Selected Years 1965-1992	128
<i>Table 70</i>	State and Local Direct General Expenditures as a Percentage of State Personal Income, Selected Years 1965-1992	130
<i>Table 71</i>	State General Expenditures, FY 1992	132
<i>Table 72</i>	State General Expenditures, Percentage Distribution, FY 1992	134
<i>Table 73</i>	State General Expenditures, Per Capita, FY 1992	136
<i>Table 74</i>	State General Expenditures as a Percentage of Personal Income, FY 1992	138
<i>Table 75</i>	Local General Expenditures, FY 1992	140
<i>Table 76</i>	Local General Expenditures, Percentage Distribution, FY 1992	142
<i>Table 77</i>	Local General Expenditures, Per Capita, FY 1992	144
<i>Table 78</i>	Local General Expenditures as a Percentage of Personal Income, FY 1992	146
Public Employment and Public Employee Retirement Systems		149
<i>Table 79</i>	Full-Time Equivalent Public Employment, Per 10,000 Population, Selected Years 1952-1992	150
<i>Table 80</i>	Public Employment in the United States, Percentage Change and Distribution, Selected Years 1929-1992	151
<i>Table 81</i>	Public Employees by State, 1992	152
<i>Table 82</i>	State and Local Payroll as a Percentage of State Personal Income, Estimated, Selected Years 1965-1992	154
<i>Table 83</i>	State and Local Employees, Estimated Annual Full-Time Earnings, Selected Years 1965-1992 ...	156
<i>Table 84</i>	State and Local Employment, Full-Time Equivalent per 10,000 Population, Selected Years 1965-1992	158
<i>Table 85</i>	State-Local Employee Retirement Systems Receipts and Payments, Selected Years 1975-1991 ...	159
<i>Table 86</i>	State-Local Employee Retirement Systems Percentage Distribution of Receipts, Selected Years 1975-1991	160
<i>Table 87</i>	State-Local Employee Retirement Systems Cash and Investment Holdings, Selected Years 1975-1991	161
Federal, State, and Local Debt		163
<i>Table 88</i>	Federal, State, and Local Debt, Selected Years 1929-1992	164
<i>Table 89</i>	State-Local Debt, by Type, FY 1992	165
<i>Table 90</i>	State-Local Debt, by Type, Per Capita, FY 1992	166
<i>Table 91</i>	State Debt, by Type, FY 1992	168
<i>Table 92</i>	State Debt, by Type, Per Capita, FY 1992	170
<i>Table 93</i>	Local Debt, by Type, FY 1992	172
<i>Table 94</i>	Local Debt, by Type, Per Capita, FY 1992	174
Special Features		177
<i>Table 95</i>	Federal Medicaid Assistance Matching Ratios, Selected Fiscal Years, 1966-1995	178
<i>Table 96</i>	State Medicaid Expenditures, Total and Percentage Change, Fiscal Years 1987-1993	180
<i>Table 97</i>	State Medicaid Expenditures as Percentage of Total State General Expenditures, Fiscal Years 1987-1993	181
<i>Table 98</i>	Representative Tax System, Tax Capacity Indexes, Selected Years, 1975-1991	182
<i>Table 99</i>	Representative Tax System, Tax Effort Indexes, Selected Years, 1975-1991	183
State Fiscal Rankings		185
Selected State-Local Revenue Items Per Capita and as a Percentage of State Personal Income, FY 1992		
<i>Table R-1</i>	Federal Aid to State-Local Government, General Revenue, and Own-Source General Revenue .	186
<i>Table R-2</i>	All Tax Revenues, Property Taxes, and Individual Income Taxes	187
<i>Table R-3</i>	Corporation Income Taxes, General Sales and Gross Receipts Taxes, and Selective Sales and Gross Receipts Taxes	188
<i>Table R-4</i>	Motor Fuels Taxes, Public Utilities Taxes, and Tobacco Products Taxes	189
<i>Table R-5</i>	Alcoholic Beverages Taxes, User Charges, and Miscellaneous	190
Selected State-Local Expenditure Items Per Capita and as a Percentage of State Personal Income, FY 1992		
<i>Table R-6</i>	General Expenditure, Direct Education, and Direct Elementary and Secondary Education	191
<i>Table R-7</i>	Direct Higher Education, Direct Public Welfare, and Direct Health and Hospitals	192
<i>Table R-8</i>	Direct Highway, Direct Police, and Direct Fire	193
<i>Table R-9</i>	Direct Protective Inspection and Regulation, Direct Sewerage and Sanitation, and Direct Corrections	194
<i>Table R-10</i>	Housing and Community Development, Governmental Administration, and Interest Payments on General Debt	195

State Fiscal Profiles	197
Profile State Rank, by Population, Total Personal Income, and Per Capita Personal Income	198
United States	199
Alabama	200
Alaska	201
Arizona	202
Arkansas	203
California	204
Colorado	205
Connecticut	206
Delaware	207
District of Columbia	208
Florida	209
Georgia	210
Hawaii	211
Idaho	212
Illinois	213
Indiana	214
Iowa	215
Kansas	216
Kentucky	217
Louisiana	218
Maine	219
Maryland	220
Massachusetts	221
Michigan	222
Minnesota	223
Mississippi	224
Missouri	225
Montana	226
Nebraska	227
Nevada	228
New Hampshire	229
New Jersey	230
New Mexico	231
New York	232
North Carolina	233
North Dakota	234
Ohio	235
Oklahoma	236
Oregon	237
Pennsylvania	238
Rhode Island	239
South Carolina	240
South Dakota	241
Tennessee	242
Texas	243
Utah	244
Vermont	245
Virginia	246
Washington	247
West Virginia	248
Wisconsin	249
Wyoming	250
Appendix	251
Table A-1 Relation of Federal Government Revenues and Expenditures, Unified Budget Receipts and Expenditures, National Income and Product Accounts Basis, Fiscal Years 1989-1993	252
Table A-2 Relation of State and Local Government Revenues and Expenditures, Census Basis, to Receipts and Expenditures, National Income and Product Accounts Basis, Fiscal Years 1987-1992	253
Glossary	255
Sources	265
Index	267

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101:101

MEMORANDUM

State of Alaska
Office of the Governor
Office of Management and Budget

June 26, 1995

TO: LRFPC Revenue Subcommittee Members

FROM: Brad Pierce 
Senior Policy Analyst

SUBJECT: Special Funds

At the last teleconference members asked me to organize the state's so called "special funds" into some kind of easily understandable categories. The attached tables are a first cut at this assignment. Of the various funds listed, the following categories might be candidates for requiring annual dividends or to write down or sell off their equity to balance future budgets:

- All Enterprise Funds (except the Alaska Clean Water Fund);
- Expendable Trust Funds; and
- Proprietary Funds.

We will be writing up a more comprehensive analysis of the potential use of the most commonly mentioned reserve accounts (AIDEA, AHFC, etc.) which should be finished next week.

Post-It™ brand fax transmittal memo 7671		of pages: 7	
To: Melissa	From: Brad		
Co.	Co.		
Dept.	Phone: 465-4677		
Fax: 258-9869	Fax: 3008		

Long Range Financial Planning Commission

Revenue Subcommittee

Categorization of State Funds

Combining Balance Sheet Totals

(Stated in Thousands)

	<u>Total Assets</u>	<u>Total Liabilities</u>	<u>FY94 Revenues</u>	<u>FY94 Expenditures</u>	<u>FY94 Year End Fund Balance</u>
General Funds	1,681,117	1,873,843	2,692,170	3,305,078	(192,526)
All Special Revenue Funds					
Disaster Relief	11,326	228	581	3,422	11,098
Training and Building	25	0	483	454	25
School	911	0	2,658	2,721	911
Fish and Game	12,265	1,105	17,066	15,288	11,160
State Reforestation	196	3	0	7	193
National Petroleum Reserve	72	0	25	255	72
Reclamation Bonding	325	190	50	0	135
<i>June 30, 1994 year end totals</i>	25,120	1,526	20,843	22,147	23,594
Debt Service Fund	148	148		33,819	343
All Capital Projects Funds					
Public Schools Group	15	0			15
Highways & Ferries Group	9,958	483	2,458 *	3,080	9,475
Airports Group	47	0			47
Health & Social Services Group	137	68		116	69
Flood & Harbor Group	1,582	295		856	1,287
<i>June 30, 1994 year end totals</i>	11,739	846		4,152	10,893

* Federal Grants in Aid

Combining Balance Sheet Totals

(Stated in Thousands)

	Total Assets	Total Liabilities	FY94 Revenues	FY94 Expenditures	FY94 Year End Fund Balance
All Enterprise Funds					
Commercial Assistance	180,113	3,166	11,077	0	81,129
Energy Assistance	97,366	1,287	1,689	0	5,130
Other Agencies	449,342	58,170	48,333	451	209,927
Commercial Assistance Enterprise Funds					
WWII Vet Revolving Loan	2,398	1,479	257	319	771
Small Business Rev. Loan	1,201	98	158	97	598
Comm. Fishing Rev. Loan	92,414	864	5,498	2,128	22,877
Tourism Revolving Loan	0	0	0	0	0
Child Care Facilities Loan	536	78	46	46	229
Historical Dist. Rev. Loan	1,036	81	65	7	181
Fisheries Enhancement	79,957	261	4,551	597	549
Mining Revolving Loan	1,505	255	342	304	755
Sm. Business Econ Devel.	1,066	50	162	42	205
<i>June 30, 1994 year end total</i>	<i>180,113</i>	<i>3,166</i>	<i>11,077</i>	<i>3,540</i>	<i>26,165</i>
Energy Assistance Enterprise Funds					
Alternative Tech & Power	3,855	727	231	464	1,448
Residential Energy Cons.	112	13	16	111	99
Power Project	86,237	0	1,329	150	3,511
Rural Electrification	4,977	547	79	0	79
Bulk Fuel Revolving Loan	2,185	0	34	41	(7)
<i>June 30, 1994 year end totals</i>	<i>97,366</i>	<i>1,287</i>	<i>1,689</i>	<i>766</i>	<i>5,130</i>

Combining Balance Sheet Totals

(Stated in Thousands)

	Total Assets	Total Liabilities	FY94 Revenues	FY94 Expenditures	FY94 Year End Cash Balance
Other Agencies Enterprise Funds					
HEALTH & SOCIAL SERVICES					
Alcoholism & Drug Abuse	125	0	0	2	6
COMMUNITY & REGIONAL AFFAIRS					
Rural Development	1,140	29	8	41	0
Housing Assistance	0	0	0	0	0
Senior Housing	0	0	0	0	0
TRANSPORTATION & PUBLIC FACILITIES					
International Airports	385,391	56,945	44,914	50,679	(265)
NATURAL RESOURCES					
Agriculture	32,198	1,024	2,583	(1,573)	250
ENVIRONMENTAL CONSERVATION					
Alaska Clean Water	30,488	172	828	119	460
<i>June 30, 1994 year end totals</i>	449,342	58,170	48,333	49,268	451

Combining Balance Sheet Totals

(Stated in Thousands)

	Total Assets	Total Liabilities	FY94 Revenues	FY94 Expenditures	FY94 Year End Fund Balance
All Trust and Agency Funds					
Expendable Trust	3,322,343	462,765			
Nonexpendable Trust	15,234,740	870,362			
Pension Trust	7,497,241	20,686			
Agency	218,781	218,781			
<i>June 30, 1994 year end totals</i>	<i>26,273,105</i>	<i>1,572,594</i>			
Expendable Trust Funds					
Memorial Scholarship	1,497	0	438	3	1,497
Ak Perm. Fund Dividend	564,760	5,656	516	528,304	559,104
Unemployment Comp.	208,153	7,075	167,141	183,418	201,078
Const. Budget Reserve	2,480,633	448,351	423,243	0	2,032,282
Statutory Budget Reserve	0	0	0	0	0
Public Advocacy Trust	2,265	2	4,700	4,788	2,263
Exxon Valdez Settlement	12,908	1,342	59,885	50,289	11,566
Alyeska Settlement Trust	6,279	167	10,602	9,241	6,112
Oil Restoration	45,848	172	1,735	10,454	45,676
<i>June 30, 1994 year end totals</i>	<i>3,322,343</i>	<i>462,765</i>	<i>668,260</i>	<i>786,497</i>	<i>2,859,578</i>
					End of Year
					Cash Balance
Nonexpendable Trust Funds					
Public School	129,887	983	7,201	3,987	126,497
Alaska Permanent	14,977,181	862,099	1,118,665	8,329	898,093
Mental Health Trust	127,672	7,280	8,022	8,781	123,384
<i>June 30, 1994 year end totals</i>	<i>15,234,740</i>	<i>870,362</i>	<i>1,133,888</i>	<i>21,097</i>	<i>1,147,974</i>

(Stated in Thousands)

Page 5

Combined Balance Sheet Totals

Component Units

(Stated in Thousands)

	Total Assets	Total Liabilities	FY94 Revenues	FY94 Expenditures	FY94 Year End Fund Balance
Special Revenue					
AK Municipal Bond Bank Authority	39,400	8,573	1,949	878	30,827
Debt Service					
AK Municipal Bond Bank Authority	132,294	132,296	7,539	7,540	(2)
<i>June 30, 1994 year end totals</i>			9,488	8,418	30,825
Proprietary Fund Types					
Alaska Indus. Dev. & Export Auth.	1,015,029	239,543	58,564	23,732	387,077
Alaska Housing Finance Corp.	4,433,779	2,661,605	345,903	273,439	686,968
Alaska Student Loan Corporation	505,478	225,628	29,294	30,692	(26,852)
Alaska Medical Facility Authority	136	0	0	1	136
Alaska Railroad Corporation	112,961	52,181	59,511	64,922	26,606
Alaska Energy Authority	821,093	364,899	32,336	51,721	(163,607)
Alaska Aerospace Development Cor	1,674	629	0	890	0
Nonexpendable Trust					
AK Science & Tech. Foundation	109,208	0	0	2,500	109,208
College and University					
University of Alaska	1,090,257	196,505			
<i>June 30, 1994 year end totals</i>	8,251,309	3,881,859	525,608	447,697	1,019,534

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101:102

**STATE OF ALASKA
DEPARTMENT OF REVENUE
TREASURY DIVISION
ANNUAL REPORT
FY93**

Laraine L. Derr, Deputy Commissioner

FY93 ANNUAL REPORT
TREASURY DIVISION

To the Commissioner of Revenue:

This report is a summary of activities in the Treasury Division for FY93. As I enter my first full year as Deputy Commissioner, I wish to congratulate the employees of the Treasury Division for a job well done for the people of Alaska.

Over the last year, Treasury's accomplishments have contributed significantly to the growth in financial stability of the State of Alaska. We have saved money for the operating fund, reduced operating costs for other departments, and generated outstanding investment returns, while assuring citizens that all accounting procedures follow the highest standards. You can be pleased with the performance of Treasury personnel.

Alaska ranks number ONE of the fifty states in electronic revenue collections. Alaska ranks in the top 25th percentile for total returns on investments (14.25% and 14.38% respectively in PERS and TRS, the two largest funds). Fixed income returns place us in the top 13th percentile as measured by Callan Associates. Real estate mortgages in portfolios held by the retirement funds were sold for \$107 million at 97% of book value -- stellar performance in a depressed real estate market.

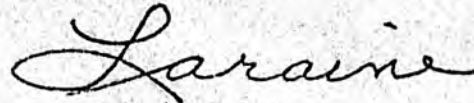
Cash Management transmitted over \$100 billion in transactions into AKSAS, the State's accounting system. Over 1.3 million checks were deposited and almost 3 million warrants were redeemed -- a record high. Revenues of over \$5.3 billion were received electronically; \$4.1 billion was paid electronically. Due to innovative approaches, new technology and new procedures, the Cash Management Section was responsible for saving over \$1 million for the State this past year.

Debt Management issued almost \$70 million in debt, both in purchasing facilities that had previously been rented and in refunding other issues because of low interest rates. This activity resulted in lower debt service requirements for the State.

The Comptroller's office is implementing new technology that will provide increased efficiency in Treasury operations. Many computer workstations were upgraded, an electronic mail system was installed and a disaster recovery plan was initiated.

The Alaska State Pension Investment Board was formed. Revenue employees are staffing that board as well as the State Bond Committee.

All in all, you can be proud that you have such a highly diversified group of employees in the Department of Revenue. It is a pleasure for me to work with this group of fine people and to serve you, in your role as Commissioner of Revenue.



Laraine L. Derr
Deputy Commissioner



STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

WALTER J. HICKEL, GOVERNOR

P.O. BOX 110400
JUNEAU, ALASKA 99811-0400
TELEPHONE: (907) 465-2300
FACSIMILE: (907) 465-2389

January 10, 1994

The Honorable Con Ralph Bunde
State Capitol, Room 112
Juneau, Alaska 99801

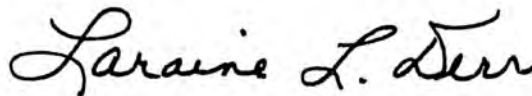
Dear Legislator:

Enclosed is a copy of the FY 93 Treasury Annual Report. It contains information on the various areas of the Treasury which include asset accounting, portfolio management, cash management, debt management and investments. This is the first year a report has been done specifically for the Treasury Division and I thought it might be useful to you.

With the FY 94 annual report, I plan to include fund balances and generally expand the report to include answers to frequently asked questions.

If you have questions regarding any section of the report, please call me.

Sincerely,



Laraine L. Derr
Deputy Commissioner

Enclosure

PORTFOLIO MANAGEMENT

OVERVIEW

FY93 began with the acceptance of an Asset Allocation Study performed by the consulting firm of Dorn, Helliesen and Cottle for the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS). The Asset Allocation Study was instituted to assist the Commissioner in developing a diversified portfolio that would achieve rates of return consistent with actuarial assumptions and minimize market risk. Concurrent with the Asset Allocation Study, Dorn, Helliesen and Cottle assisted the Commissioner and staff in developing and implementing investment policies.

On July 8, 1992, the Commissioner, Deputy Commissioner, and Chief Investment Officer signed into effect the Asset Allocation and Investment Policies. Work began immediately to implement the policies by first reviewing the Domestic Equity Portfolio. Details of the year in review will be featured in each asset class section but certain highlights should be noted.

In the Fixed Income Portfolio, managed internally by Treasury Staff, performance was outstanding with returns for the year of 15.13% in the Retirement Systems' Portfolios. The performance exceeded the benchmark *Lehman Brothers Government/Corporate Index* by 2% and ranked Alaska in the top 13th percentile in the country.

Another accomplishment in the Fixed Income Portfolio was initiation of a short-term investment pool. The investment pool allows staff to keep less cash in reserve to meet cash flow requirements. In a normal positive yield curve environment, extending maturities adds incremental return to all the funds.

The Real Estate Section can also look back on the year with satisfaction, knowing that they completed a bulk sale of the Mortgage Portfolio at very competitive market prices. The sale also enhanced the

control and maintenance of existing non-liquidated mortgages, thus allowing staff to make timely decisions with more accurate information.

For FY93, total returns for the Public Employees' Retirement System and the Teachers' Retirement System were 14.25% and 14.38%, respectively. These returns were sufficient to rank the performance of the funds in the top 25th percentile of the Public Retirement Systems in the nation. Performance was measured by the Department of Revenue's independent performance measurement consultant, Callan Associates, Inc.

Performance of the shorter maturity funds, such as the General Fund, was consistent with the excellent performance of PERS and TRS. These funds were constrained by the maturity restraints and the need to minimize risk. The approach is consistent with managing the State's cash flow needs.

A review of the year would not be complete without a discussion of the creation of the Alaska State Pension Investment Board (ASPIB). The eight member Board, four appointed by the Governor, two elected representatives of the Teachers' Retirement System, and two elected representatives from the Public Employees' Retirement System, convened in February of 1993. Board members participated in an intensive four-month educational process. The educational process culminated at the June Board meeting in Soldotna with the acceptance of fiduciary responsibility effective on July 1, 1993. The Board also accepted the Asset Allocation and Investment Policies.

EQUITIES

Implementation of the Asset Allocation began with a thorough review of the Domestic Equity Portfolio. The review consisted of an evaluation of each equity manager's style and historical performance.

The review concluded that one manager should be dismissed, and that the total equity portfolio had a style bias toward large capitalized growth stocks. This indicated the need for greater style diversification, such as acquiring a value style manager and companies with smaller capitalization.

With the assistance of the firm of Dorn, Helliesen and Cottle, staff initiated searches to find equity managers that have expertise in managing portfolios consisting of companies with smaller capitalization. The initial review process involved analyzing over 70 equity management firms. Six firms were invited to make presentations to the Commissioner, Deputy Commissioner, and Chief Investment Officer.

Of the six finalists, four managers were selected. Two of the selected firms employ a style bias toward value stocks and two specialize in growth companies. In the fall of 1992, each of the four managers was funded with seventy-five million dollars (\$75,000,000).

After completing the small capitalization manager search, staff initiated a search to add equity managers who employ a value style. This decision evolved from the analysis that the domestic equity portfolio was structured with a bias toward growth stock.

The review process was the same as the small cap equity manager search. Four value managers were invited to make a presentation to staff. From the four presentations, two managers were selected, and each was funded with one hundred twelve million five hundred thousand dollars (\$112,500,000) early in 1993.

The concluding search in the Domestic Equity Portfolio was for a manager with expertise in Tactical Asset Allocation. A Tactical Asset Allocation manager analyzes the valuations of the equity and bond markets and adjusts the market exposure toward the asset class that adds the greatest value.

Again, the process was the same as the other searches with three finalists making presentations for one position. After the selection, the funding took place on January 4, 1993, with three hundred million dollars (\$300,000,000) committed to tactical asset allocation.

With the Domestic Equity Portfolio re-balanced, attention was directed toward the International Equity Portfolio. The existing portfolio consists of two managers with a mandate to out-perform the *Morgan Stanley Capital International Europe, Australia, and Far East Index* (EAFE).

The decision was to leave one manager with an EAFE mandate, and to change the other manager's mandate to managing a portfolio of European equities. Other actions were to add two global managers, hire two managers with expertise in the Pacific Basin EX-Japan, and to seek one or two managers with expertise in the emerging markets. With the exception of hiring the emerging market managers, all the searches were completed in FY93.

The search process was identical to the domestic equity searches with the following conclusion:

1. One existing domestic equity manager's mandate was expanded to include global equity with a three hundred million dollar (\$300,000,000) portfolio.
2. A new global manager was hired and funded with one hundred twenty-five million dollars (\$125,000,000).
3. Two Pacific Basin EX-Japan managers were hired and each was funded with approximately fifty-six million dollars (\$56,000,000).

The emerging market manager search was not instituted in FY93. However, the Alaska State Pension Investment Board (ASPIB) has

authorized a search and the selection and funding should be concluded by January, 1994.

The aggregate performance of both the domestic and international equity managers exceeded the median performance of the managers of the Callan Associates' database. For FY93, the Domestic Equity Portfolio had returns of 15.67%, which exceeded the benchmark S&P 500 Index (13.58%) by over of 2%. While out-performing most active managers, the International Portfolio under-performed the EAFE Index (8.44% versus 20.28%), because one manager limited their exposure to the Japanese stock market. The Japanese stock market had returns in excess of 40%.

The restructuring of the Domestic and International Equity Portfolios should enhance future performances. Risk will also be reduced due to improved style diversification.

FIXED INCOME

The Treasury Division manages thirteen state, retirement, and endowment trust funds. The entire \$6.1 billion fixed income investments are managed internally by a professional staff of three. During FY93 fixed income investments produced \$520 million investment income and capital gains. Each fund is managed to meet its specific requirements and objectives.

SHORT-TERM FUNDS

The short-term funds are managed with a maximum two-year maturity constraint. Preservation of the principal and liquidity are the main objectives of these funds. Primary investments include U.S. Treasuries and Agencies, high grade corporate securities, money market instruments, and repurchase agreements (collateralized by U.S. Treasuries only).

During the fiscal year, Portfolio staff, with the cooperation of other Treasury staff, consolidated the investments of several short term funds into an investment pool. This added several benefits to the management of these monies. The pooling of securities enables funds to enjoy lower transaction costs. This includes commission costs and operation costs. The investment pool also allows various funds to minimize overnight cash investments. Under a positive yield curve environment, these funds are able to capture incremental yield. Most critical, this is accomplished without compromising liquidity and principal concerns.

LONG-TERM FUNDS

During FY93 the retirement trust funds provided a generous return of 15.13%. These investments have consistently produced superior returns within a structured conservative investment strategy developed to produce superior returns with limited risk. The 15.13% return compares favorably to the returns of all fixed income portfolios in the Callan Associates universe of almost 400 institutional fixed income portfolios. Alaska's 1993 returns were in the top 13 percent among these portfolios. Measured against this universe over a period of five years, Alaska's returns have consistently been in the top 25 percent.

INVESTMENT STRATEGY

These returns have been produced by a strategy designed for consistent long-term returns with limited risk. The strategy is based upon three key foundations. First, investing is a long-term undertaking. Therefore long-term trends, objectives, and risk/return analysis should guide the process. Short-term opportunities or trends may present themselves but focus on the long term can never be lost.

Second, investment effort should be focused where the long-term risk/return relationship is most advantageous. Ibbotson Associates in Chicago has compiled historical return data covering the period from 1926 through 1992, which covers the great depression in the 30's through the recent "up" markets in the 80's. A review of this data reveals two key points central to Alaska's investment approach.

**FY93 ANNUAL REPORT
TREASURY DIVISION**

Intermediate government bonds (5 to 10 year maturity) have a higher return (5.2% vs. 4.8%) than long-term government bonds (10+ year maturities) with lower risk. Risk is defined as the variability of returns. Next, long-term corporate bonds have a higher return, 5.5% vs. 4.8%, than long-term government bonds with less risk. Therefore Alaska's investments are focused on intermediate corporate and government bonds.

Diversification and risk control are the final keys to Alaska's investment portfolios. The corporate bond portfolio is restricted to investment grade bonds. There are no "junk bonds" in the portfolio. Alaska will not purchase more than 10% of any individual issue and no individual issuer's debt will comprise more than 5% of the total portfolio. There are further restrictions on the lowest levels of investment grade debt. All these restrictions serve to improve the liquidity of the portfolio and reduce the risk that one company's trouble will significantly affect the entire portfolio.

ENDOWMENT FUNDS

Portfolio staff also manages the fixed income assets of various endowment funds. Under the similar long-term investment approach, these funds have also enjoyed excellent results. The FY93 results of the endowment funds ranked in the top 21 percent of the Callan Endowment Universe. On a five-year basis, the results also ranked favorably in the top 30 percent of the universe.

LOOKING FORWARD

Portfolio staff intends to form two investment pools during FY94. One pool will be for fixed income assets of Retirement Funds and the other will be for Endowment Funds. The funds will realize lower transaction costs and ultimately, higher returns.

In conjunction with establishment of investment pools, Portfolio staff will continue to review current investment guidelines of various funds with all interested parties.

REAL ESTATE INVESTMENT

Mortgage Portfolio

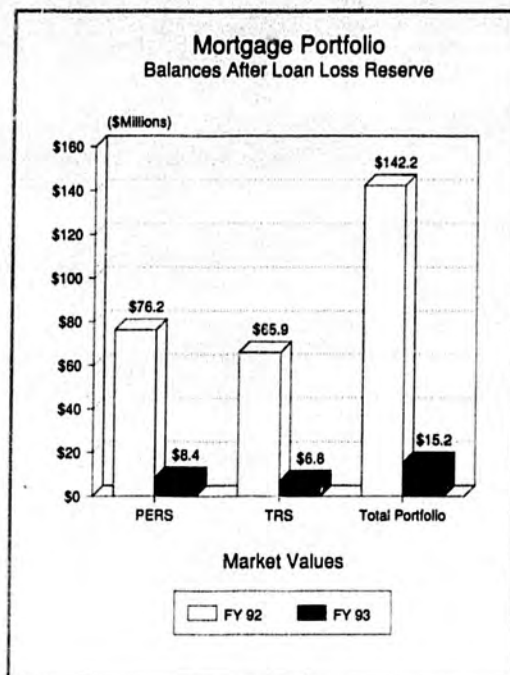
FY93 Goals and Objectives

To develop and implement a plan to liquidate the Mortgage Portfolio in an organized and prudent manner.

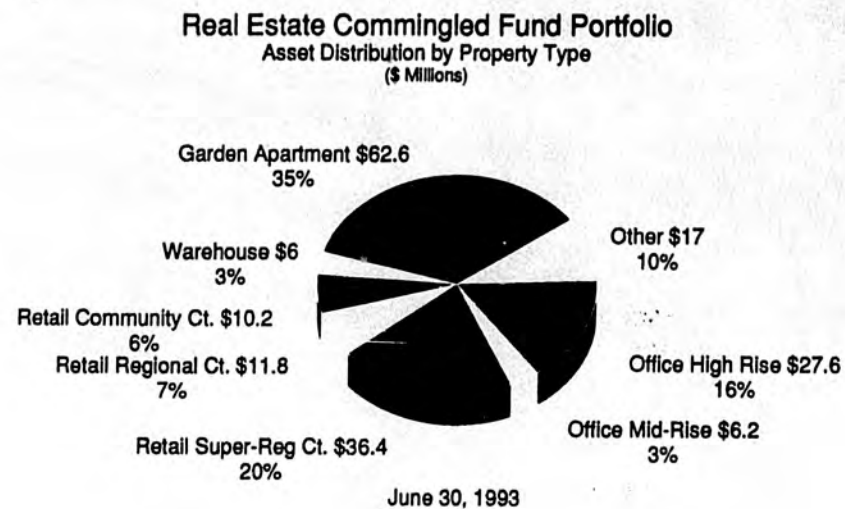
The following is a recap of FY93 activities that resulted in the implementation of a plan that reduced the Portfolio from \$142,200,000 to \$15,200,000 through loan sales, paydowns, sales of Real Estate Owned, and re-valuation of the remaining portfolio assets. (Graph A)

Mortgage Portfolio Public Offering:

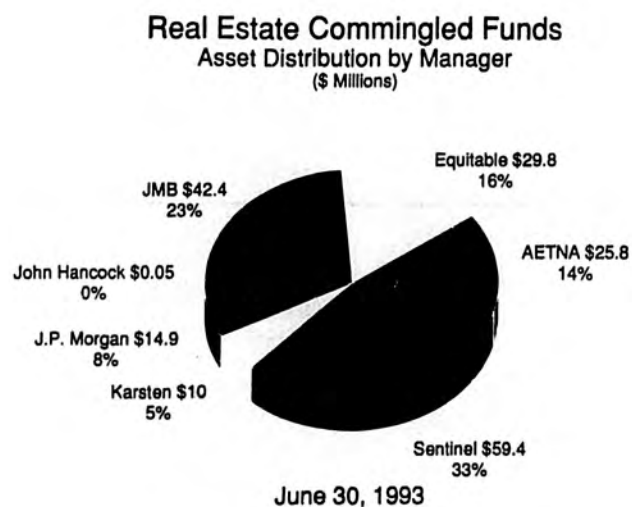
A public offering of all mortgage assets, including performing loans, non-performing loans, Real Estate Owned (REO), contaminated properties, and judgments, was held during the months of November, 1992, through May, 1993 (including the time to prepare and close). National Bank of Alaska's bids on the performing loans, in the 0 to 59 day and 60 to 89 day delinquent categories, were considered by staff to be more than satisfactory. Approximately \$107,000,000 in loans were sold at an average of 97% of par. The residential loans were sold at 103% of par. The commercial loans were sold at 91% of par.



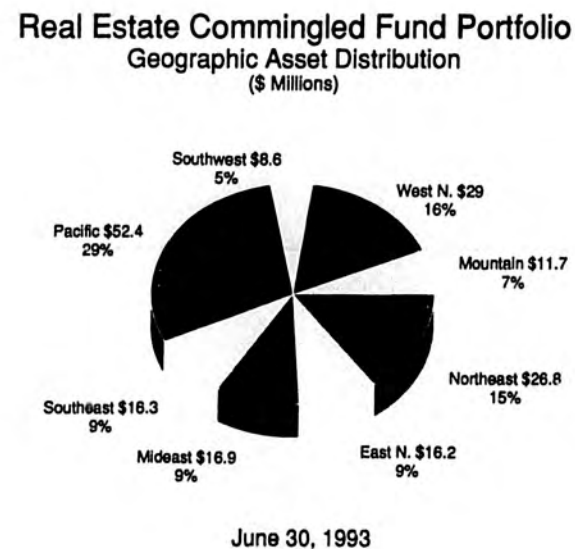
Graph A



Graph C



Graph B



Graph D

FY93 ANNUAL REPORT
TREASURY DIVISION

It should be noted that National Bank of Alaska successfully bid against two national firms. Since the sale was 95% Alaskan loans, the Treasury staff was pleased because the successful NBA bids would allow the loan servicing to remain in Alaska.

As opposed to hiring a specialized firm to organize and effect a mortgage portfolio sale, the entire project was handled by staff personnel with a minimal cost for contract labor. This was accomplished by the Real Estate and Accounting staffs' performing "above and beyond the call of duty".

As an additional note, certain commercial loans which were anticipated to be prepaid were removed from the sale (within the offering guidelines), resulting in full payment at par rather than our receiving 91% of par. As a result, the State "saved" about \$180,000.

Accounting Changes:

With the help of the Accounting and Portfolio Management staffs, we are currently upgrading our internal reporting to provide more up-to-date information on capital expenditures and income on each asset we control. Additionally, internal control procedures are being modified.

Changes in REO Sales Policies:

In November of 1992, seller financing, previously offered on REO, was discontinued. The terms typically were 10% down, 20 year amortization, 10% interest. It was concluded that the future effects of such financing would cause more problems than the immediate ones it solved. More conservative seller financing on specific properties will be recommended to the Chief Investment Officer on a case by case basis.

Other changes in the Real Estate Section's policies include:

- a) pricing REO to the current market;
- b) increased efforts to avoid foreclosures;
- c) continuous prudent aversion to lengthy litigation, resulting in reduced legal costs and quicker processing of loan

- modifications and foreclosures; and
- d) close scrutiny of any proposed capital improvements.

REO Sales:

In FY93, approximately 50 REO assets were sold for \$10,000,000, resulting in a loss of \$2,200,000. As of August 1, 1993, there were 70 REO properties with listed prices, including pending sales, totaling \$9,000,000, 28 REO sales totaling \$2,300,000 are pending. A few REO assets are not currently for sale due to contamination or legal problems. Because we still have a source of potential foreclosures, the REO asset category will continue to incur additions.

Quality of The Remaining Mortgage Portfolio:

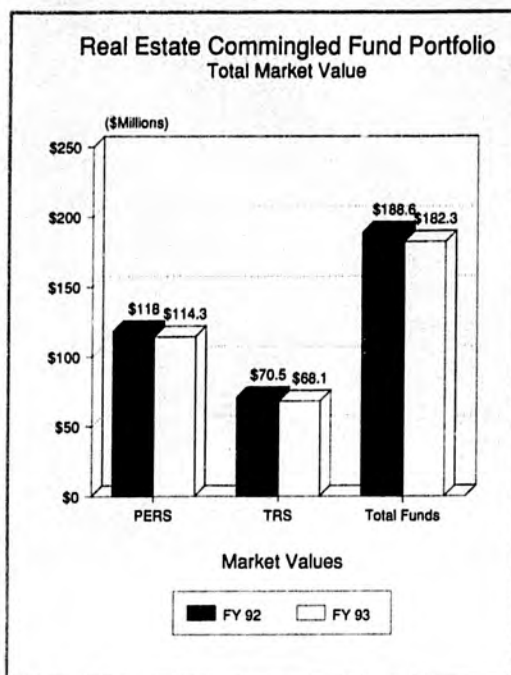
The remaining portfolio is of poor quality because:

- a) the overall quality of the REO, contaminated properties, and the non-amortizing/non-interest-accruing loans, has deteriorated as the percentage of assets on the books for extended periods has increased; and
- b) the sale to NBA involved only performing loans, leaving the troubled loans, REO, contaminated properties, and judgments in the portfolio.

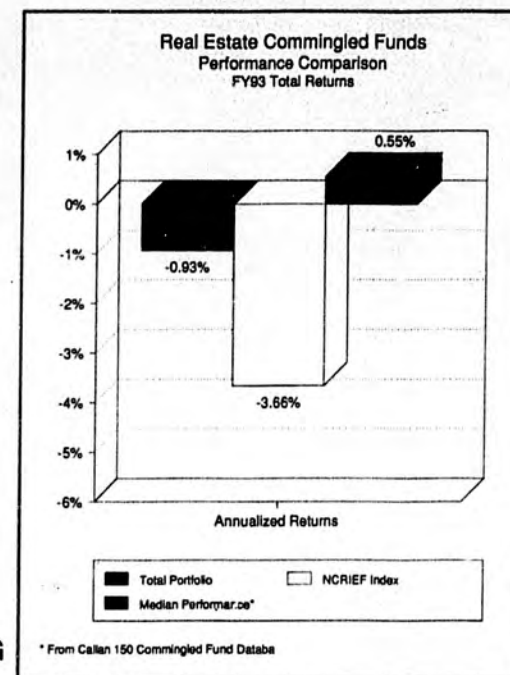
Mortgage Portfolio Asset Write-Down:

As of June 30, 1993, the remaining Mortgage Portfolio assets were valued by staff on an asset by asset basis resulting in the following:

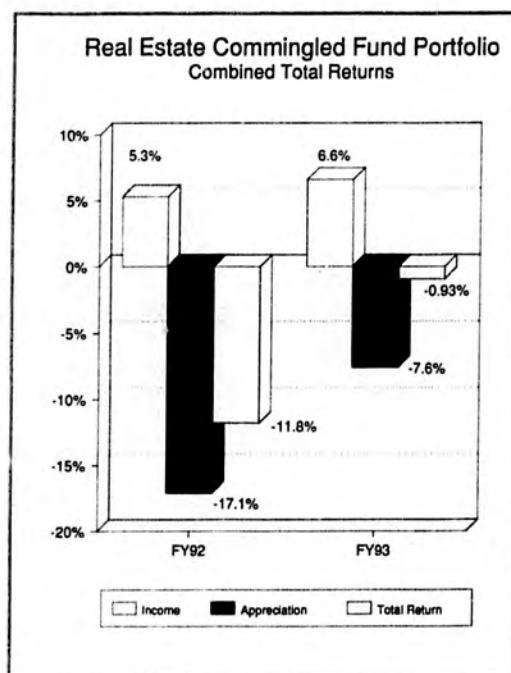
- a) REO, contaminated properties, and judgments were written down from \$15,800,000 to \$7,300,000 (\$8,500,000 write-down = 54%); and
- b) loans with a principal balance totaling \$14,300,000 were considered to have a potential loss factor of \$6,400,000 (45%).



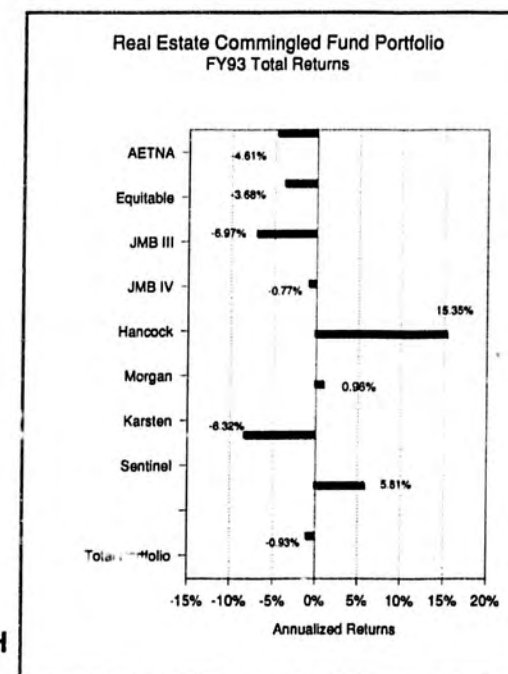
Graph E



Graph G



Graph F



Graph H

FY93 ANNUAL REPORT
TREASURY DIVISION

It is anticipated that the above write-downs and the revised reserve against future loan losses are sufficient to prevent additional near-term adjustments to the Loan Loss Reserve.

Mortgage Portfolio Value as of June 30, 1993:

90 accounts, including REO, contaminated properties, and judgments, with a written-down book value	\$7,300,000
80 loans (40 of which are 90 or more days delinquent with a principal balance before Loan Loss Reserve	<u>14,300,000</u>
*SUBTOTAL	<u>\$21,600,000</u>
Less Loan Loss Reserve	<u>6,400,000</u>
Mortgage Portfolio Book Value 6/30/93	\$15,200,000

COMMINGLED FUNDS

Performance:

The real estate equities are made up of holdings in seven commingled funds managed by nationally recognized real estate investment advisors (Graphs B, C and D). The market value of these holdings declined from \$118.0 million in FY92 to \$114.3 million in FY93. (Graph E)

Total returns of commingled funds improved substantially from -11.8% in FY92 to -0.9% in FY93. While the income component increased from 5.3% to 6.6%, the greater change was in the appreciation component that improved from -17.1% to -7.6%. (Graph F)

The -0.9% return compares favorably with the NCREIF Index of -3.66%. Callan's 150 fund performance database median reflected a total return of 0.55%. (Graphs G & H)

While improvement in total returns have been achieved, our commingled funds have yet to produce positive returns. What should be noted, however, is that the income component of the total return is positive and improving. Secondly, the appreciation component improvement is signaling a declining rate of overall value loss.

PORTFOLIO MANAGEMENT PERSONNEL- Investment Section

Bob Storer - Chief Investment Officer. Primary responsibility is to oversee Portfolio Management and insure that asset allocation is fully implemented.



Michael Cheung - CFA. Investment Officer. Primary responsibility is to manage retirement and endowment portfolios.

FY93 ANNUAL REPORT
TREASURY DIVISION

Portfolio Management (con't)

John Jenks - CCM. Investment Officer. Primary responsibility is to manage general investment fund and other fixed income funds with maturity constraints.



Phyllis Lewis - Clerk Typist. Provides clerical support for Chief Investment Officer and portfolio managers.



Steve Verschoor. Investment Officer. Primary responsibility is to support portfolio personnel with graphics, research, etc.



Jeff Hassler - Investment Officer. Primary responsibility is to manage the real estate section. Jeff joined the Division in 1992.

FY93 ANNUAL REPORT
TREASURY DIVISION

Karen Carlson - Loan Manager.
Oversees all mortgage portfolio
activities of real estate section.



Mary Ann Isturis - Supports loan
personnel, internal reporting and
expense reconciliation.



Pona Samuel - Loan Officer. Assists
in all activities of real estate. Direct
responsibility for judgement collection.



Darren Spence - Clerk Typist.
supports the entire staff with
skills in word processing and
organization.



CASH MANAGEMENT

As this is our first annual report, Cash Management elected to provide background information and data from prior years, which delineates past performance and helps clarify current year information.

Cash Management is Alaska's bank and cash control center of the state's financial system. This section of Treasury has the duties and responsibilities of managing Alaska's largest bank. Total cash and investments are equivalent to an amount almost five times greater than the largest bank located within Alaska. As the bank of the state, Cash Management collects all revenues, pays all expenditures, manages and determines the amount of cash available for investment each day for the general and custodial funds.

Cash Management consists of seven employees that work as a team. Employees are cross trained to perform duties of others in their absence. Complete interaction however, is limited due to separation of duties, which is required to provide maximum security of funds with a limited staff. No other area of the department requires 100% completion of its duties on a daily basis. Over the last ten years, Cash Management has successfully managed the significant increase in volume and number of funds, while incurring a reduction in staff.

Duties of the Cash Management staff include: collection and recording of state taxes, royalties, federal government payments, fees and investment income; monitoring of cash flows; establishing, managing and maintaining banking contracts; compensating balances; investments with financial institutions; bank service fees; collateralization agreements; redemption of all state warrants; implementation and oversight of the Cash Management Improvement Act (CMIA); Cash Management consulting; electronic payments; system supports and insuring the safety of funds as they flow from receipt to lawful disbursement. Cash Management establishes policies and procedures to ensure safe and efficient cash controls.

We are proud of our accomplishments, especially the cost effective changes made in conjunction with the more efficient processing, during a period of increasing costs and volume of activity. We operate in a disciplined professional manner, as we communicate daily with taxpayers, banking personnel, and state agency personnel at various levels within the respective organizations.

HIGHLIGHTS OF FY93 REPORT

1. Transmitted over 50,000 accounting transactions totaling more than \$100 billion (\$100,000,000,000) to the Alaska State Accounting System, (AKSAS).
2. Collected 90% of total receipts (\$5.3 billion) electronically making Alaska number one in percentage of electronic collection of revenues.
3. Projected 95% of electronic remittances more than a day in advance for investment on day of receipt.
4. Processed more than \$837 million, received on June 30, 1993, from over 40 electronic payments.
5. Deposited over 1.3 million checks, totaling more than \$450 million to state banks concentration system.
6. Due to a new innovative approach, collected 74% (\$337,000) of non sufficient fund (NSF) items returned to the state.
7. Collected over \$300 million through lock boxes and reduced bank fees for lock box processing, by over \$60,000.
8. Reduced Department of Labor bank service costs by more than \$75,000 annually.
9. Saved state more than \$100,000 per year, by establishing a new

FY93 ANNUAL REPORT
TREASURY DIVISION

warrant redemption contract to include the microfilming process.

10. Redeemed 2,951,872 warrants -- a record high.
11. Installation of a new wire transfer system, including a dedicated line for communication to State Street Bank (SSB), the State's custodian and safekeeping bank.
12. Generated an additional \$500,000 in interest income, in conjunction with the issuance of the state's first electronic ACH payments.
13. Transmitted 517 electronic payments totaling \$4.1 billion.
14. Recommended and implemented a foreign currency payment program. The new payment program reduced ASMI's costs by approximately \$450,000.
15. Negotiated and signed CMIA Agreement with U.S. Treasury -- results include conversion of \$50 million in federal warrants received annually to electronic payments from the federal government.
16. Initiated direct deposit of Permanent Fund Dividend checks and direct deposit of payroll.

OPERATIONAL ACHIEVEMENT

It is not possible to communicate all of the tasks nor the magnitude of activities performed, but the following provides an overview of the responsibilities, accomplishments and the amount of activity in the area of Cash Management.

During FY 93, over 50,000 accounting transactions totaling in excess of \$100 billion, processed through Cash Management into AKSAS. Included were all the cash transactions for agency deposits, investment transactions, etc. Cash Management processed approximately 10,000 treasury receipts. With the advent of AKSAS, Cash Management assumed the responsibility of assisting and monitoring the liquidation of

treasury receipts to the appropriate agencies and to insure that the agencies cleared treasury receipts timely. Out of the \$5.3 billion deposited, less than \$10,000 was cleared to miscellaneous income, therefore assisting the state agencies in achieving accurate accountability of state revenues.

STATE BANK OPERATION

The banking process involves the management of 34 bank accounts with 314 individual agency subaccounts located in seven banks. The cash investment process involves managing the cash of 19 funds located at SSB. The state's cash depository and investment process is segregate into two distinct processes. All large remittances, consisting of ACH and wire transfers from the federal government and individual remitters, are processed and managed through SSB. The state agency banking and warrant redemption operations are located in state, with the exception of the depository sites located at Bank of Montreal and Key Bank Washington. All warrants are issued with the state's unique transit routing number. Warrants are presented for payment to Key Bank of Alaska, the state's warrant redemption bank, through the Anchorage Clearing House and the Seattle branch of the San Francisco Federal Reserve.

The following figures show the general investment fund's depository summary identifying the different methods of collecting state revenues. Retirement funds are not included. As one can see, 82% of the general investment deposits were collected by 1,058 wire transfers. With the inclusion of the 1,272 federal receipts collected by ACH, the state collects 90% of its general investment deposits electronically which eliminates delays in the states use of the revenues. The percentage of total revenues collected electronically ranks Alaska as number one.

FY93 ANNUAL REPORT
TREASURY DIVISION

**General Investment Depository Summary FY93
(IN MILLIONS)**

Taxes & Other Receipts	\$2,846.6	53.60%
Oil & Gas Settlements	762.7	14.36%
A.P.F.C. Dividend Transfer	463.7	8.73%
<u>Federal Program Funds</u>	<u>279.0</u>	<u>5.25%</u>
FEDERAL WIRE TRANSFERS	\$4,352.0	81.95%
<u>Federal Program Funds</u>	<u>418.0</u>	<u>7.87%</u>
ELECTRONIC FUNDS TRANSFERS	\$4,770.0	89.82%
Insurance Tax Payments	24.3	0.46%
Commerce Loan Programs	20.7	0.39%
<u>Student Loan Payments</u>	<u>39.8</u>	<u>0.75%</u>
BANK LOCK BOX COLLECTIONS	\$84.8	1.60%
Canadian Receipts	0.5	0.01%
Washington State Receipts	2.7	0.05%
First National Receipts	405.0	7.63%
Key Bank Receipts	13.8	0.26%
<u>NBA Receipts</u>	<u>33.9</u>	<u>0.64%</u>
DEPOSIT CONCENTRATION SYSTEMS	\$455.9	8.58%
RECEIPTS PAID BY CHECK	\$540.7	10.18%
TOTAL TAXES AND OTHER RECEIPTS	\$5,310.7	100.0%

Cash Management projects, more than a day in advance, over 95% of the state's cash available for investment by communicating with the remitter and through the use of electronic remittances. Due to the excellent past experience and the state's good credit rating, SSB allows investment of the projected amounts prior to receipt of payment. For example, on June 30, it was projected that cash totaling \$837 million was to be received, which consisted of over 40 wire transfers. Portfolio Management had outstanding trades to be settled for a like amount. Therefore, SSB had the potential of incurring a daylight overdraft and making a loan of \$1.6 billion. SSB was made aware of this on June 29, as they are provided a daily list of next day expected electronic remittances. Accuracy is of utmost importance on projected receipts. However, it is often difficult to obtain advance payment information from taxpayers.

IN-STATE BANKING

A few years ago, Cash Management developed an efficient depository concentration system. All state agencies utilize this system to deposit cash and checks received, at respective locations. All preprinted deposit slips contain a Magnetic Ink Character Recognition (MICR) line, encoded with machine readable characters. With the development of unique subaccount numbers used to identify agencies depositing locations, the subaccount number was then incorporated into the MICR line of the deposit slip. The banks' sorting equipment electronically reads and captures the MICR information, which includes the subaccount number and amount of deposit, for transmission to us on a daily basis. The same subaccount number is also incorporated into the endorsement stamp for identification of all returned items.

Cash Management maintains control in ordering all deposit slips and endorsement stamps on behalf of the state agencies.

By using the banks' branch banking network, daily depositing and consolidation of in-state deposits into a single account is accomplished overnight. Electronic retrieval of all banking transactions is processed

FY93 ANNUAL REPORT
TREASURY DIVISION

into AKSAS through Treasury's system, Resource. During FY93, over 1.3 million checks totaling more than \$450 million were deposited by state agencies.

First National Bank of Anchorage has since converted the University of Alaska, U.S. Postal Service and other major customers to the subaccount system concept. We consider this a testimony of success and a strong indication of its effectiveness. We can proudly say we enhanced and improved the depository banking process within the State of Alaska.

Returned Item Program

Another success story for FY93! Previous to FY93, non sufficient funds, stale dated or account closed, etc. items were returned by Cash Management to the depositing agency after an AKSAS journal entry was keyed into the system. In the spring of 1992, Cash Management initiated an improved collection process. A pilot study was conducted, with NSF items returned by four banks. It verified that improvements could be made to a fragmented, inefficient approach in collection of returned items. In FY93, of the 1.3 million checks deposited, 2,860 checks totaling \$1,068,900 were returned for various reasons. The table reflects a summary of the various items:

**SUMMARY OF ALL RETURNED ITEMS PROCESSED
BY CASH MANAGEMENT**

For the period of July 1, 1992 through June 30, 1993

Number of items returned	2,860
Amount of all returned items	1,068,900

<u>Return Totals by Description</u>	<u>Amount</u>	<u>Count</u>
Non sufficient funds	\$201,462	686
Non sufficient funds presented twice	\$424,976	1,500
Account closed	\$65,066	313
Stale dated	\$18,307	81

Signature missing	\$68,800	32
Refer to maker	\$9,349	51
Stop payment	\$222,881	118
Other	\$58,058	79

TOTALS	\$1,068,909	2,860
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Return Totals by Action Taken:

Redeposit	\$60,086	645
Cashier's checks obtained from bank	\$193,108	410
Charged back to agency	\$715,706	1,805

TOTALS	\$1,068,900	2,860
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With the implementation of the new cash management program, NSF checks drawn against FNBA, KEYB, NBAA and First Bank are now held for up to five business days. Each day the four banks are contacted to verify if funds are available to cover the NSF items. If funds are available, a copy of the NSF item is faxed to the bank. At the time of the daily bank deposit, the returned item is exchanged for a cashier's check, which is then deposited. This eliminates preparing an accounting entry to AKSAS and returning the item to the state depositing agency. During FY93, 74% of the items or 1,032 items out of 1,395 were collected. That was 73% of the dollar amount or \$337,164; \$190,014 of that total had been destined to be placed in a status as uncollectible. The table shows the number and amount collected and the amount charged back to the agencies.

**SUMMARY OF NSF RETURNED ITEMS PROCESSED BY CASH
MANAGEMENT ON**

FNBA, NBAA, KEYB AND FIRST BANK

For the period of July 1, 1992 through June 30, 1993

Number of NSF returned items received	1,395
Number of collected items	1,032

FY93 ANNUAL REPORT
TREASURY DIVISION

Number of uncollected items	363	
Percent of NSF returned items collected		74%
Amount of NSF returned items	\$460,984	
Amount collected	\$337,164	
Percent collected by dollar amount		73%

Return Totals by Action Taken:	Amount	Count
Redeposit	\$144,057	622
Cashier's checks obtained from bank	\$193,108	410
Charged back to agency	\$123,819	363
TOTALS	\$460,984	1,395

A need still exists for a centralized collection program for the state and the use of a collection agency. The new Cash Management program was only a partial solution. During FY93, returned items totaling \$715,706 were returned to state agencies for follow-up. The Department of Revenue is permitted to charge 1% of the amount or \$10 for each returned item. This has not been done and could partially support the cost of a centralized collection and returned item program.

LOCK BOXES

Cash Management has established five different lock boxes for accelerating the collection of funds and data capture for state agencies. They are as follows:

Department of Administration, Division of Retirement & Benefits.

A lock box used to collect the monthly remittances from the school districts, political subdivisions and municipalities was established at First National Bank of Anchorage for PERS and TRS. During FY93, \$215 million was received and processed through the lock box. The lock box process provided for investment of the funds approximately three to five days sooner, than in the past. Future objectives include continued

enhancement of the collection process. Based on a recent inquiry, limited surveillance appears to be in place to assure timely receipt of payments. The conversion to an ACH debit process would be a significant enhancement, in which funds are extracted electronically from the remitter's bank account, on a specific due date each month.

Department of Education, Alaska Commission on Postsecondary Education.

Postsecondary Education Commission has had a lock box for collecting student loan payments for a number of years with Key Bank of Alaska. In 1991, as a result of Cash Management's recommendation and assistance, Postsecondary Education converted from using a MICR coupon to using an OCR coupon, which significantly reduced the number of coupons processed and the number of errors incurred. The bank was able to convert to a machine capture of coupon data from the previous manual data entry process, thus reducing the costs by 10 cents per coupon. Presently there are 132,000 loans in the repayment status. The reduction in cost is partially being offset by the increased number of coupons, which has recently grown to over 25,000 a month. Each year, another group of loans enters into the repayment status. The table illustrates the last four years of coupon numbers and bank costs for processing student loan remittances.

<u>Year</u>	<u>MICR</u>	<u>OCR</u>	<u>Total Bank Fees Paid</u>
1990	367,809	0	\$80,148
1991	383,590	0	105,205
1992	183,969	148,280	73,832
1993	27,861	235,809	52,157

Because of Cash Management's diligence, Postsecondary's performance improved. Bank costs to process student loan repayments were reduced by \$50,000 annually.

FY93 ANNUAL REPORT
TREASURY DIVISION

Department of Commerce and Economic Development, Division of Investments.

Loan payments for fishing vessels, fishing permits and other loan programs controlled by the Division of Investments are processed by Key Bank of Alaska. As with Postsecondary Education, a similar recommendation was made to the Department of Commerce to convert their coupons from MICR to OCR. Similar results were obtained, only on a much smaller scale, due to the lower volume of activity. Their activity reflects a \$7,700 annual savings in bank fees paid as shown by the table:

<u>Year</u>	<u>MICR</u>	<u>OCR</u>	<u>Total Bank Fees Paid</u>
1991	26,533	0	\$11,566
1992	602	25,031	7,257
1993	264	19,242	3,830

Department of Commerce and Economic Development, Division of Insurance.

A lock box was established two years ago at First Union Bank of Charlotte N.C. to speed up the collection of approximately \$25 million in annual insurance company premium tax payments. Deposit data is electronically captured daily, and funds moved each day to SSB for investment. Payments have been moved from March-April to payment on March 1, which coincides with the filing of tax returns. An ongoing recommendation to the Division of Insurance is to convert payments by the insurance companies to monthly or quarterly. It will remain on our objective list until the change is accomplished.

Department of Revenue, Mortgage Management.

The lock box is for the collection of monthly mortgage loan payments. During FY93, \$13 million was received. The lock box will probably be closed in FY 94 due to the sale of the mortgages.

Department of Labor - Department of Revenue, Cash Management.

In 1991, Cash Management assumed the responsibility for managing the Department of Labor's (DOL) three bank accounts. This consists of determining funds available to be wire transferred to the Unemployment Trust Fund and requesting funds on a daily basis from the federal government to pay for warrants being presented. Prior to Cash Management's involvement, DOL's costs were more than \$100,000 annually for banking services. In FY93, total banking service costs for DOL activity totaled \$26,663, a savings of \$75,000. The U.S. Department of Labor monitors account balances each year. Since assuming the responsibility in FY93, Cash Management again exceeded the U.S. Department of Labor's level of Achievement, a rating not achieved by DOL. DOL is not charged for Cash Management's service.

Warrant Redemption Service

Effective January 1, 1993 a new three year, plus two year renewal warrant redemption contract was entered into with Key Bank for redemption of all state warrants. The new revised warrant agreement was a major accomplishment during FY93. It provides services at a lower cost over what was previously considered a very attractive rate, 2.7 cents per warrant.

The Department of Education (DOE) had been filming the state warrants in Juneau. Warrants were shipped to Juneau at a cost of \$50 per day. DOE charged Treasury \$14,000 annually, plus film and cartridge costs. It was determined that truncating warrants in Anchorage would generate a significant savings. The installation of new equipment by Key Bank improved their filming capabilities and eliminated a major problem at a substantial savings to the state. Under the warrant redemption contract, we were able to obtain the redemption and filming process for 1.7 cents a warrant. With the elimination of the filming, shipping, etc., the one cent reduction (\$24,000) will save the state more than \$100,000 a year. In addition, and at no cost, Key Bank agreed to store the warrants for 90 days. After the 90 day period, the warrants are

**FY93 ANNUAL REPORT
TREASURY DIVISION**

destroyed by Key Bank. With this change, we thus eliminated storage and disposal costs. The state warrants were previously stored in Archives for one year and then destroyed.

Each item processed by Key Bank is assigned a specific identification number, known as a trace number. The trace number, along with the warrant number and dollar amount, is data captured and transmitted to Juneau, on a daily basis, by Key Bank. The transmission is then interfaced into AKSAS for reconciliation against outstanding warrants. State agencies can now look up warrants on AKSAS and immediately communicate the information to Cash Management for retrieval of the warrant(s) or copies from Key Bank. Previously, agencies waited up to three weeks for DOE to film the warrants before they could obtain a copy. During FY93, the state redeemed 2,951,872 warrants, a record high, with an increase of 70,000 warrants over FY 92. In addition to the cost savings, the improved process is much more efficient for the agencies, the bank, Cash Management and DOE.

Undoubtedly, the new revised warrant agreement and process was a major accomplishment during FY93.

OUT OF STATE BANKING

During the past year, the conversion to a windows product and use of MicroSoft Excel became part of the new State Street/Cash Management system. In addition to the installation of a dedicated line to the custodial bank, SSB, a new wire transfer system was completed. Daily cash flows for the 19 funds and two investment pools are incorporated into a Cash Management Excel worksheet. Money movements centralized at SSB include the large tax and royalty payments, federal payments, investment maturities and purchases, and movement of cash amongst funds. Cash data for all funds, including non equity cash investment transactions, is keyed daily into a worksheet to determine cash available for movement. Included were daily repos and 1,425 portfolio management investment transactions.

NON-WARRANT DISBURSEMENT

Cash Management is responsible for non-warrant disbursements, which consists of wire transfers, ACH payments (wholesale) and international drafts. Due to finality of the transmission, accuracy and controls are of utmost importance. During FY93, 372 wire transfers totaling \$3.6 billion, 135 foreign wires and drafts totaling \$6.2 million and 10 ACH transmissions totaling \$460 million were transmitted for a combined total amount of \$4.1 billion.

INTERNATIONAL PAYMENTS

Need a payment made to a country in French francs? What is the U.S. equivalent? Past agency procedures included checking the newspaper or calling a local bank for an exchange rate and then converting the amount into U.S. dollars. In many cases, an increased amount was sent, just to make sure that enough money was transferred. In February, a program to provide payment in foreign currencies to international recipients was implemented with SSB. In 5 months, 25 foreign currency payments totaling \$1,041,323 were transmitted for receipt the next day. Previously, payments were always sent in U.S. dollars. Due to exchange rate calculations, bank conversion fees and delays in crediting accounts, numerous problems were incurred. Agencies have since saved money and improved client relations, due to the ability of transferring foreign currency through SSB. ASMI for example, has eliminated the Public Relations Agency 15% fee from contracts for handling foreign payments. ASMI has reduced costs by approximately \$450,000 and expects additional savings as more of the contracts are changed.

QUALIFIED AND NON-QUALIFIED POOLS

In an effort to reduce the excess volume of daily repo transactions for each individual fund, Cash Management recommended and initiated, with the assistance of other treasury personnel, the use of short term pools offered by SSB. It eliminated the transaction volume problem,

FY93 ANNUAL REPORT
TREASURY DIVISION

reduced the daily amount of repo's and offered the opportunity to generate a higher yield.

STATE'S FIRST ACH PAYMENTS - EDUCATION FOUNDATION PAYMENTS

In a continuing effort to see objectives accomplished, Cash Management recommended to the Department of Education, the use of ACH as a cost effective and more efficient method of payment. A review of the cash flow forecast showed that sizeable monthly payments were not being sent out at the same time each month. After further evaluation, it was discovered that checks were being mailed 10 to 12 days prior to the required due date. An analysis revealed, that by initiating ACH payments for settlement on a specific date, it would generate more than \$500,000 (\$460.1 million/10 months x 3.25% x 12/360) of additional interest income plus provide for a higher level of cash outflow predictability. The additional work by Cash Management and DOE in establishing the foundation payments as ACH payments proved to be worthwhile. It also gave notice that Cash Management had the capability to transmit ACH payments and was the first to do so for the state. DOE has been contacted to convert other similar type payments to ACH.

RECONCILIATION

A daily reconciliation of cash is performed in which bank balances are reconciled against Treasury's system, Resource, and AKSAS. Cash transactions are accounted for on a daily basis. It is an excellent control and provides immediate notification of differences and potential problems. Reconciliation is an overlooked function, but worthy of mention, as it only gets recognized when there is a problem.

BANK SERVICE FEES

Shown is a summary of the state's banking costs incurred from FY 89 through FY93. Presently, the Cash Management activity fees are not

being charged by SSB. The state has been assured that Cash Management fees would not be charged until the systems promised, at the time of the contract negotiations, are provided. It is estimated that fees will be at least \$100,000 annually when charges are implemented. Previous charges for Cash Management services provided by CoresStates was approximately \$100,000 annually.

All banking costs are paid by compensating balances and are thus, a non budgetary item. Cash Management manages the account balance levels so that the earnings generated from the balances are used as compensation for services provided. Zero interest certificates of deposits are established with Key Bank and First National Bank of Anchorage. This eliminates the reserve requirement and increases the earnings generated by the balances. Banking costs have been reduced by approximately \$100,000 during a period of increased fees charged by banks and during a period of increased volume of transactions. In FY93 Cash Management reduced the cost of Treasury managed programs by more than \$50,000 while the non Treasury programs grew by \$12,000 as shown by the following table:

BANK SERVICE CHARGES BY PROGRAM

NON-TREASURY FY89 FY90 FY91 FY92 FY93
PROGRAM COSTS:

Labor - Check Redemption & Depository	\$101,937	\$21,002	\$0	\$0	\$0
Revenue - Child Support Enforcement	28,799	35,453	41,784	44,784	56,903

TREASURY PROGRAM COSTS:

Depository Concentration	120,201	110,039	103,309	107,594	109,904
Warrant Redemption	75,094	74,972	78,836	82,106	47,394

FY93 ANNUAL REPORT
TREASURY DIVISION

Postsecondary -					
Lock box	65,848	80,148	105,205	73,832	52,157
Commerce - Lock box	5,001	14,456	11,566	7,257	3,830
Insurance - Lock box	0	0	0	3,944	3,362
Labor -					
Warrant Redemption	0	9,675	12,730	16,461	21,857
Labor - Depository	0	2,851	5,843	4,899	4,806
Risk Management	0	0	0	2,321	2,429

Total Bank Charges \$396,880 \$348,596 \$359,273 \$343,198 \$302,642

On the following page is a listing by bank of the total activity and costs incurred by the state for FY93.

SPECIAL PROJECTS

For years, Cash Management has been encouraging electronic payments and the beneficial results that could be obtained. Direct deposit of payroll and direct deposit of Permanent fund dividends are a significant accomplishment during FY93. Cash Management is an ongoing participant in making both of these programs a success.

CASH DEFICIENCY

The first Department of Revenue cash deficiency plan was developed during FY93. Although not officially approved, the basic framework has been established. Cash Management feels more comfortable knowing that a detailed plan is in existence.

BUDGET RESERVE RECONCILIATION AND INTEREST CALCULATION.

The request to calculate interest for the Constitutional Budget Reserve, General Fund etc. for settlement payments turned into a major project. Due to the complexity and involvement by the various participants and individuals in the movement among the various funds, a significant

amount of time was spent reconciling and calculating interest. Cash Management's normal responsibilities are to record revenue receipts and not specific accounting placement. The interest calculation is not a normal Cash Management function. However, due to its complexity, it was delegated to the Cash Management staff.

CASH MANAGEMENT IMPROVEMENT ACT OF 1990 (CMIA).

After a number of attempts, a federal law which governs the transfer of money between the federal government and the state was passed. The law required each state to enter into an agreement with the U.S. Treasury. The process of trying to conform to federal requirements while bringing state agencies into compliance developed into a difficult project. Compliance and prompt reimbursement will only be accomplished with close surveillance, a process Cash Management is not staffed to perform.

A task force of agency personnel was assembled to assist Cash Management with the project. The Department of Administration determined that they could generate the warrant clearance patterns. The Office of Management and Budget assisted in performing the agency reviews and drafting the operational procedures. The agreement was completed and signed by the U.S. Treasury and the Commissioner on June 30, 1993. Although changes will be required, an excellent agreement is in place. Certain requirements are yet to be developed -- an interest tracking and calculation program and establishment of a follow up program. The opportunity to present CMIA to the Governor and his cabinet, by the Commissioner, Deputy Commissioner and the Cash Manager & Investment Officer was an appropriate step in communication of the project.

SUMMARY

Cash Management provides services to numerous agencies, funds and the State in general. As the bank for the state, accuracy and timeliness are of utmost consideration. We manage large numbers of transactions and move large amounts of money daily. The processing of over

BANK SERVICE CHARGES AND VOLUME ACTIVITY

	FIRST NATIONAL OF ANCHORAGE		NATIONAL BANK OF ALASKA		KEY BANK ALASKA		OTHER BANKS		ALL BANK SUMMARY	
	VOLUME	COST	VOLUME	COST	VOLUME	COST	VOLUME	COST	VOLUME	COST
ACCOUNT ANALYSIS					143	1,430			143	1,430
ACCOUNT MAINTENANCE		3,623	144	1,152	143	754	11	141	298	5,670
ACCOUNT RECONCILIATION					10	3,000			10	3,000
ACTIVITY / BALANCE REPORTING			13	480	17	1,115	275	609	305	2,204
BUNDLED CURRENCY-ANCH			133	171					133	171
CASH DEPOSITED (PER 100)	133,064	9,980			5,624	366			138,688	10,346
CHECK RECONCILIATION		295							0	295
CHECKS PAID			1,237	247	144,010	21,597			145,247	21,844
COIN SOLD (ROLLS)	1,750	175							1,750	175
COLLECTIONS					37	417			37	417
CREDITS					10,109	1,355			10,109	1,355
DEBITS	2,450	394			18,640	2,540			21,090	2,934
DELIVERY CHARGES					629	18,558			629	18,558
DEPOSITS POSTED	36,624	7,460	4,677	1,403	12,132	799	108	56	53,541	9,718
DUPLICATE MICROFILM					117	936			117	936
FDIC INSURANCE			57,675	1,106	556	648		326	58,231	2,080
ITEMS DEP - FOREIGN			30,647	2,605	175,986	13,339			206,633	15,944
ITEMS DEP - LOCAL			20,035	1,102	216,080	10,804			236,115	11,906
ITEMS DEPOSITED	868,143	56,429						2,115	868,143	58,544
LOCK BOX FEES		1,230			294,749	33,723	2,393	2,182	297,142	37,135
MISC CHARGES		537	1	27	12	2,034	16	3	29	2,601
NSF CHARGES	12	180		17					12	197
RESEARCH			2	8	378	2,835			380	2,843
RETURN ITEMS	5,921	8,882	93	140	308	601			6,322	9,622
ROLL OF COINS-ANCH			4,682	510					4,682	510
SORT CHECKS					6,226	405			6,226	405
STATEMENTS	251	502	2	72	382	1,146			635	1,720
STOP PAYS	4	60	1	45	257	3,545			262	3,650
SUPPLIES		3,566	18	414	6	18,564			24	22,544
WARRANTS PROCESSED					2,951,872	50,182			2,951,872	50,182
WIRES IN					516	2,580			516	2,580
WIRES OUT	15	300			78	780	5	45	98	1,125
		\$93,612		\$9,499		\$194,053		\$5,477		\$302,641

CASH MANAGEMENT
TREASURY DIVISION

FY93 ANNUAL REPORT
TREASURY DIVISION

50,000 accounting entries totaling more than \$100 billion into AKSAS is a statement in itself. During FY93, we collected \$4.8 billion electronically, reduced banking fees \$55,000, increased General Fund interest income over \$500,000, collected \$337,000 NSF checks, saved in excess of \$100,000 with a new warrant and microfilming contract, reduced agency international payment costs by \$450,000, transmitted the first state ACH payments, and negotiated the CMIA Agreement.

CASH MANAGEMENT PERSONNEL

Vernon Voss - CCM,
Investment Officer.

Responsible for overall cash management and policy. Monitor funds' balances, money movements, cash flows, transmitter of ACH and wire transfers, collateral agreements, bank contracts and compensation, CMIA, and cash management consultant.



Bruce Smith -CCM,
Investment Officer.
Management of cash balances for trust funds, warrant redemption bank, daily banking and agency banking needs, initiate wire transfers and ACH payments, opening, closing and bank account maintenance-authorized signers, and daily fund cash projection.



Joe Meek - CCM, Accountant.
Accounting and cash management system's specialist, financial electronic transmission and communications, reconciliation and controls supervision, cash management consultant, special projects.

Nick Saceda - Accounting Technician, bank-treasury system - AKSAS account reconciliation, bank service and account analysis, data capture and special cash management reporting.



FY93 ANNUAL REPORT
TREASURY DIVISION

Debbie Idone - Accounting Technician, bank processing and agency accounting process, electronic remittance projection, Federal funds and CMIA funds requests, NSF program, ACH initiation, generate and process journal entries, depository concentration banks funds management, cash management consultant to agencies and banks.



Patti Rodts - Accounting Clerk, return item and NSF collection program, agency Federal funds requests, assist agency with Treasury Receipts, generate journal entries, subaccount banking supplies management, bank depository process, counter and telephone attendant.



Cheryl Shakespeare - Accounting Technician, daily retrieval and processing of banking transactions, process journal entries, monitors and assists state agencies with liquidation of all treasury receipts, retrieval of microfilmed warrants requested by agencies, DTC processing, bank depository process, data capture and report generation.

DEBT MANAGEMENT

Responsibilities and Objectives

The Debt Management section within the Treasury Division, together with State Bond Committee, is responsible for managing the issuance of State debt, providing information and policy analysis on bonded indebtedness.

This section manages the issuance of State general obligation debt, lease-financing debt and international airports' revenue debt and does certain tasks related to the issuance by Alaska Housing Finance Corporation of State guaranteed bonds for veterans home mortgages. Information and analysis are provided on State, state agency, and municipal debt. The section serves as staff to the State Bond Committee.

Debt Management can be divided into four areas of activities. Presented below is a brief description and specific results of each area of activity for FY93 and FY 94 to date:

1. Debt Issuance includes the determination of amount and timing of bond sales, coordinating the preparation of legal documents by bond counsel and the preparation of the bond prospectus, advertising the sale, rating agency presentation with the financial advisor, negotiating the sale to underwriters, obtaining approval from the State Bond Committee for authorizing resolutions and bid award, closing sales and performing arbitrage and rebate calculations to meet IRS requirements.

Specific debt issuance activity for FY93 and 94 included the following:

- a. Wildwood Acquisition, Certificate of Participation, 1992 Series for \$5,655,000,
- b. Wildwood Improvements - Certificate of Participation, 1992

series for \$4,990,000,

c. Palmer Court House, Certificate of Participation, 1993 Series A for \$3,300,000,

d. Court Plaza Building, Certificate of Participation, 1993 Series B for \$5,500,000, and

e. State of Alaska International Airports Refunding Revenue Bonds Series H and I for \$50,445,000.

All the above indebtedness will result in substantial direct and indirect cost benefits to the State.

The issuance of Alaska Housing Finance Corporation, Veterans mortgage program, collateralized bonds, 1993 first series for \$65,000,000 were reviewed and approved by the State Bond Committee.

2. Debt Management includes the selection, contracting and coordination of bond counsel, financial advisor, and bond trustee.

Bond counsel and financial advisor contracts will terminate at the end of December 1993. New requests for proposals will be initiated this fall.

3. Debt Report Preparation includes the development of a debt calendar and an annual report on bonded indebtedness of the State, The Alaska Public Debt publication was issued during February of 1993. This publication was sent to administrative officials, legislative representatives and interested parties.

4. Policy Development includes developing guidelines and performing policy analysis on debt management by the State, State agencies, and municipalities.

FY93 ANNUAL REPORT
TREASURY DIVISION

Legislative testimony was presented on various pieces of legislation dealing principally with lease purchase financing of real property and school indebtedness.

A "Bidders List" was developed through a competitive proposal process for the Bond Committee. This "Bidders List" is used by the Bond Committee for the selection of senior and co-manager underwriters for negotiated issuance.

The Debt Management section participated as the Commissioner's representative on the Alaska Municipal Bond Bank Board as well as assisted the executive director and board with development of revised regulations, procurement of underwriters, and issuance of debt.

Brian Andrews - Debt Manager,
responsible for all debt issuances for
State, staff to State Bond Committee,
prepares debt report, responsible for
securing financial advisors,
underwriters for debt issuance.



Accounting Section Overview

The Accounting Section is responsible for four main areas:

- Investment accounting and safekeeping
- Information/accounting systems
- Maintaining a Division wide computer system
- Administrative services

Over the past year, a great deal of effort has been made to upgrade the existing data processing systems and review the needs for a future system while maintaining a high level of quality for financial information.

As of June 30, 1993 the accounting personnel consists of the Comptroller, two Accountant IIIs, and two Accounting Technicians IIIs. These people are responsible for the accounting for 14 separately invested funds as well as the administrative functions such as the budget accounting for the Treasury Division.

Prior division management made the decision to maintain the official "books of record" for the investments managed by Treasury. Over the past two years, the policy has been re-examined to determine possible alternatives. One choice would be to rely on the accounting services of the custodian bank. Another course of action would be to hire the services of an outside investment accounting firm. From this review, the conclusion is that the prudent policy for Treasury is to maintain a separate accounting system to track and monitor the investments of the Funds.

The decision to maintain distinct "books of record" has lead to a search for a new investment accounting and information system to replace the older system currently in place. The current system does not have the capability to perform the accounting and reporting functions which are now required. It is anticipated that the need for timely and accurate information will increase in the future, particularly in light of the formation of the new Alaska State Pension Investment Board. It is the

desire of those involved to provide a system which will allow for the automation of much of the data entry requirements, allowing the accounting staff to concentrate on more analysis and review of the information. One example of this would be providing budgetary information for the Alaska Pension Investment Board which more clearly identifies the costs of managing the pension funds.

The establishment of a new investment accounting system will be the primary focus of the Accounting Section for the next two years. During this period, the help of external parties such as the custodian bank will be maximized to the extent it does not impact our ability to provide accurate and timely information or compromise critical internal controls. Part of this process must include a review of the accounting staffing levels to ensure adequate staff to meet the ever increasing information requirements while maintaining proper internal controls.

Data Processing

Many changes have been made to the data processing system of the Treasury Division during fiscal year 1993. As a result of adding a full-time computer specialist, Treasury's computer network is more reliable, secure and easier to use. Treasury now has a stable system which will allow efforts to be concentrated on enhancements to the investment, cash management, accounting and reporting systems.

The goals for this area for FY93 were to:

- 1) Hire data processing Analyst/Programmer;
- 2) Update computer hardware and software to increase system reliability, security and capability to use more advanced software programs;

3) Provide computer training resources for all Treasury staff in an effort to increase abilities and comfort in using computer in daily work.

The goals were accomplished as follows:

- 1) Doug Grimm was hired in November, 1992. Doug is an Analyst/Programmer IV and has extensive experience in network systems and data communications.
- 2) During FY93, approximately half of the computer workstations were upgraded to newer systems. The older network file server was also replaced. These changes allowed Treasury to begin using programs based on the easier to use Microsoft Windows environment.
- 3) An electronic mail system was installed on the network. Along with increasing communication opportunities within Treasury, the system has been connected to other networks within the Department of Revenue.
- 4) All Software licenses were reviewed and additional copies were purchased in order to assure compliance with license agreements. Additionally, a license metering system was installed on the network.
- 5) A new communications system was installed between Treasury and the Division's custodian bank, State Street Bank & Trust in Boston. This system enables Treasury to have instant access to State Street's computers and reporting systems through our existing network.
- 6) A plan was initiated for using the Alaska Permanent Fund Corporation as a disaster recovery site. Special communications equipment was purchased which will allow Treasury or the Permanent Fund to continue critical operations should either organization be unable to use their offices.
- 7) After the installation of the new software programs on the network, in-house training resources such as weekly training sessions and video training courses were made available to all Treasury employees.

Investment Accounting

The goals in investment accounting were to:

- 1) Provide information reporting for investment activities which enhanced decision making capabilities; and**
- 2) Provide professional training for accounting staff to stay current on new security types and accounting standards.**

The goals were accomplished as follows:

- 1) Established new reports for trading activity as requested by the Chief Investment Officer
- 2) Completed an in-house training session prepared and presented by State Street Bank personnel
- 3) Worked closely with the Portfolio Management and Cash Management Section personnel to establish two investment pools for short-term fixed income securities
- 4) Devised additional reporting techniques to assist in the sale of the majority of the mortgage portfolios

Information/Accounting Systems

The goal for this area was to:

Review data processing / information systems to determine future system functional requirements.

It was accomplished thus:

Completed a review of future system requirements and prepared a Request for Proposal to procure a new "Treasury Management System".

FY93 ANNUAL REPORT
TREASURY DIVISION

It was concluded from this process that no single system would meet our needs. A new procurement process will continue into FY94.

ACCOUNTING PERSONNEL

Mark Prussing, CPA -Comptroller, manager of accounting section, establishes and implements policies, procedures and systems for reporting financial activity and providing security for non-cash assets.



Sue Scott - Accountant, supervises all mortgage accounting transactions, supports production and maintenance of Treasury's operating budget, oversees all Division expenditures.



Sharon Pusich Gill - Accountant, creates monthly and annual financial statements for ten investment funds and four commingled investment pools, provides a key link for financial information to other state agencies.

Valerie Watson - Accounting Technician, accounts for all fixed income investments made by portfolio section, reports investment activity and positions, reconciles various accounting systems.

